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Emerging Directed Trust Company Model

Challenging the Industry Dominance of Bundled Service Providers and Promising Greater Flexibility and Lower Fees for Families and Their Advisors

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Much has been written about modern multi-participant trust governance structures (sometimes called "open architecture trust designs") and evolving principles of state trust law related to "directed trusts".[1] The directed trust model threatens to undermine the market share and pricing power of traditional bundled trustee service firms. Although that threat is real, it can be overstated; there will probably always be a market for the top-tier providers of fully-bundled trust services that can provide grantors and beneficiaries excellent service and one-stop shopping.

Still, the emergence in several "preferred" trust jurisdictions of upstart nondepository public directed trust companies ("DTCs") is an undeniable disruptive force to be reckoned with. Those trust service providers who recognize and are willing to exploit these opportunities can offer the unbundled services, *a la carte* pricing and inexpensive access to the progressive states' trust laws that are increasingly coveted in a growing national trust marketplace. Traditional providers of bundled trustee services with unwieldy cost structures and embedded cultures will be challenged to adjust their business models to compete in this new environment. This article will provide some observations on the opportunities and perils that the DTC model presents to professional fiduciaries, consumers of trust services and their estate planning advisors.

Defining the "Directed Trust"

A traditional bundled professional trustee performs all fiduciary functions for the trusts under its management. These include exercising the important labor-intensive

[1] *See, e.g.,* Diamond and Flubacher, *The Trustee's Role in Directed Trusts*, 37 Trusts & Estates 24 (December 2010) (hereafter cited as "Diamond and Flubacher"); Clarke and Zeydel, *Directed Trusts: The Statutory Approaches to Authority and Liability*, 35 Trusts & Estates 14 (September 2008) (hereinafter cited as "Clarke and Zeydel").

and liability-sensitive discretionary investment management and distribution responsibilities, performing all ministerial administrative responsibilities necessary to implement those exercises of discretion, preparing fiduciary accountings and trust tax returns, and otherwise administering its trusts in accordance with the governing instruments and applicable state trust law.

The Risk Management and Cost Structures of a Traditional Bank Trust Departments [2]

A large bank trust department designed to deliver bundled trust services requires elaborately structured risk management policies and procedures to allow the bank's layered committees and armies of vice presidents and trust officers to perform the multiple fiduciary responsibilities inherent in the role and limit the bank's exposure for

[2] Although the article refers to bank trust departments in discussing the attributes of a bundled trust service provider, the discussion applies to any regulated trust institution (bank-affiliated or nondepository) that is not directed as to the investments of the trusts it administers. For the purposes of this article, a "bundled trust service provider" will mean any regulated (state or federal chartered and supervised) institution possessing trust powers that manages investments in-house or outsources the investment management functions (through agency arrangements, separately managed accounts ("SMAs") or unified management accounts ("UMAs")), but retains non-excluded fiduciary status for the investments of some or all of the trusts that it manages, as described in note 7, *infra*, and the accompanying text.

By contrast, a "DTC" is defined as any public ***nondepository*** trust institution that: (i) is chartered and supervised in a DTC-friendly regulatory environment (see note 11, *infra*, and accompanying text); (ii) operates exclusively in one or more states that afford robust excluded fiduciary protection for trustees directed as to at least the investment function (see note 7, *infra*, and the accompanying text), and (iii) provides no direct or oversight investment management services for its trusts governed by those states' laws.

Thus, in addition to bearing less regulatory costs and burdens, the defining feature of a DTC for the purposes of this article is the lack of any internal investment management or oversight personnel or investment surcharge exposure, except for possible liability for negligent or bad faith execution of an independent investment co-fiduciary, irrespective of whether the DTC is also directed as to other functions (such as trust distributions). In the author's experience, most "pure play" DTCs seek engagements in which they are directed as to both investments and distributions, but are willing to consider accounts that require them to assume some responsibility for discretionary distributions. The lack of any investment management surcharge risk exposure is the most critical attribute of a DTC, as investment mismanagement is the most frequent basis for fiduciary surcharge awards against full service trustees. *See generally* Reddy, *How Not to Get Sued*, Registered Rep. 30 (April 2005) (citing Center for Fiduciary Analysis study reporting 22% compounded annual increase in fiduciary investment cases); Campisi, *New Horizons in Fiduciary Risk*, 2004 ALI-ABA Course of Study, *Representing Estate and Trust Beneficiaries and Fiduciaries* (July 2004) (discussion of several recent well-publicized state court decisions involving significant awards against corporate fiduciaries for investment losses and mismanagement, including the infamous *Dumont, Janes* and *Wood* cases).

