

# **Reinventing The Corporate Administration of Personal Trusts – A Marketing Opportunity For Banks**

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## **Introduction**

- Whose money is it?

Recently I ran across a Wilmington Trust advertisement alleging that they never forget that it is the beneficiaries' money that they are managing. I'd never seen such an ad before and I do follow trust advertising. It made me think that Wilmington Trust, despite losing a federal class action several years ago for charging an unauthorized fee on their common funds, today has got the right attitude – one that beneficiaries could well appreciate. And its an interesting marketing gambit, playing to the perception on the part of beneficiaries that it is their money. But whose money is it? Ed Schlesinger – he's that outspoken beneficiary friendly New York lawyer who can get action from a bank when needed – would argue that besides the IRS, trustees sometimes believe that its their money while beneficiaries think its their money when in fact our legal system presumes and trust lawyers will be happy to confirm that even after death it is still the settlor's money! Why our personal trust system should differ from the English and Canadian systems which as you may know view trust assets as belonging to the beneficiaries is not entirely clear. What is clear, at least to beneficiaries, is that banks act as if it is their money.

## **The 'Business' of Personal Trust**

- Collusive relationships reduce risk

Personal trust is 'comfortable' enterprise because traffic often flows by referral from 'friendly' law firms, accountants and estate planners with whom banks do other business. In other words, trust and estate administration is a business that is largely marketed not directly to the client but within the legal/financial community, a community largely dedicated to playing ball with the banks. Secondly, should a client relationship turn sour to the point that a removal or surcharge action is threatened, this collusive network makes the beneficiaries' search for independent, affordable, competent counsel very difficult. When a situation threatens to escalate further, a bank can generally rely on the fact that its legal expenses will be reimbursed from the trust and that, in any event, matters will be adjudicated on the basis of state statutes drafted by and for the industry and by a orphans/surrogate court inclined to give the benefit of the doubt to the corporate trustee. In fact, the business is so comfortable that most banks don't bother to maintain a litigation reserve. Why fret when according to the Federal Financial Institutions Examination Council, settlements, surcharges and all other losses totaled a mere .1% of total

fiduciary income in 1998.<sup>1</sup> Given that the corporate trustee has legal title to and sole custody of the trust assets, it is not a wonder that some banks are tempted to blur the line between the right to control (the legal interest) and the right to enjoy (the so-called beneficial interest)!

- A high margin enterprise

A 1990 article suggesting that “trust and related securities activities may represent the best hope for the banking industry’s long term profitability”<sup>2</sup> pointed out that it is the bank’s personal trust department that is the most profitable –30.7% pretax margins – as compared to other trust related activities. Consider Mellon, for example. In 1991, a federal district court determined that Mellon’s .... trust and investment department’s pretax “...operating margin was approximately 45% on total revenues of \$300M...”<sup>3</sup> compared to about 6% on the commercial side. In fact, a 45% operating margin is consistent with that of the Boston Company, a 1993 Mellon acquisition which had previously reported trust margins of 45%.<sup>4</sup> Most recently, the FDIC released 1998 figures on banks and thrifts for personal and ERISA regulated accounts. Net trust income was reported to be 33% of total fiduciary revenues compared to about 19% for the so-called independent (non-deposit) trust companies.<sup>5</sup> And profitability will likely continue to increase. Financial Services Associates of Niles, MI in a 1998 report indicated that despite the fact that 46% of study participants raised their fees in the past two years, “...many banks have real opportunities to increase their revenue through price increases (and that in addition) ...some organizations price their services irrationally (i.e. too low) in relation to both cost and value”.<sup>6</sup> (Brackets added). In fact as former OCC Deputy Comptroller Dean Miller points out, whereas trust once played a distant second to lending as a bank revenue producer, today “...trust services...have become a much more significant contributor...and in some instances, the major (revenue) contributor”<sup>7</sup> (Bracket added).

- Locked-up accounts discourage competition but enhance profitability

Under the present system, changing corporate trustees or simply challenging the administration of a personal trust is usually not an option for beneficiaries because of the time and costs involved, a reality which impacts administration by discouraging competition for their accounts. Besides the fact that older trusts typically lack a trustee removal clause, Schlesinger, speaking at an ABA conference in NY back in 1993, explains that if a dispute arises “...the beneficiary (will be forced to use) his/her money to fight the trustee and the trustee (will use) the beneficiaries’ money to fight the beneficiary so it’s more or less like asking the beneficiary to dig his or her own financial grave.”<sup>8</sup> Judge Katz, commenting on his 1992 decision in the Mellon sweep fee case, declared that it was a lack of competition that enabled the bank to charge an additional fee for daily sweeping of its personal trust accounts. He went on to suggest that “an irrevocable or even a revocable trust naming Mellon as trustee is in a rather inelastic demand position”<sup>9</sup>. And in an article that appeared in *United States Banker* back in 1990, wonderfully

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<sup>1</sup> *Trust Assets of Financial Institutions – 1998*, Federal Financial Institutions Examination Council, Washington D.C., p. 103.

<sup>2</sup> BEI Galombe, “Trusts and Estates”, February, 1990.

<sup>3</sup> *Findings of Fact and Conclusions of Law*, John B. Upp, et al v. Mellon Bank, N.A. Civil Action No. 91-5229 in the United States District Court for the Eastern District of Pennsylvania, filed August 7, 1992, p. 6.

