What Advisors Have Been Waiting For

Directed Trusts Made Simple

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- Everything a financial advisor needs to know about directed trusts

WEALTH ADVISORS
Trust Company

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Directed Trusts Made Simple

"Don't invest in anything you don't understand" — Peter Lynch

Most financial advisors are well aware of what directed trusts can do for them and their clients (e.g. increase AUM). However, with dozens of directed trust companies competing for attention (and business), the "noise" out there can prevent the really important benefits of these vehicles from getting through to advisors.

The critical point to keep in mind is that the trust industry is undergoing a quiet revolution that has wrested control of trust accounts away from traditional trustees—primarily in the banks and other large institutions—and back into the hands of independent trust companies and advisors.

Legal experts contend that there have been more changes in trust law in the last 20 years than have taken place in the prior two centuries. These changes have been buildling in scope and promise to affect every aspect of how trusts are invested and administered for decades to come.

Ultimately, the most significant changes will relate to who will perform the critical duties related to the trust and how these duties will be assigned. In any event, these are exciting times for financial advisors who want to play a bigger role in their clients' assets, now and in the future . . . but to do so effectively, financial advisors must have a basic understanding of what directed trusts are really all about.

What is a Directed Trust?

In previous generations, trustees retained full authority over both the way trust assets were used to enrich the beneficiaries and the way those assets were invested. As many trust companies evolved into broad-based wealth management firms, this effectively put financial advisors serving the high-net-worth market in the position of having to cede control of a portion or all of their clients' assets to a competitor.

However, legal statutes in some states allow the creators of a trust to direct the trust company to follow the investment choices of an outside advisor.

In these directed trust arrangements, control over the assets (and the investment fees they generate) remains with the legacy advisor, while the trustee administers the trust itself. Since both trustee and investment advisor are thus free to do what they do best, this aligns the interest of all parties with the grantors and beneficiaries themselves, while minimizing potential conflicts.

Three Simple Rules

The key point to remember about directed trusts is that someone other than the trustee manages the underlying assets. In a common law (traditional) trust, the trustee is responsible for both the administration of the property held in trust and how it is invested. In a directed trust, these functions are split up between the trustee and other entities. The following simple rules apply to the law of trusts:

Simple Rule 1. In the absence of a statute to the contrary, the common law handed down over the centuries through case law applies to trusts in all states. What does this mean to the financial advisor?

Simple Rule 2. Under the common law, a trustee **cannot** delegate either its duties or its liability. As Harvard professor Austin W. Scott puts it, "The whole responsibility for the management of the property is thrown upon the trustee."

Simple Rule 3. Each state has total control over the laws that apply to trusts and trustees. Several states have in fact enacted laws that override the common law rule against non-delegation.

The non-delegation rule encouraged the evolution of the "unitary trustee," which concentrates all investment and administration functions under the control of a modern bank trust department or trust company. Trust agreements are often drafted to create significant roadblocks to, or completely prevent, removing or changing who is serving as trustee.

For many decades, bank trustees enjoyed an unchallenged monopoly as providers of corporate trustee services, and under the non-delegation rule they also enjoyed a monopoly over how trust assets were invested.

However, it is abundantly clear the Baby Boom generation will not follow their parents' estate planning patterns. Traditional bank trustees no longer appeal to "boomer" clients, a fact borne out by the net outflows of trust assets to non-bank advisors. For advisors who did not relish the prospect of losing their best clients (and their assets) to bank trust departments, this is a tremendous opportunity.

Best States for Directed Trusts

South Dakota has been a national leader when it comes to enacting new statutes that override various aspects of common trust law. For our purposes, one of the most important changes that South Dakota has made is to allow local trust companies to provide alternatives to the non-delegation rule.

In states like South Dakota, the grantor of the trust can choose to allow the trustee (usually a bank or trust company) to delegate the investment responsibilities to someone else (often a registered investment advisor, stockbroker, financial planner, or other family advisor).