claims of breach of fiduciary duty. The directors, officers and support personnel are compensated commensurate with their experience, expertise and levels of responsibility. The department's policy manual describes the roles and responsibilities of various committees of directors and officers, including (without limitation) a trust committee, investment committee, special asset committee, discretionary action committee, audit committee and various subcommittees. Day-to-day trust portfolio management is typically handled by highly-compensated investment officers, some of whom possess the Certified Financial Analyst ("CFA") credential. Distributions and operations are the responsibility of trust operations officers, trust administration officers and in many cases client-facing relationship managers and marketing officers.

The classic regulated corporate trustee collects from each of its trusts annual fees of between 50 and 120 basis points, depending on the trust's principal value. These fees have historically been adequate to cover the trust department's extensive overhead and provide a comfortable and relatively stable profit margin to supplement the bank's more cyclical net interest and other operating income from its commercial and retail banking operations. Before directed trusts became popular, the high costs of operating in a regulated industry with significant barriers to entry for alternative business models gave the incumbent bundled service providers significant pricing power and created an almost infinitely elastic demand for their services.

The Relatively Modest Organization and Cost Structure of a Modern Directed Trust Company

Unlike this comprehensive trust service model, a directed trust arrangement involves a co-trustee or a non-trustee fiduciary, typically a "trust protector" or "trust advisor", empowered to direct the trustee holding legal title to the trust assets to execute the empowered party's directions concerning the critical discretionary investment or trust distribution powers, or both. The independent DTC is relegated to implementing those directions and often performing other administrative functions such as recordkeeping, maintaining principal and income accounts, preparing and filing trust tax returns, and the like. This is why such DTCs functioning in a completely directed trustee capacity are often referred to as "administrative trustees".

DTCs can operate lean and mean in inexpensive, highly utilitarian Class B office space with more manageable risk management policies and procedures, less high-priced management personnel, no investment professionals, and an appropriate number of administrative personnel to handle the accounts the DTC administers. As nondepository institutions typically operating under hospitable state regulatory regimes, they can benefit from lower capitalization and bonding requirements and less onerous supervision, reducing operating overhead relative to depository institutions with trust departments and nondepository institutions subject to strict rules.[3] DTCs generally charge a relatively modest annual fee for services commensurate with the DTC's

[3] Jurisdictions with "one size fits all" regulatory regimes that make no concessions to nondepository trust companies are a vestige of the days when only bank-affiliated trust companies provided fiduciary services. There is obviously a significantly greater risk to the public welfare and costs associated with the failure and receivership of a bank that collects deposits and makes loans, versus a nondepository DTC that takes mere custody of trust assets. This is discussed in more detail in note 11, *supra*, and the accompanying text.

correspondingly lower levels of risk, responsibility and overhead. This allows any other co-fiduciaries handling more labor-intensive, higher risk investment and/or distribution functions to profitably charge a reasonable fee for their services. Thus, on an "all-in" basis, the total fees paid to the DTC and the other compensated participants can be comparable (in some cases lower) to the single annual fee paid to a traditional bundled provider.[4]

The Demographic, Cultural, Legal and Regulatory Factors Driving the DTC Model

Several demographic, industry and legal trends have coalesced to drive the increasing demand for directed trusts and the DTCs that serve them. Unlike previous generations, when wealthy families were generally more conservative investors and looked to the institutional stability of banks as their trustee and investment advisor/manager of choice, a common theme among today's affluent is that they prefer a ***specialized*** approach that gives them the flexibility to choose their own investment professionals. They increasingly reject the notion that a jack-of-all-trades can be a master of any. That is particularly the case in the modern world of complex "dynasty" trust administration involving layers of discretionary distribution powers, and wide-open trust investment standards.[5]