<sup>4</sup> Ken Brown, “Mellon’s Fund Deals Slow To Bear Fruit”, (*The Wall St. Journal*, March 15, 2000), p.27

<sup>5</sup> *Trust Assets of Financial Institutions – 1998*, op. cit., p. 104.

<sup>6</sup> *Price Compare, Trust Pricing Analysis Report*, (1998), Financial Services Associates Inc., Niles, MI.

<sup>7</sup> Dean Miller, “The Supervision of Bank Asset Management Activities”, *Trusts & Estates*, (March, 2000), p. 60.

<sup>8</sup> *Do We Need a New Standard For Removal of Trustees and Termination of Trusts*, American Bar Association, Section of Real Property, Probate and Trust Law, Plaza Hotel, NYC, August 10, 1993, p. 11.

<sup>9</sup> *Findings of Fact and Conclusions of Law*, John B. Upp et al v. Mellon Bank, op. cit., p. 11.

entitled “In Trust We Profit”, J. Carter Bacot, one time CEO of the Bank of New York, argues that ‘trust business is good business (because in part) pricing is relatively inelastic.<sup>10</sup> (Bracket added.) Indeed, Mary Lou Fellows, a professor from the University of Minnesota Law School who spoke at the same ABA conference, went so far as to recommend that trustees have a limited lifespan – say 5 to 15 years – after which they should be replaceable by vote of the sui juris beneficiaries. In her comments, she referred to “...the monopoly situation that occurs when a trustee is named.”<sup>11</sup> Trust authorities Jesse Dukeminier and Stanley Johanson in their new book, “Wills, Trusts and Estates”, also observe that “...the inability of beneficiaries to change trustees lessens competition among trust companies and contributes to higher trustee fees...(and asks pointedly)...should this rule be changed?”<sup>12</sup> (Bracket added). Interestingly, Yale trust expert and prudent investor rule drafter John Langbein once disagreed, arguing that a no-fault divorce philosophy would “...give the beneficiary a great deal of license to shop (his/her) trust endlessly...(winding up at a)...place where the fiduciary may not be as competent (or as) faithful as the settlor would have wanted”.<sup>13</sup> Reportedly he has changed his position and now affirms that he supports portability if all the sui juris beneficiaries agree. (Brackets added). On the other hand, University of California law professor and Third Restatement reporter Edward Halbach Jr. does not currently support the idea that beneficiaries should be able to replace their corporate trustees except for cause, believing it would increase costs and therefore fees charged to beneficiaries.

- Politics a factor in restricting competition

The Heirs<sup>®</sup> organization tried for over five years to pass a bill in Pennsylvania that would allow personal trust beneficiaries to move their trusts from one bank to another without having to prove cause. Despite support from key legislators including Fumo, Bell, Swartz and Itkin, Senate Judiciary Committee chair Stewart Greenleaf who served as the bill’s prime sponsor in the Senate reported that the bill died in (his) committee because the banks simply didn’t want it. (For the record, Greenleaf refused to spend political capital by forcing the bill out of committee or even by insisting on a formal vote by his committee.)

One real life example of how portability and politics can directly impact trust revenues is James Edward’s court fight to move the 600M McCune charitable trust, Pittsburgh’s third largest philanthropic foundation, away from Integra (now National City Bank) to PNC. According to Edwards, PNC had offered to cut Integra’s rates by half, thereby increasing funds available for distribution to Pittsburgh based charities. An appeal directed to then Attorney General Ernie Prelate to permit the installation of a family member as cotrustee as provided for under the McCune will went unheeded. Such a change which would have facilitated, among other objectives, a move to PNC was dismissed by the courts despite protests from a blue-ribbon committee of Pittsburgh civic leaders including the owner of the Pittsburgh Tribune-Review, the Chief Executive of Allegheny County and the President of Duquesne University. Meanwhile National City Bank continues to invest 30% of the trust portfolio in its own stock. But because its stock has not performed well recently, the McCune trust is no longer growing. Edwards believes that despite solid legal grounds, political considerations have thwarted the family’s efforts to improve administration.

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<sup>10</sup> J. Carter Bacot, “In Trust We Profit,” (*United States Banker*, March 1990), p. 54.

<sup>11</sup> Do We Need a New Standard for Removal of Trustees and Termination of Trusts, op. cit., p. 62.

<sup>12</sup> Jesse Dukeminier and Stanley M. Johanson, *Wills, Trusts and Estates*, (Aspen Law & Business, Gaithersburg, N.Y. 2000), p. 661.

<sup>13</sup> *Do We Need a New Standard for Removal of Trustees and Termination of Trusts*, op. cit., p. 81.

