Private Trust Companies A Primer

FAMILY OFFICES HAVE BEEN AROUND FOR YEARS, AND A FEW FAMILY OFFICES HAVE HELD TRUST POWERS OVER THE YEARS, CREATING A FAMILY PRIVATE TRUST COMPANY HAS BEEN RELATIVELY UNUSUAL FOR WEALTHY FAMILIES. HOWEVER, RECENT CHANGES IN STATE LAWS, NEW TECHNOLOGIES PERMITTING LOWER COST OPERATIONS AND AN INCREASE IN OUTSOURCING OPTIONS HAVE MADE THE PRIVATE TRUST COMPANY STRUCTURE MORE ATTRACTIVE THAN EVER TO FAMILIES SEEKING TO RETAIN CONTROL OVER THEIR FIDUCIARY ACTIVTIES.

Choosing a Private Trust Company

A private trust company, also known as a family trust company, is an entity that provides trust and fiduciary services to a single-family group. It is a state-chartered, regulated entity and, as such, is prohibited from doing business with the general public.

As more and more states enact legislation to encourage private trust companies (PTCs), these structures are gaining in popularity. For families who hold family businesses, have active investment- oriented family offices, or who are simply frustrated by the constant turnover and service limitations of their institutional fiduciaries, the private trust company offers a unique opportunity to further both the estate planning as well as the family governance aspects of their wealth management plans. However, the path from choosing to pursue a private trust company charter to actual operation can be full of challenges for families who fail to address substantive operational and governance issues up front. This article provides a brief overview of the PTC landscape and attempts to lay out some of the pros and cons of this structure.

Benefits of a Private Trust Company

Private trust companies (“PTC”s) offer many advantages to families in the management of irrevocable trusts used for estate planning and, in the context of family businesses, a vehicle for succession planning. These benefits include:

CLEAR TRUSTEE SUCCESSION. Creating and naming a family owned private trust company as trustee can help insulate the family from the risks of individual trustees (who die or may become incapacitated) as well as corporate fiduciaries (who can undergo mergers, changing ownership and service models drastically, or even go out of business entirely). A PTC provides a *known successor* for family trusts and can ensure that the PTC will reflect the family’s values and goals in the ongoing management of the assets. Moreover, the PTC will usually hire (internally or outsourced) professionals to manage the trusts and provide for family involvement in the various operational committees, ensuring institutional-quality oversight for the family assets.

NON-TRADITIONAL ASSET MANAGEMENT. Generally speaking, wealth is created through the ownership of

concentrated holdings, usually rooted in the creation of a business venture, which may or may not be "family owned." PTCs can be structured to preserve the ownership of these assets. Under the Uniform Prudent Investor Act (adopted in almost all states), trust documents may specifically direct the trustee to hold assets but the laws still require a trustee to exercise "prudent" judgment as to when the purposes of the trust might be better served by diversifying out of the concentrated or illiquid asset. A PTC can be structured to provide very tailored due diligence and oversight of unusual assets or concentrated positions, permitting a better balance between the perceived need to diversify and the grantor or beneficiary's desire to hold the asset. PTCs can also hold other assets, such as real estate, private equity or alternative assets such as hedge funds in concentrations that may be appropriate for the family but might not be acceptable to a commercial fiduciary. As PTCs have no profit motive, no proprietary product and no conflicts of interest, the entity can reduce costs of trust administration, while ensuring that risk management is targeted to the needs of the family.

LIMITED LIABILITY FOR TRUSTEES AND FAMILY MEMBERS. Trustees have personal liability for their decisions. This can be a deterrent for qualified individuals who would otherwise be willing to advise a family in a fiduciary capacity. Using a PTC can allow these individuals to assume an active role on the board of directors, with an added level of liability protection provided by PTC level D&O insurance. Further, a well-constructed PTC can provide the infrastructure (and administrative support) to establish clear processes and procedures for trust administration, so that there is no tradeoff between institutional oversight and personal service.