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[4] It is important at this juncture to distinguish between a "directed trust" and the ability of a trustee to "delegate" investment responsibility. A trustee possessing its investment responsibility and delegating all or a portion of that responsibility to a compensated agent is held to similar standards of fiduciary responsibility (and liability) that would apply if the trustee directly manages the investments. *See generally* Diamond and Flubacher, note 1, *supra*, at 25-26 (discussing how unlike directed trusts, delegated trusts do not achieve true "bifurcation" of investment risks and responsibilities and will therefore require the delegating trustee to extend more effort, assume more risk and presumably charge more of a fee than a directed trustee); King and McDowell, *Delegated vs. Directed Trusts*, 33 Trusts & Estates 26 (July 2006).

[5] There is an old adage: "How do you make a small fortune? Give a bank a large one to manage in trust." Dukeminier and Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. Rev. 1303, 1335 (2003). In defense of the banks,

The new multi-participant directed trust structures offer the promise of the best of both worlds. On one hand the settlor and trust beneficiaries have the comfort and stability of a local, state-regulated and adequately capitalized financial institution to serve as administrative trustee to hold legal title to the trust assets and charge a reasonable fee for those services. On the other hand in a prudent investor environment they avail themselves in the new prudent investment environment of the broader benefits of being able to choose from a wide-open universe of non-trustee distribution directors and investment specialists with extensive research capabilities, contrasting investment styles and access to alternative investment classes. And these governance structures can also accommodate those families looking to play a direct role in investment management and distribution decision making through committees that can empower settlors and beneficiaries to control or influence all but "tax sensitive" discretionary powers.

Six Progressive Jurisdictions are Uniquely Positioned Themselves to Catch the DTC Wave

The evolution of the legal and regulatory environments in all but a handful of progressive trust jurisdictions has not, however, kept pace with the increasing demand for these open architecture governance structures. The few states that have taken up the directed trust gauntlet have recognized that creating a hospitable legal, regulatory

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this bias is perhaps most attributable to historically restrictive fiduciary investment laws ("legal lists" and prudent men) that hamstrung bank trust investment personnel. There is empirical evidence that the more prudent investor standards and total return regulation have freed institutional trustees to better compete with other compensated professionals investing non-trust assets. *See* Schonzenbach and Sitkoff, *The Prudent Investor Rule and Trust Asset Allocation: An Empirical Analysis*, 35 ACTEC Journal 314 (2010). Also, many corporate trustees (particularly the largest) have complemented their in-house investment capabilities with best-in-class open architecture platforms, or embraced open architecture completely. Still, the prejudice persists and will create serious headwinds for corporate trustees attempting to market their proprietary investments.

and tax environment will foster the development of a thriving trust services industry within their borders and provide all of the incidental economic development benefits of white collar jobs, tax revenues and ancillary service providers. These progressive jurisdictions recognize that the popularity of long-term (even perpetual) trusts as wealth management, asset protection and wealth transfer tax avoidance structures, combined with tremendous concentrations of fungible financial wealth, liberal choice and conflicts of law principles and the relaxation of interstate banking restrictions, have created a national marketplace for directed trust services. A family living in a regressive trust jurisdiction need not move to a progressive state to secure the benefits of a directed trust established and administered in that jurisdiction. They need only enter into a trust agreement with a DTC domiciled in a preferred jurisdiction that will own and administer the trust's intangible personal property.

The Six Progressive States' Trust Law and Regulatory Infrastructures

The progressive trust jurisdictions that are on this short list are, in alphabetical order: Alaska, Delaware, Nevada, New Hampshire, South Dakota and Wyoming. Each of the six has, to one degree or another, built sufficient legal infrastructure in the three critical areas necessary to sustain a competitive local directed trust industry.