## **The ‘Regulation’ of Personal Trusts**

Stricter regulation of bank fiduciary activities appears may be on its way. To paraphrase a recent article by Dean Miller, the delivery of services to beneficiaries suffers because of ill defined fiducial regulatory standards, a lack of coordinated oversight by regulatory agencies, the secrecy of the bank supervisory process - which itself precludes complaints from beneficiaries - and an overall regulatory focus not on a bank’s fiduciary responsibilities but on keeping the bank solvent. Miller also infers that nowhere is the lack of effective regulation more obvious than with the rise of beneficiary support organizations and the current wave of class actions targeting common fund conversions into proprietary funds, a situation which he believes should be remedied by either giving the SEC exclusive jurisdiction over bank trust investment activities or forcing banks to withdraw from the mutual fund business.<sup>14</sup>

## **What are Beneficiaries Saying?**

Has the ability of the industry not only to control the business but advantage beneficiaries’ lack of understanding in matters fiducial fostered (at least the perception of) indifferent, indolent, inflexible administration? As client education continues to improve, will the ‘system’ turn out to be the bank’s undoing? Virtually all the beneficiaries that I talk to are unhappy. For others that don’t bother to call, ignorance is undoubtedly bliss. Of immediate concern to beneficiaries is the current bank practice of jumpstarting their own proprietary mutual funds through conversion of common trust funds and even tax disadvantaged sales of individual securities. While conversion certainly offers a few minor advantages, beneficiaries object both to the additional advisory fees/costs and a more active management style which is feared may significantly compromise future trust returns. Not satisfied with ever higher revenues based on rising asset values, the industry continues to raise fee rates regularly every two-three years and cut costs for one by vastly expanding the number of accounts-reportedly sometimes as high as 400 – assigned to an individual trust officer. A case in point is one local bank with which I am intimately familiar whose rates have gone up 350% over 20 years with no discernible improvement in either investment acumen or service. Meanwhile, beneficiaries continue to complain about revolving door administration, low income/growth and especially a lack of responsive communication, in fact, about many of the same issues aired in 1991 - 92 when both industry consultant Russ Prince<sup>15</sup> and Heirs<sup>®16</sup> surveyed beneficiaries with bank managed trusts. Granted-beneficiaries can be aggravating with their naive questions and sometimes unreasonable demands for information and concessions. But that’s because in part – to quote the 1992 Prince study – “...beneficiaries (do) not comprehend the ramifications of having a trust account. The education of...beneficiaries is therefore left up to the trust officers.”<sup>17</sup> Unfortunately, however, the industry devotes little attention to education as, for example, the duties of a fiduciary, beneficiary rights and especially the fundamentals of money management, ironic in the context of relationship that is supposedly governed by a standard of conduct - to quote Justice Cordozo -

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<sup>14</sup> Dean Miller, “The Supervision of Bank Asset Management Activities”, (*Trusts & Estates*, March 2000), pp. 54-60.

<sup>15</sup> Russ Alan Prince, “Beneficiaries Are Satisfied When Involvement Is Generated”, (*Trusts & Estates*, August 1991), pp. 55-60.

<sup>16</sup> Standish H. Smith, “A Survey of Trustors and Trust Beneficiaries”, The Heirs<sup>®</sup> organization, 1992.

<sup>17</sup> Prince, *op. cit.*, p. 59

“... stricter than the morals of the marketplace... (a standard being not one of)...honesty alone but the punctilio of an honor the most sensitive....”<sup>18</sup>

## **So Where is the Industry Headed?**

According to Mark Edwards writing recently in *Trusts for the New Century*, “...bank trust departments (lack) the personal strategies and interests clients seek...(in fact)...there has been an increasing reluctance on the part of...clients to utilize the services of corporate fiduciaries... (based in part on the)...unfulfilled expectancies of many trust beneficiaries”.<sup>19</sup> (Brackets added). But this is, of course, old news. In 1973, Ralph Nader published ‘CityBank’, essentially a condemnation of First National City Bank’s personal trust practices, a book which at the time provoked a congressional inquiry as to whether banks should be barred from administering personal trusts.<sup>20</sup> Later, in 1989, trust authority Frederick Keydel was telling attendees of a University of Miami estate planning conference that “...corporate trustees are sometimes a disappointment...(and that wealthy California families) ...never use bank trustees”.<sup>21</sup> Even bankers Goodwin and McDowell of Citibank (NY) and Citicorp Trust (S.D.) respectively point out that while “...10 years ago approximately 90 percent of the clients of a major money-center bank allowed that institution to manage all their money, now 70 percent of these clients use multiple managers”.<sup>22</sup> Not to put too fine a point on the matter, that survey on beneficiary complaints that Heirs<sup>®</sup> published in 1992 enjoyed total sales of about 12 copies!<sup>23</sup> So there you have it. While trust assets under corporate management are still rising, yet banks continue to lose market share to the independents, brokerage firms and individual trustees – in short often to guys that used to work for the banks and know how the game is played and who are now busy offering concessions and getting the bank’s action as a result! In fact, it might be argued that the non-deposit ‘independent’ trust companies are doing a better job than the banks according to federal statistics. During 1998, the latest year for which data are available, total settlements, surcharge and other losses represented only .06% of total fiduciary income for the non-deposit trust companies compared to .1% for the banks/thrifts!<sup>24</sup>

## **What Can the Industry Do To Reinvent Itself?**

- Better administration begins with the settlor

Let’s get back to the Wilmington Trust ad – remember that’s the one that says it’s the beneficiaries’ money and explain what makes this such a smart marketing ploy. Experience suggests that beneficiaries feel very strongly not only that its their money (or, at the least, their family’s money) but more importantly, that they have little control over its management - that they are, in fact, pawns of the banks. So why not turn it around, pretend its their money and

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<sup>18</sup> In *Meinhard vs. Salmon*, (New York District), Vol. 249, p. 458.