In these cases, known as delegated trusts, the trustee's liability is not reduced. The delegated investment manager remains subject to trustee guidance, manages the trust investments per an IPS and acts a fiduciary for investment management.

For most practical purposes with delegated trusts, the trustee retains continuing liability for investment performance.

Takeaway Points

- The delegated method is analogous to a subcontractor relationship with the trust subcontracting investment duties to the advisor.
- Trusts that have delegated the investment management to another entity, such as a RIA, require the trust company to perform varying degrees of due diligence as well as ongoing monitoring and supervision. Advisors should

ask the vendor specific questions regarding due diligence requirements. An Investment Policy Statement is generally required when the relationship begins.

- Advisors should be aware that trust companies offering only a delegated trust solution often state in their marketing, that the client will receive personal attention from a trusted advisor and the added confidence that the trustee is supervising how the assets are invested. Whether this "two professionals for the price of one" proposition is a positive or negative depends on the trustee's view of risk and level of confidence in the advisor.

How Directed Trusts Work

Directed trust statutes approach the trustee liability issue by formally defining the separate duties and responsibilities of trustee and advisor. The statutes allow a grantor/client to appoint both as fiduciaries in a trust agreement. The advisor is charged with all investment duties and is held responsible for how the investments perform. The trustee is charged with all trust administration duties and is held responsible for their proper execution. This separation of duties is called "bifurcation" in industry marketing lingo.

When an individual decides to use a directed approach for his or her trust, he or she generally appoints an existing advisor or advisory firm in the trust document. Directed trust statutes usually consider the advisor to be a fiduciary even though the investment function is practically separated from the traditional fiduciary tasks associated with trust administration.

Specifics vary by state. South Dakota and Utah are examples of definition-driven directed trust statutes. The South Dakota statute is generally considered to be the standard for directed statutes because of its clarity with regard to delineating the separate duties that advisor and trustee perform.

South Dakota also provides for additional roles within the arrangement. Grantors can appoint a "distribution advisor" charged with the duty of directing the trustee to make (or withhold) distributions. Not surprisingly, these three-party arrangements are referred to as "trifurcation."

Depending on the state, the standard under which the separate parties are liable ranges from gross negligence to willful misconduct.

Takeaway Points

- The definition-driven approach eliminates the trustee's duty to monitor or supervise investments.

- Directed trust statutes more easily accommodate multiple fiduciaries and non-fiduciary appointments like special trustees and trust protectors.
- Grantors directly appoint the advisor/advisory firm under the controlling document and so their primary client relationship remains with their legacy advisors, not the trust company.

Blended Statutes and Uniform Trust Code States

Many directed trust companies operate in states with delegated or directed statutes. They are not as recognized as states with vibrant trust statutes such as South Dakota, Delaware, Alaska, Utah, Nevada.

In addition, several other states have statutes drafted and pending. It is important to recognize that even in states that do not currently support directed or delegated trusts, a trustee can always accept direction or delegate the investment function as it sees fit. Trustees are free to take a business risk and conduct their affairs accordingly, though few do so with regularity.

Trust Administration under the Directed Trust

To paraphrase Yogi Berra, "Trusts are 90% investments; the other half is administration." From the advisor's perspective, the corporate trustee role is often considered a "back office" function and therefore unimportant when everything is running smoothly.

To the contrary, the administration function is critical and often ultimately surfaces as a key element in the grantor's decision-making process. Many otherwise financially sophisticated people can be more concerned over administration issues than the way the underlying assets will be invested. After all, they probably already have an investment advisor, while the process of trust administration is likely to be new and somewhat outside their experience.

Because the advisor is a primary point of contact for clients, he or she must have a basic understanding of the primary duties of the corporate trustee. These fall into two main categories:

1. **Non-discretionary tasks.** These include making income payments on a monthly, quarterly or annually or as otherwise directed by the trust agreement. Trustees must also pay out principal as set forth in the trust agreement and attend to all other matters the trust agreement directs. These duties are not optional or discretionary, but must be carried out as stated in the trust document.
2. **Discretionary tasks.** The trust document may also charge the trustee with the responsibility to make certain decisions according to his or her own discretion. If the

trust is silent on an issue, the trustee's fiduciary duty may also require him or her to make discretionary decisions. For example, a trust may indicate that the trustee can make principal payments "after considering other sources of income available to the beneficiary," in which case the trustee should demand extensive documentation from the beneficiary before making a decision.