First and Foremost: A Robust Directed Trustee Statute

Each of these jurisdictions have codified directed trust principles that meet three critical requirements. First, they specifically recognize the classes of non-trustee participants that can perform trustee functions. Most of the six preferred jurisdictions statutes' identify "trust advisors" and "trust protectors" to serve in these roles.[6] Although it is not necessary, some helpfully provide an exclusive or a non-exclusive listing of the powers and responsibilities that each of them may assume. Second, these states' statutes provide as a default rule that each empowered party, whether a trustee or non-trustee, performing a trust function will do so in a fiduciary capacity with direct accountability to the trust beneficiaries and submission to the jurisdiction of the preferred state's local courts. Finally, each of the six states' laws protect a disempowered directed fiduciary from liability for following the directions of the empowered party except to the extent that the directed fiduciary fails to execute the directions negligently or in bad faith. Most of the progressive states' laws satisfy this third and most critical requirement by defining a directed trustee as an "excluded fiduciary" with no duties to: (i) question whether the empowered party is acting within the scope of that party's authority, (ii) intervene to prevent or redress a breach, or (iii) warn the beneficiaries that any given direction exceeds the empowered party's authority or otherwise constitutes a breach.[7]

Being governed by a clear and comprehensive directed trust statute will enable a DTC domiciled in a preferred trust state to price the administrative services it provides without a fiduciary surcharge premium or to cover the costs of exercising due diligence responsibilities on the empowered party's directions that would be appropriate in the absence of the "excluded fiduciary" exoneration provision. Moreover, it will send a clear

[6] For a complete discussion of the directed trust statutes of some of the proposed jurisdictions, *see* Clarke and Zydel, note 1, *supra*.
[7] For a discussion of some of these statutes, and some important substantive differences between them, *see* Diamond and Flubacher, note 1, *supra*, at 26-27.

signal to any court in surcharge litigation initiated against the DTC in the preferred trust state that the state's legislature has spoken by declaring as a matter of the state's public policy that the DTC will be liable only for bad faith or negligent execution. No such assurances can be given to a DTC operating in a state with no directed trust legislation or a statute that does not satisfy each of the three critical elements described above.

For example, the directed trust statute in a state adopting the Model Uniform Trust Code will not protect a DTC operating in that state from liability for executing directions if the DTC's administrative personnel knew that doing so would constitute a "material breach" of the empowered party's fiduciary duties, or would be "manifestly contrary to the terms of the trust".[8] These vague standards leave the door open wide for a disgruntled beneficiary or a results-oriented court to mine the deep pockets of the DTC if, for example, it implements a direction that results in loss or damage to the trust estate. A DTC operating in a state without bullet-proof directed trust laws would face diminished prospects for a successful appeal of a surcharge order based on the deferential standard of appellate review for questions of fact and mixed questions of law and fact. Even some non-UTC states with statutes that attempt to go beyond the protections afforded by the UTC could leave a DTC vulnerable.[9] Reaching that result would have been difficult for any court applying the statute of a progressive trust

[8] UTC §808 (b).

[9] For example, despite the superficially clear directed trustee exoneration language of the Virginia directed trust statute that was reviewed by a Virginia appellate court, the court nonetheless vacated and remanded the lower court's dismissal of the action against a directed trustee for a determination whether that trustee violated its "duty to warn" the trust's beneficiaries of an investment director's decisions that went wrong. *See Rollins v. Branch Banking & Trust Co. of Va.*, 56 Va. Cir. 147, 2001 WL 340 37931 (Va. Cir. Ct., 4/30/01).

jurisdiction that clearly negates any such duty to warn on the part of a directed trustee.[10]

Accessible Judicial and Non-Judicial Trust Modification Opportunities

Each of the six preferred trust jurisdictions offer liberal opportunities for non-resident situs seekers to "retrofit" their existing irrevocable trusts' governance structures from the bundled trusts to the directed trust format and change their principal place of administration from a regressive trust state by facilitating the appointment of a directed trustee in the preferred jurisdiction. These opportunities include, without limitation, decanting, assessable trust modification standards (particularly related to administrative provisions), nonjudicial settlement agreements and virtual representation.