<sup>19</sup> Mark T. Edwards, “Trusts for the New Century”, *The Newsletter of the NCBA’s Estate Planning & Fiduciary Law Section*, (November, 1998), p. 7

<sup>20</sup> David Leinsdorf and Donald Etra, “Citibank” (Grossman Publishers, NY, 1973). The book is out of print.

<sup>21</sup> Frederick R. Keydel, “Trustee Selection, Succession and Removal: Ways to Blend Expertise with Family Control”, *The Twenty Third Annual Philip E. Heckerling Institute on Estate Planning*, (The University of Miami; Pub. by Matthew Bender & Co., NY, NY).

<sup>22</sup> Iris J. Goodwin & Pierce McDowell, “Delegating Responsibility: Trustees Explore The Once Taboo”, *Trusts & Estates*, (March 1999), p. 9. (The authors are quoting from an earlier article in *Forbes*).

<sup>23</sup> Smith, op. cit.

<sup>24</sup> Trust Assets of Financial Institutions – 1998, op. cit., pp. 104, 105.

figure out what it will take to keep beneficiaries really satisfied, really satisfied. If some independents are doing it, why not the banks!

Here are some ideas. Promote harmony by discouraging discretionary trusts. Encourage settlors to appoint an individual – or better two individuals – as cotrustees, preferably beneficiaries or at least relatives. Suggest using a so-called ‘trust protector’. Promote more beneficiary oversight within the instrument as appropriate. Point out to the settlor that rather than drafting one huge family trust, multiple trusts with just one income beneficiary and preferably not more than one remainder interest each will reduce both beneficiary squabbles and any opportunity for the bank to play one beneficiary off against another. Most importantly, impose a competitive discipline by insisting on a trustee removal clause in the instrument so that every account is at risk of walking to a competitor. (Even today, not every trust instrument has one even though there are no longer any tax consequences for the income beneficiary.) Maybe the bank should point out to the settlor that his/her beneficiaries will be more apt to monitor the performance of their trust and that the bank therefore will be encouraged to do a better job if the beneficiaries can elect a no-fault, cheap and speedy divorce as the occasion may demand. Maybe the bank should point out to the settlor that the bank is not the his/her relative or friend serving altruistically but a corporation whose primary mission is profit. Hence perhaps the bank might agree to cap the fee rate and its deductible costs and, in general, not to tap trust corpus without the prior consent of the beneficiaries. Indeed, maybe its the bank’s job to push for controls that will balance the legal playing field to the point where the bank is forced to put the beneficiaries’ interests first as required by the spirit and letter of the law. Think of the credibility a bank could earn by insisting that a removal clause be incorporated in the instrument or by ancillary agreement. By so doing, the bank sends a loud and clear message to the settlor that it need not erect barricades to maintain its accounts because there is no need to do so – that the settlor’s beneficiaries will want to stay put because no one else can do the job better!

- More on no-fault divorce

Where a removal clause is absent as is typically the case on older trusts, banks might follow the lead of some independents and agree to a graceful exit if requested to do so by the beneficiaries and certainly when threatened with a buyout. Why not advantage the fact that the beneficiary who can choose his/her own corporate trustee has a sense of control and thus will be less inclined to blame the bank if something doesn’t work out – or bait the bank with unreasonable demands! Make no mistake. Portability is a major, major issue with locked-in beneficiaries. Glenmede Trust, a white-shoe independent trustee founded by the Pew family, told Heirs<sup>®</sup> a few years ago that they maintain an ‘open door’ policy – i.e. they will not contest any beneficiaries’ request for resignation – as a way of encouraging the troops to solve the problem or risk losing the account or maybe their job! Contrast Glenmede’s attitude to the traditional bank response to a beneficiaries’ request for resignation – ‘if the settlor wanted you to be able to remove the bank, he/she would have included a removal clause in the instrument’. Specious as the argument goes and it is specious, there is really little sense to locking up some accounts while others capitalize on the leverage provided by a removal clause. Of course, a workable ‘no-fault’ divorce policy should include provisions to insure that:

- the account will be transferred within 60 business days - unless very special documentable circumstances exist...

- no additional costs will be imposed – including inception/termination fees and/or accounting/legal costs...
- transfer will be in kind, common trust funds excepted...
- investments will be maintained until date of transfer.

If adopted as policy by all local PBA members, a bank need not necessarily risk lower revenues because one bank's loss may well be another's gain.

- The trust investments; one shoe doesn't fit all or does it?

An issue that often divides bank and beneficiaries is investment strategy. In one case very close to home, the beneficiary has made it quite clear that the objective should be maximum growth. Yet the bank continues to spread an all-equity 15M account over some 63 individual holdings plus two funds comprising 26 business sectors. 'What's the point' - was the question I put to the bank's chief investment officer at a recent reception for the its private banking clients. Why could not the portfolio be more highly concentrated in today's growth industries – internet related, communications, health care and even offshore – instead of, for example, metals and mining, consumer durables and retailing, particularly since so many of the investments are in huge blue chip companies each of which already has well diversified interests. To be sure, I'm not trashing the big caps. But I wonder whether the necessarily long term investment horizon of a trust is not better serviced both by sidestepping the investment style du jour as well as those companies whose size, visibility and durability insure fully efficient pricing. Would not the smaller caps be more likely to grow with reasonable dispatch into tomorrow's big caps? It wasn't a question of clairvoyance regarding the future of any particular company even though the bank in question had picked up a lot of winners over the years including Intel at \$8 and Hewlett Packard at \$2! Nor was the bank being asked to be a market timer. The question was simply why the bank didn't take stronger but diversified positions within those select industries which are pushing today's economy, perhaps an easier bet than trying to identify the next Cisco. So was the bank trying to emulate the S&P? The answer - and indeed it was a surprise - was yes! The next question would have been why then did not the bank just pull the plug and go with Vanguard's 18 basis point S&P index fund or better still, Vanguard's Growth Index fund which is limited to S&P growth stocks. Or could the bank offer numbers demonstrating that the bank's active management style yielded better net returns at nada unique risk. Unfortunately he walked away. I was left to wonder whether the reduction in unique risk afforded by such 'super diversification' was worth the possible opportunity costs involved. Or do banks find it 'convenient' to be able to tout 'market performance' as a defensive ploy to those who would complain about lackluster investment results? Or perhaps banks find it cost effective to follow the established players because so many analysts on competitor's payrolls are running interference.