Picking the Right Corporate Trustee

Advisors seeking a trust company for a directed trust that does not contain discretionary provisions can focus on the easy questions:

- Is a dedicated trust officer responsible for each account?
- How are income or principal requests handled? What are the turnaround times and payment methods?
- How are communications with the beneficiary handled?
- How quickly can the trust company respond to document review, interpretation and explanation requests from a client or financial advisor?

When trustee discretion is an issue, the process of finding the right fit can become more difficult. Advisors should not expect a trustee charged to act with discretion to be a "pushover" or simple rubber-stamp entity, so it is important to be able to establish a good working relationship.

Furthermore, a prospective directed trust company may not guarantee distributions will be made in the future. Such commitments could jeopardize the trust and and would compromise the trustee's fiduciary duty to the beneficiaries of the trust.

Picking the Right Trustee . . . *for Your Client*

To quote Yogi Berra again, "You can observe a lot about people by just watching them." Advisors introducing business to a directed trust company should remember that their best clients may be at stake. If a good "fit" between the advisor and the prospective trustee is important, it is absolutely crucial that the client and the new trustee be able to work well together.

Although there are no definitive guidelines, advisors should keep the following points in mind when interviewing prospective directed trust companies:

- Does the trust company mention the role of advisor, if any, in the administration process?
- Do answers to specific process questions consist of "rapid fire" lists of requirements and documentation to be provided by the client?

- Do the answers indicate the trustee is in a position of power and authority, or reflect an attitude of cooperation and respect for the client?

Listen for verbal clues that the trust company has hired and trained employees to embrace the directed trust concept. People from the bank trust world may not understand or appreciate the need to work on a partnership basis with advisors and their clients. Advisors have replaced the trust officers of old to be the new trust advisor.

Operational Considerations

The vast majority of directed trust companies, such as Wealth Advisors Trust Company, do not custody investment assets. This function is provided by leading custodial providers such as TD Ameritrade, Fidelity, Pershing, Schwab, to name a few. Therefore, the trust assets remain on the advisor's trading/custodial platform increasing service and operational efficiency for the advisor and client.

- Assets remain on the advisor's current custodial platform.
- The trustee is granted access to information electronically.
- Client statements and performance reporting are unaffected by the trustee relationship.
- Client receives a separate trust statement reflecting the fiduciary accounting for the period.

Fees

Advisors should be aware that the directed trusts separate the investment advisory fee from the corporate trustee fee. Advisors are generally allowed to set their fee at their discretion, but the combined fee may still end up lower than what the client would pay in an all-in-one bank trustee situation. These traditional bank trust companies charge a fee that compensates them for their investment management fiduciary risk plus other "soft non-value added services" provided to clients.

In general, fee schedules for directed trust companies fall in a range from 0.50% to 0.75% on the first $3 million and then drop according to varying breakpoints thereafter. Minimum fees range from $5,000 regardless of asset level, although ILIT fees are generally in the $1,500 range.

Additional fees may apply for real estate held in trust, estate settlement and termination fees, tax preparation and/or filing, or miscellaneous extraordinary services.

Note: The IRS has ruled that all corporate trustees are now required to separately account for investment and administration fees. This is intended to remove the tax advantage of a "unitary" trust in which the entire trustee fee can be deducted, as opposed to a trust that charges separate fees and only allows partial deductibility of fees. Directed trusts already break out the fees in this way, but because this is a relatively new development, it provides an advisor with a good "talking point."

Converting or Transferring an Existing Trust

The process of transferring a trust to a new trustee can be efficiently done. This requires all parties providing the required information in a timely manner. Directed trust companies have a great deal of experience in the trust transfer area and can provide valuable assistance in navigating the process.