IMPROVED INVESTMENT OPPORTUNITIES AND OVERSIGHT. Many PTCs are formed by families with large pools of liquid assets (often from the sale of a business) and managed on a commingled basis. The PTC structure can facilitate the creation of investment vehicles, such as common trust funds, to allow trusts of all sizes to access asset classes with higher minimums. These vehicles can provide better pricing and lower investment minimums because the common trust fund, not the individual investor trusts, are seen by investment managers as a single entity. Thus family trusts accounts, regardless of size, can invest in assets such as private equity funds or hedge funds that would be otherwise inaccessible.

KNOWN LEVELS OF REGULATORY OVERSIGHT. With the recent changes to the exemptions for family offices from SEC regulation, many families are turning to PTCs as a way to avoid becoming a "registered investment advisor" with the attendant disclosure to the SEC. While the choice of a PTC structure is not without its own regulatory considerations, many states permit PTCs to ask for exemptions from the standard regulatory requirements that would apply to banks or trust companies that serve the broader public.

CHOICE OF STATE LAWS. As state laws on decanting, taxation, and prudent investor rules vary, the PTC can permit a family to choose a jurisdiction most beneficial to the particular issues facing the family in its succession planning. Separately, each state has different rules for how a PTC can qualify and operate in its jurisdiction (discussed below) that will often dictate where the PTC will be set up. Several states have actively sought PTC business and have adopted legislation to facilitate the creation and operation of PTCs in those jurisdictions. Further, a PTC can usually create subsidiaries to gain access to any jurisdiction necessary, allowing for even more forum shopping as trusts are created.

FAMILY LEADERSHIP OPPORTUNITIES. The PTC offers an opportunity for family members to have significant

involvement in the oversight and operation of the governing entity, within limits. While the IRS has provided some guidance in Notice 2008-63 on the operation of PTCs, the extent of family involvement is still somewhat unclear. The IRS notice discourages family member involvement in discretionary distributions or amendment committees; however, the operation of a PTC still provides many opportunities for a family to participate in the dialog around trust management to an extent denied them in an institutional relationship. This, in turn, creates an opportunity for the family to better shape the long-term stewardship of their family's wealth and cultural goals. Trustees have an obligation to ensure that the beneficiaries of trusts understand the provisions and are knowledgeable as to the management of their trust assets, which also ensures the education and development of family members.

Considerations to forming a PTC

The regulatory oversight at a state level can seem daunting, the formation of a PTC is relatively easy, although not to be entered into lightly. There are several financial and legal considerations at play. First, most states have some capital requirement for the PTC itself, in order for it to act as a fiduciary and exercise the fiduciary powers granted under state law. These capital requirements can range from a few hundred thousand dollars to several million dollars of capital. Upfront legal fees can add another hundred thousand dollars or more to the process and there may be application fees at the state level. Further, trust companies often need to have some level of administrative and reporting capability, which can be developed internally or outsourced. While these costs may seem significant, most families realize overall cost savings, particularly when compared to corporate fiduciaries (who must operate at often significant profit margins to account for overhead).

Because a PTC can tailor its services to the family's needs, and hire external providers on an as needed basis, the operational costs can be significantly reduced. All PTCs will have some level of public disclosure, depending on the chartering state, but families can either select a state that will allow for exemption from these requirements, or adopt a structure that limits any public disclosure. While some states (South Dakota) require significant personal and financial information from principal shareholders, board members and executive officers of the PTC, others have minimal disclosure and information requirements (Tennessee). One final consideration is often the state requirements for a local presence. This can vary by state and require simply a mailbox to an established office or frequent presence in the state by at least some of the officers.

ALTERNATIVES TO CONSIDER

When considering a PTC, it is important to understand the alternatives available. Where the assets are not significant, or where the family governance structures do not exist, creation of a PTC may not be a viable option.

CORPORATE TRUSTEES. A corporate trustee, usually a commercial bank or perhaps a dedicated trust company, has the administrative infrastructure and expertise to handle trust administration. Many have strong beneficiary programs and can provide support to an individual co-Trustee as well. Depending on the structure of the family, a corporate trustee might be the best alternative in terms of cost and operational overhead. Many families will pair a corporate trustee with an individual family trustee. However, where the assets of a family are complex, or illiquid, and involve ownership of operating busiensses, many corporate trustees are reluctant to act in a full fiduciary capacity. Also, family members may wish to use several different corporate trustees, depending on their personal investment management relationships.