Certainly, the sophisticated stock picker who can achieve a high average reward to risk ratio within a reasonably diversified portfolio shouldn't be rewarded with a lawsuit if a particular investment goes sour. Fortunately, with the adoption of Pennsylvania's new prudent investor rule last June, banks can now focus on overall portfolio results and worry less that a particular investment gone south will turn into a lawsuit. One could argue, in fact, that by encouraging any investment which meets the purpose of the trust, the new rule has diminished the bite of the old 'anti-netting' rule which stated that good overall performance could not be used to justify a specific failed investment. So I would encourage banks to invest more

aggressively but only after first carefully assessing a client's risk tolerance, explaining and quantifying if possible the fact that lower risk will likely be bought on the back of lower total return. Secondly, I would suggest getting the client's written agreement on whatever investment strategy is to be employed and, as appropriate, take stronger positions in fewer issues, practicing damage control by following those issues as closely as resources will permit. Isn't that what 'active' management should be about? And if results don't meet a preset criterion say after five years, I would encourage banks to voluntarily agree to go the low cost index route. Further, if 'growth' isn't deemed the right play, perhaps the bank ought to provide a very clear written explanation as to why the account isn't destined to be managed in a tax sensitive manner as required under prudent investor rules! Where the client is not near death and conversion to a unitrust is possible, why not consider a 100% growth equities portfolio instead of playing safe with a traditional 50-50 or 60-40 equity vs. fixed income mix. Add value by bringing investment discipline and objectivity to the investment task rather than pandering – via an elaborate 'master list' - to the inclinations of less expert settlors and beneficiaries whose biases may be their (and the bank's) undoing. To quote Dr. Harold B. Ehrlich of Brandywire Management Services (NY, NY), "the common marketing maximum of giving the consumer what he or she wants should not apply to a serious investment plan. Catering to the client's whims can lead to financial trouble, or at least to losing a client."<sup>25</sup> Gain credibility by letting the client see the bank's historical investment performance in managing both individual portfolios and funds, net and gross of fees, risk adjusted or no, as measured against appropriate indices. Indeed, clients might benefit from software currently in development that will simulate portfolio returns for both active and passive investing strategies as a function of asset allocation, expected inflation rates, costs and fees as well as tax climate. In addition, such software can be used to assess the probability that a particular investment plan will deliver inflation adjusted inception assets to the remainders as required under prudent investor. Finally, consider offering the option of an exchange fund when unrealized gains discourage outright sale.

- Converting 'income only' trusts to a unitrust model

I have used investments as an example of how trustee and beneficiary could work as a team rather than as adversaries which is what one finds is so often the case. Another area of particular concern to beneficiaries is – surprise! - inadequate income. With S&P yields around 1.1% but principal (hopefully) expanding, the trust grows but income payouts sometimes stagnate or even diminish. So a switch from the old 'income only' trust to a 'total return' model with a 3-5% or even 6% payout calculated on say a rolling three year average offers the income beneficiary a return more typical of what a settlor setting up a large cap trust fund during the mid-fifties as well as from the mid-seventies through the mid-eighties might have anticipated. Further, such a return is well within the historical 11% total return typical for large cap equity portfolios. In addition, according to Mark Edwards writing in "Trusts for the New Century",<sup>26</sup> a 3 to 5% percent payout can be expected to "...pass the remainder beneficiaries an inflation adjusted principal equal to the inception amount (according to) many studies..." as well as avoid possible adverse tax consequences thanks to the 5&5 exception of IRS sections 2041(b) and 2514(e).<sup>27</sup> (Bracket added). In addition, a payout based on a rolling average of market value over three years makes sense because, according to James Garland writing in "The Problems

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<sup>25</sup> Harold B. Ehrlich, "Asset Allocation Considerations: Advice for Advisors", *Trusts & Estates*, (November, 1999), p. 36.

<sup>26</sup> Edwards, op. cit., p.6.