A trust document must incorporate language separating the investment and administration responsibilities in order for it to be considered a directed trust. Since most trust transfer opportunities come from bank trustees, it is important to understand that an existing irrevocable trust must be modified to add the directed trust language.

The trend in many states is to streamline the modification process and eliminate the requirement of going to court. For revocable trusts, a simple amendment signed by the grantors can be used to add the required directed trust language.

Judicial modification is available in all states. The states vary with regard to the consents required and representation of minor and unborn children. The process can be relatively simple, provided all interested parties agree to transfer. In states like Texas, the trust modification statutes have been liberalized to ease the requirements and process of court ordered trust modifications. Contested matters are difficult to work with and do not make strong candidates for directed trusts.

Non-judicial settlement agreements (NJSA) are permitted in about a dozen states, primarily in the Midwest. Under NJSAs, interested parties are allowed to sign an agreement with provisions deviating from the trust's original terms: for example, changing trustees or the situs of the trust, or adding the successors' directed trust provisions. Substantive terms of the trust that affect distributions or other money matters cannot be changed under an NJSA.

In a perfect world, the trust document will also contain the required provisions or powers to allow transfer of the trust by exercise of a power to appoint a successor trustee. Unfortunately, these provisions are surprisingly rare, especially where older trusts are concerned.

New Directed Trusts

The process of creating a directed trust is quite similar to the more general trust creation procedure, but there are a few additional points to consider.

The trustee must provide the attorney with "required or suggested provisions" that incorporate the directed trust provisions into the trust. Depending on the attorney and state or states involved, additional legal counsel may be required. In most cases, the family's attorney will complete the documentation required. The attorney's concern will generally be in regard to working with the law of another state. The directed trust company should assist all parties - client, advisor and attorney—to bridge this knowledge gap, efficiently and with little or no cost.

Capturing Trust Assets with Directed Trusts

"Build a better mousetrap and the world will beat a path to your door" — Ralph Waldo Emerson

The Opportunity

In a white paper entitled "Opportunity Knocks" Bob Clarke, contributing editor of Investment Advisor magazine, stated:

"The effects of adding directed trust services to the economics of an advisory practice can be nothing short of dramatic. In an informal poll, independent advisors estimated that as much as 80% of their current assets under management will move into trusts in the next 10years."

Incorporating directed trusts into your existing business is not rocket science. Considering the potential reward, it is well worth the time and effort to acquire the capability to work with trusts and refer clients to trust companies as needed.

Once acquired, this expertise can be used both defensively (protecting the book from being poached by trust-capable advisors or unitary trust companies) and offensively (attracting new assets from non-trust-capable advisors). It can also assist in the creation of strategic partnerships with CPAs and attorneys.

Acquiring trust expertise can be accomplished by:

- **Self-study.** The trust business really is a simple proposition when you consider that the corporate trustee will be handling the distribution issues and other "traditional" trust decisions.
- **Recruiting** a professional already knowledgeable with trust concepts, perhaps acquired from a trust department.
- Establishing a **strategic partnership** with an estate planning attorney. A growing legion of attorneys has embraced the

direct trust concept and seeks to collaborate with advisors prepared to serve in a fiduciary investment capacity.

- Using the **resources and experience** at directed trust firms to leverage your knowledge and time.

Four Simple Prospecting Ideas

1. Review all current accounts for revocable trust titles. The probability is very high that a bank is named as successor trustee somewhere in the document. Make a note to discuss directed trusts and the associated client centric value-add at the next client meeting.

- Be prepared to suggest that a directed trust company be named the first trust successor after the grantor's death or co-trustee at the first death with your firm named as the advisor.
- Do not encourage older clients to name themselves as trustees as a means of deferring the trustee issue. Clients often seek the advisor's opinion as when a corporate trustee should be brought in.
- Remember, high-net-worth clients receive dozens of invitations to seminars on a monthly basis. Banks have sophisticated systems in place to provide referrals to their Wealth Division.
- Be aware that clients will move their account when their concern for an orderly estate settlement plan outweighs investment performance and personal relationship issues.