DIRECTED TRUSTS. Other options exist for families using corporate fiduciaries but may not provide the desired

levels of control. Many states permit the use of "*directed trusts*" where the administrative duties can be separated from the investment of trust assets. As such, a corporate trust company can be hired as a "directed" trustee for all or part of a trust corpus and will take "directions" from a designated external individual or committee. Most directed trusts must be created, so this option is often not available to existing trusts without some form of alteration (either "decanting" to a new trust, if permitted under state law or seeking a court order to amend the trust). While directed trusteeships can avoid the need for a regulated PTC, the ultimate matter of controlling succession and decisions with respect to directed assets remains.

COMMON TRUSTEES. Other families will choose to use a *common trustee*, often in coordination with a directed trust structure so that all family trusts have *one corporate fiduciary* and one *common investment committee*. The treatment of these investment committees is uncertain under the new SEC rules with respect to registered investment advisors so this structure may simply trade one type of regulatory oversight for another (although these investment committees should fall within the definition of a family office but each situation should be reviewed under SEC notices on family office operations (SEC Release No. IA-3220)). Likewise, the succession and control issues remain as individual committee members' transition. If a family is adopting a single corporate fiduciary and using an investment committee to direct trust assets, they would be wise to have some form of formal governance (and legal support) to the investment committee operations, both in terms of its operation as well as contractual limitations with trusts that are managed by the committee. This structure also still exposes the family to the risk of transitions at the corporate fiduciary level, where they have little control over changes in either the cost of the services or a change to the service structure. This lack of control remains a deterrent for many families. If this alternative is pursued, families should select a trustee through a rigorous selection process and provide for some continuing oversight and due diligence process as to the management team selected.

Finally, there are many smaller commercial trust companies that are eager to add assets to their balance sheets. Families looking at these providers should consider the owners' exit strategies and whether a joint venture is possible (or even of interest). A very large family might be able to negotiate an equity stake in the controlling entity, or some significant discount for services. Investment management firms, including trust companies, often trade at significant multiples to established book valuations in a sale; this premium is never passed along to the clients but retained by the equity owners. For families of substantial size, it seems feasible that failing to monetize the value of these trust assets by negotiating an equity stake or a significant break in fees might be considered a breach of their own fiduciary obligation to the family and succeeding generations when alternatives like a PTC exist.

Conclusion

While a Private Trust Company is not a viable alternative for every family, for families of significant wealth, families with operating businesses, or families with unusual assets, such as significant real estate investments, active family offices, or just odd assets like art or collectibles, the PTC should be given serious consideration as an alternative to a corporate or individual fiduciary. The collateral benefits to family operations, governance and succession plans (not to mention operational cost savings) can far outweigh the initial headaches of setting up a potentially complex entity.

WORKING WITH US: Wealthaven's independent views and deep expertise across business, investments, estate

and tax planning can be an invaluable resource for families creating or refining the governance structures around significant and/or complex assets. By supplying technical knowledge and an objective voice, we can assist the family in identifying the proper vehicles, or forums, to ensure succession plans are successfully implemented.

With Private Trust Companies, we can advise on the structure, choice of jurisdiction and work with local counsel to set up the entity. We provide operating support, either as a consultant to the board or in the actual administration of trust assets. We believe strongly that a properly structured trust company needs to have robust, yet reasonable, policies, procedures and internal controls for its operation. We work with the existing family office team to develop these procedures or create them specifically for the family's needs and abilities. Further, as part of our overall planning services, Wealthaven works in partnership with the family members, and their legal and financial advisors to proactively review investment, insurance and estate plans, allowing for the trust company to identify any issues for its fiduciary oversight of the trust assets.

For families seeking a less complicated solution, we will create an infrastructure to support the use of directed or administrative trust structures in conjunction with corporate (commercial) trustees, such as a bank or brokerage firm. Finally, Wealthaven principals can be named to act as a trustee (sole or co-trustee) with your family members or can serve as a trust protector.

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