<sup>27</sup> Edwards, op. cit., p. 6.

with Unitrusts”, “...bear markets of the last fifteen years have lasted between four and eighteen months”.<sup>28</sup> Investing for growth and distributing principal rather than income is, of course, tax advantageous since, as you know, generally the trust will pay any capital gains tax due at a maximum rate of 20%, obviously preferable to forcing the income beneficiary to pay what may be a higher rate on income. Note that this tax advantage may be compromised if the distribution is ‘in kind’ rather than cash in which case according to Edwards, DNI will be carried out to the distributee, increasing his/her taxable income.<sup>29</sup>

Since growth equities offer the prospect of higher total return over both fixed income and hi-yielding equities despite the usual exorbitant p-e’s and sometimes distressing volatility, it would seem prudent-if not obligatory-to convert existing portfolios to growth if a unitrust is contemplated. So long as equity markets continue to ramp upward which is probably more likely than other possible scenarios, combining unitrust with a growth portfolio makes the bank’s job easier by eliminating squabbles between incomes vs. remainders over whether fees are taken from principal or income and with the bank over whether the investments should favor income vs. growth. Since a unitrust-growth portfolio package promises to deliver more income to income beneficiaries, corpus to remainders and (hopefully) fee base to the bank, everyone wins!

If the instrument is discretionary with respect to principal distributions, includes an ascertainable standard and/or authorizes the income beneficiary to receive capital distributions in the form of stock dividends/splits or at least does not flatly prohibit principal distributions, then conversion to the unitrust model may well be possible. But what about a situation where facilitating language is lacking and the bank is apprehensive about a downstream lawsuit from the remainders for distributing what is perceived to be their money. Here, short of reforming the trust, capturing the trust assets within an LLC may legitimize principal distributions, a strategy that has been studied by Bessemer Trust. In any event, obviously the prudent trustee will want to get the prior approval of at least the named, non-contingent, sui juris beneficiaries and even the prior approval of the income beneficiaries before approaching the remainder interests on the matter. Should a remainder balk, then perhaps he/she could be induced to accept an early distribution of a portion of the assets - possibly structured as a loan payable from trust corpus at termination – in order to encourage cooperation.

#### - Communications / Accountability

The trust accounting statements to which I have been exposed do not always appear to be models of clarity or disclosure. That’s unfortunate, since the trustee - beneficiary relationship is, in theory, a fiducial relationship of great sensitivity, it seems beneficiaries should be entitled to statements that are timely, comprehensive, detailed and understandable. Without full information and particularly in states with a tight statute of limitations, a beneficiaries’ interests can be compromised. In FL, for example, a beneficiary has only six months to file for breach of trust following receipt of an interim statement assuming disclosure is adequate. And even if inadequate, the beneficiary may still be barred from filing a surcharge action by laches.

The recently revised accounting statements of that local bank with which I am intimately familiar now omits the date on which the account is assayed either for purposes of account valuation or for fee calculation purposes. Nor does the bank show the number of basis points being charged or calculations thereof. Auditing or other possible fees charged to common trust funds are not broken out. Yet their new statement is trumpeted as providing a “...clearer, more

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<sup>28</sup> James P. Garland, “The Problems With Unitrusts”, *The Journal of Private Portfolio Management*, (Spring, 1999).

<sup>29</sup> Edwards, op. cit., p. 6

concise, presentation of your important account information". Further, it is not thought to be common practice to itemize fees/costs taken from principal on third party funds that form a part of a personal trust portfolio, an issue that could even become more important if the banks take increasing advantage of recent state statutes permitting the deduction of other expenses from common funds.

Tracking trust results could be vastly improved. Why not, for example, compare fixed income and equity sectors against standard indices as well as compare overall portfolio, sector and component security/fund performance from one reporting period to the next. Why not also notify the client of impending portfolio changes and furnish a confirmation slip when a trade is completed? Maybe this is too much or not the kind of information a bank would like to bestow regularly on a client. But then consider the rapport a bank could establish by presenting all the facts! Agreed - most beneficiaries aren't complaining on this point. But they surely know the information it out there and may wonder why its not being made available. Is it so unreasonable to suggest that the investment officer call the client regularly to discuss the fortunes or misfortunes of each trust investment – something that is much easier to do if the trust is confined to a standard but restricted portfolio? And by doing so, wouldn't it be easy to target another complaint of beneficiaries – that banks do not respond in a timely manner to breaking news, preferring to review portfolio holdings in systemic fashion only once a year?

Another idea is to offer information gracefully. Pretend that the client is entitled to same even no local statute requires the bank's cooperation. Here's a poignant example. Beneficiaries of a trust managed by a Texas bank recently requested information about fees charged on a revocable trust prior to the trust turning irrevocable at the settlor's death. After explaining in detail why the bank was not obligated to provide same, it went on as follows:

We are, therefore, under no duty to furnish you with copies of accountings and fee computations for the periods during which Mr. and Mrs. \_\_\_\_\_ (your parents, now deceased) were in a position to approve or disapprove those accountings and fees.

We will, however, furnish you with copies of accountings, some of which were rendered quarterly, and some of which were rendered monthly, if you are willing to pay the cost of our reproducing them. Our charge for furnishing you with those accountings will be \$10 per statement produced, whether quarterly or monthly, and \$50 per hour for all assistant time expended in producing those statements. In addition, we will charge \$75 per hour for officer time required.

After we retrieve and forward copies of those accountings to you, you are likely to have questions concerning the computation of fees. In addition to the above charges, we will charge a fee of \$150 per hour to \$200 per hour for time expended by officers of this department in explaining and interpreting those statements and computations.

If you are willing to pay for retrieval and copying of statements, we will then proceed to give you an estimate as to the cost of doing so. Please let me know if you want us to proceed. (Bracket added).