2. Update the firm website to include discussion of a directed trust service. Provide a clear explanation of the directed service with links to strategic partners.

3. Review your client's other estate planning documents, such as Wills, to understand who the trustee will be at the client's death. If it is a traditional bank trust company, alert your client that you will be "fired" at his or her death and determine whether that is his or her current desire.

4. Send a letter to local estate planning attorneys announcing your ability to serve as investment fiduciary under directed trusts. Directed trusts are a very hot topic in the CLE and seminar arena. Attorneys who embrace the directed trust concept can become valuable referral sources.

Simple Sales Rules for Client Meetings

1. Advisors should be able to describe directed trusts and their emergence as the result of the many changes currently sweeping the trust industry.

2. Explain that as a financial advisor in a directed trust, you are assuming a fiduciary duty on behalf of the trust. Be prepared to describe the corporate trustee's role without diminishing the importance (much less the necessity) of a professional trustee.

3. Have one or more directed trustee vendors in mind. Be prepared to explain the nature of the directed statute (delegated or directed).

4. Emphasize that investment and administration fees are charged separately. While the directed trust company fee is generally lower than what clients would pay a unitary trust company, the combined fee may still differ from what the client will pay elsewhere. The directed trustee is not concerned with your advisory fee.

5. Be prepared to explain your succession plan. Clients will actually raise this objection on their own! When you are presenting an estate planning solution that could last 20–40 years (or even forever), clients need to know there is a plan in place to serve the family needs now and in the theoretically distant future.

Directed Trusts Made Simple: Summary

- Directed trusts are authorized by separate and distinct state statutes that override the common rule against non-delegation of trustee duties.
- The directed statutes are divided into "delegated" and "directed" models.
- Irrevocable trusts can be modified to include direct trust provisions.
- Custody is maintained on the advisor's platform.
- Fees are charged separately.
- The opportunity to retain current accounts and gather new AUM is significant.
- Prospecting for directed trusts is simple and creates new strategic partnerships for the advisor.
- Selling directed trusts should be a natural and positive process!

As the "unitary" trustee continues to struggle to serve the needs of a new generation of grantors and beneficiaries who have higher customer service expectations, more complex asset management needs, and an increased desire to control their financial destiny, one is reminded of a commercial where the late Dennis Hopper is seated on a stool in the middle of a desert highway and says, "Your generation is not headed for bingo tonight!"

About the Authors

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About Wealth Advisors Trust Company

Wealth Advisors Trust Company (WATC) was created for advisors. We collaborate with financial planners, investment advisors, insurance agents, wealth managers, and family offices as they structure, implement, and monitor the life cycle plans of their clients and families. WATC provides directed & delegated trustee, trust administration, and back-office services and solutions for advisors' clients. Rather than competing with professional advisors, WATC works with professional advisors across the country, assisting them in achieving their clients' financial goals.

Appendix: Questions Often Asked about Directed Trusts

Directed trusts often raises a host of questions. Here are some typical questions advisors and their clients have asked trust providers about making arrangements to set up a directed trust. Wealth Advisors Trust Company can provide answers to these and other questions:

1. "What type of investments work best in a directed trust?"

a. Bonds, stocks, mutual funds and ETFs

b. Owner occupied and second home real estate

c. Closely held stock such as LLC interests

d. Fine wine and art collections

e. Collectibles such as autos, stamps, or coins

2. "What state features should you look for when establishing a directed trust arrangement?"

a. Directed trust statute

b. No state income tax imposed at trust level

c. Asset protection statute

d. Dynastic trust statute

e. State legislature annually updates the trust statute

3. " What kind of liability does an advisor have with a directed trust?"

a. Fiduciary liability for all investment activities

b. Liability generally restricted to willful misconduct

c. Advisor has no liability for acts of the corporate trustees

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