Yours very truly,

While the trust officer was certainly correct in arguing it had no duty to provide the beneficiaries with information on the parent's prior revocable trust, the bank's statement that "...acceptance of our accountings (by the settlor) constituted approval" is questionable. (Bracket added). But the more interesting issues are the arrogant, pompous tone of the letter and the threat that the beneficiaries will be writing a big check if they persist in their demands. How does a letter like this further client relations? But here's the point. By demonstrating a

willingness to disclose, banks could establish a better rapport and improve their credibility with clients. Contrast the above letter to one from Bank One to its clients – we quote:

If you are not satisfied with our service quality in any given year, we will return to you the fees paid or any portion thereof that you believe is fair.

By way of explanation, Bank One added that...

It will first return the fees, then apologize and then ask the client what went wrong...(and)...if it becomes apparent the client wants something we cannot give them, then we will explain (that) either by the instrument or by law (that) we cannot give them (that) something... (Brackets added.)

Whether Bank One would put up with a client that demanded reimbursement of fees on a ongoing basis is unclear. Reportedly, the bank would resign in such instances.

- Fees/costs

Is the bank providing the most economical management possible consistent with its duty to minimize expenses? Certainly that is not the case when common trust funds or individual portfolios are converted to proprietary mutual funds. Where is the justification for loading up a trust account with a 75 basis point 12b-1 fee, for example? In particular, how can an increase in cash management costs from 15 to at least 60 basis points be justified when the typical account consists mostly, if not exclusively, of T-bills<sup>30</sup> suggests Declan O’Sullivan, the portfolio manager who protested the conversion of common trust funds into proprietary funds at Provident Bank (Cincinnati, Oh) and was demoted for his efforts. And, of course, ‘internal’ advisory fees no longer scale down as more and more of the trust assets are diverted into proprietary funds. What do you suppose the reaction might be if settlors/beneficiaries understood that investment expenses of even 1% can diminish returns by 9% and 18% over 10 and 20 years respectively?<sup>31</sup> Then think of the good will that could be generated if trust beneficiaries were offered the opportunity to convert back into a predecessor common fund or, preferably, just its component stocks. Bye the bye, a third class action has just been filed against First Union by a Philadelphia law firm. It is alleged that although conversion was handled on a tax-neutral basis, the bank soon sold securities from its proprietary fund, thus forcing beneficiaries to incur capital gains taxes contrary to the terms of a contract between the parties.

Often times banks calculate fees on a growing asset base but take same solely from income. That’s fine in terms of encouraging capital growth. But its hardly fair to the income interests who, courts increasingly agree, should be preferred over the remainder interests since it is the former that were best known to the settlor. Certainly no income beneficiary with an ‘income only’ trust which defies conversion to a unitrust model is happy with an average S&P 1.1% payout, a situation which can lead to a demand for more fixed income to his/his own and the trust’s detriment. So instead of arguing that fees must be taken from income because the instrument makes reference to the fact that it is the net income that is to be distributed to the income beneficiary, thereby implying that expenses are deductible from income, not principal, banks might take a broader view. Banks might consider, for example, dividing up expenses in proportion to historical income vs. capital gain returns, a method which would be consistent with

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<sup>30</sup> Declan O’Sullivan, *The Asset Gatherers*, unpublished manuscript, October, 1999.

<sup>31</sup> Luther J. Avery and Patrick J. Collins, “Managing Investment Expenses: Trustee Duty To Avoid Unreasonable or Inappropriate Costs”, ACTEC Notes (Fall, 1999), p. 129.

the idea that the account is being managed for the benefit of both incomes and remainders and with the bank's duty to be impartial to both parties. So long as the instrument allows discretion or contains an ascertainable standard or other provision allowing distributions of principal or at least does not flatly prohibit same, then fees technically can still be taken from income but matched by an offsetting principal distribution, a strategy employed by that bank with which I am intimately familiar!

In general, a bank might also agree not to impose any charges on trust corpus/income unless approved by the beneficiaries, freeze the fee rate and insure, in any case, that such concessions or other policies favored by the beneficiaries were made a part of any buyout agreement with a consolidating institution. But if guaranteeing a flat rate for the term of the trust is totally indigestible, banks might consider offering more than one plan at different prices. The more expensive would offer a flat, all inclusive rate for the term of the trust while a less expensive plan would only freeze the rate for a limited period – say ten years with an option to renew with no more than an 'X' percent increase over the initial schedule. In either case, fees would be inclusive of any additional costs incident to the use of third party funds including international funds. Since settlors could not have anticipated the substantial rise in rates imposed by banks over the years, freezing the rate would be consistent with the settlor's expectations/intentions.

Banks might also consider establishing a uniform fee/cost schedule, scaling with account size but otherwise consistent for all personal trust clients for whom the lack of a removal clause hampers the ability to negotiate rates. The fee rate for those that lack a removal clause could, for example, be set at the average fee paid by those clients who have such a clause. Further, instead of disseminating a so-called 'standard schedule of compensation' which in normal practice is normally discounted 15-20%, disclose the fees actually charged. Fees could also be routinely aggregated on multiple accounts set up by the same donor. And if a discount is offered on revocables where the investments are managed by the trust creator, why not extend a like discount to beneficiaries anytime investments are delegated to a third party.

- Candidate in-house service improvements

Why not consider making the trust department a preferred career choice so as to reduce personnel turnover by, for example, improving trust officer training. Banks might also consider improving communications and fiduciary credibility by preparing a settlor/beneficiary's guide book spelling out investment strategy and policy when confronted with various kinds of administrative decisions. Why not plan seminars or simply get-togethers where bank personnel can meet clients, both in-house and prospective. Why not support the development of an independent Board of Fiduciary Standards that would ease administrative burdens and reduce risk by providing a comprehensive set of 'bright line' industry standards, a step clearly beyond current guidelines which are usually so flexible as to despair of enforcement and which bear revision only sporadically. Since personal trust is not a well regulated industry and has yet to subject to the scrutiny of the SEC, why not allow clients access to relevant litigation, something that will be available on-line within year's end at least where cases go to trial. I would also encourage banks to deemphasize referral driven business because it poses a conflict of interest for those providing the referrals or, at a minimum, disclose any business relationship with the referring party and, in particular, whether or not a fee was paid for the account. Justice Cardozo would be pleased if banks disclosed other under the table kickbacks, whether soft dollar (e.g.

‘free’ investment research) or hard dollar (e.g. rebates of 12b-1 fees). Instead, banks might promote a healthier, more competitive industry by marketing directly to the settlor (and his/her beneficiaries) by beginning to offer some of the specific concessions mentioned previously.

- Giving and Getting

Banks and beneficiaries need to work together to find higher common ground for trust to be truly a ‘relationship’ business. Maybe the key to better investment performance is using the hedge fund formula – a basic all inclusive trust administration fee plus an incentive fee for performance exceeding a specific benchmark. If banks would support more active participation by beneficiaries, the latter might well agree not to sue a trustee over an investment gone sour so long as there was no evidence of a conflict of interest on the bank’s part, a provision that could also be implemented by a shortened, tighter statute of limitations. Or, for example, the bank’s contract with settlor or beneficiaries could include a) a unilateral right to resign - useful if the bank should become uncomfortable with the relationship - and/or b) a waiver of responsibility for an individual cotrustee’s actions. Further, banks could reduce exposure and improve ‘involvement’ by alerting clients to pending investment transactions or other administrative actions and requesting their prior approval. But if that’s too tough, why not at least show interest by simply phoning the client once a month to see how things are going? As Prince reported in his 1992 study, a satisfied client is not only much less apt to sue but much more apt to provide positive referrals and vice versa.<sup>32</sup> As Prince points out, building positive relationships is key to marketing a bank’s trust services – quote “...networking is the cornerstone of garnering new business from the affluent...there is an absolute need for referrals from existing client’s.”<sup>33</sup>

If banks changed direction, I believe the payoff would be fewer dumb questions and threats of lawsuits, a more agreeable working environment for staff, increased word-of-mouth recommendations from beneficiaries and eventually more settlors choosing the bank as their corporate trustee. Once banks recognize, in the words of University of Connecticut law professor and beneficiaries’ advocate, Bob Whitman, that trusts are for beneficiaries, not for settlors and that it is the beneficiaries’ money, the industry can position itself to become a market leader in personal trust administration and leave the Vanguards, Schwabs (including U.S. Trust) and Merrill Lynchs’ in the dust! Its not an impossibility because we already are working with start-up independents willing to make significant concessions in order to receive referrals from Heirs<sup>®</sup>.

## **Final Comments**

The key is to be proactive rather than a passive administrator who believes he/she is working for someone who (conveniently) is dead. Banks should reach out to the settlor and especially beneficiaries because they could serve as the bank’s best and least expensive sales force and, bye the bye, might well be doing Dad’s estate planning. Banks, justifiably or not, do not enjoy premier stature in the world of corporate trusteeship. Experience suggests a bank’s

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<sup>32</sup> Prince, op. cit., p. 56.

<sup>33</sup> Prince, op. cit., p. 56.

only drawing cards are that they do not steal, have the financial resources to stay in business and, infrequently, offer a 'hang tough' attitude on principal distributions. But banks could offer much, much more. They could advantage the opportunity to improve marketability by first educating the client as to what constitutes beneficiary friendly, sophisticated administration and then doing what it takes to demonstrate that they are committed to putting the client's interest first, confident that by doing the bank's interests will ultimately be well served. As it is, the industry may be sacrificing long term viability on the alter of high short term margins. Indeed, what is a prospect supposed to think when a private organization such as Heirs<sup>®</sup> can trigger over 120 print articles, radio and local/national TV coverage on beneficiary issues? So instead of squeezing accounts until beneficiaries are sent screaming to higher level management, state/federal regulatory agencies, local/national press or are induced to set up a website targeting a specific bank-as with Amsouth recently-or even picketing as is happening today on the streets of Palm Beach and N.Y., banks can and should adapt their business model to an ever more sophisticated client. In fact, there is even a new website called FIDUCIARYCHOICE.COM where a bank can follow the lead of Merrill Lynch and place information regarding its fees and services for access by beneficiaries and settlors.

Further data on beneficiary matters can be found in various Heirs<sup>®</sup> publications including the *Heirs<sup>®</sup> Personal Trust Handbook*. The latter contains an agreement in two versions – one between the settlor and corporate trustee and a second between beneficiaries and trustee – which is designed to insure better relationships. In fact, as we speak, Heirs<sup>®</sup> is developing a stable of independent trust companies who will offer the terms of this agreement in return for a referral. That offer is open to all.