Less Onerous Chartering and Regulatory Oversight of Nondepository Institutions

All of the preferred jurisdictions also have enacted special banking act provisions for the chartering and supervision of public "nondepository" public DTCs or "limited purpose trust companies" that cannot accept deposits or make loans. These relaxed requirements recognize that a lighter-touch regulatory regime is appropriate given the diminished risk of public harm and receivership costs in the event of the failure or misconduct of a nondepository institution when compared to the trust department of a traditional state or federally-regulated institution that also takes deposits and makes loans. The relaxed requirements are generally reflected in lower initial capital

[10] *See Duemler v. Wilmington Trust Co.*, Del. Ch., C.A. 20033 NC, 2004, Strine, V.C. (Nov 24, 2004). A more detailed discussion of both *Rollins* and *Duemler* and their implications appear in Diamond and Flubacher, note 1, *supra*, at 27-28, and Clarke and Zeydel, note 1, *supra*, at 17-18.

requirements, lesser fidelity and liquidation insurance and bonding requirements, more liberal options for investing statutory capital, less frequent examinations, and relaxed (or no) requirements for resident directors and bricks and mortar in the chartering state, or some combination of those attributes.

Among the six jurisdictions, Delaware's regulatory regime is regarded as cutting the least slack for their limited purpose trust companies, and South Dakota is regarded as having the most accessible and least costly chartering and supervision requirements.[11]

Regulator Sophistication/Experience with Regulating Nondepository Institutions

Implicit in each of the progressive state's trust and banking codes is the state's legislature's policy value judgment about how hospitable it wishes to be as a domicile of choice for nondepository DTCs and trusts that might migrate to them from other states. Some of these six states have erected higher regulatory barriers to entry and operate for DTCs than others. They have done so presumably because they wish to keep out nefarious, undercapitalized providers without solid backing or well considered business plans, and discourage "rent-a-charter" interlopers who plan to conduct all or a majority of their business outside the jurisdiction.

[11]For example, South Dakota requires minimum capital of $200,000 for start-up public DTCs, and imposes only minimal requirements for South Dakota resident officers and directors and presence (office space and personnel). Delaware, by contrast, requires $1,000,000 of minimum capital, and scales its resident employee and office space requirements to the trust company's assets under management. South Dakota's statute prescribing the capital requirements for nondepository trust companies specifically " . . . recognizes that [South Dakota's] capital requirements . . . are [not intended to] be judged by the same standards as banks", and that the basic protection for fiduciary clients is provided through bonding and insurance, not capital.

In reviewing a DTC's charter application and examining existing DTCs, each state's bank commissioner will take his or her cues from the tenor of that state's banking code's chartering and supervision requirements applicable to DTCs. The regulator has a mandate to be conscientious in his or her review of a bank or trust company candidate's charter application and the banking department's examination and enforcement activities to guard against consumer harm, maintain the integrity of the state's banking and trust industry and preserve the regulator's limited resources available to cover the costs of receivership and liquidation. A banking commission operating under a special light-touch statutory regime applicable to DTCs must balance that prophylactic purpose with the legislature's mandate that the regulator not be so heavy-handed as to discourage responsible charter applicants and impose unmanageable regulatory burdens and compliance costs on any given DTC with a sustainable business plan and operating in a responsible fashion. To do so would prevent the progressive state's directed trust providers from charging competitive fees and attracting sufficient business to compete on a national scale, thereby frustrating the policy goal of the progressive state's trust and banking law reforms.

Some banking departments in the preferred trust jurisdictions may have done a better job than others in striking a reasonable balance between these competing considerations.[12] All of them, however, remain more competitive relative to the more

[12] South Dakota's Division of Banking recorded a record number of public DTC charter applications in 2010. *See South Dakota Sets New Record for New Trust Companies*, The Trust Advisor Blog (May 15, 2010) (hereinafter cited as "Trust Advisor"), www.thetrustadvisor.com/news/sd-record. In addition to the favorable statutory chartering requirements, the blog post quotes the Division's then legal counsel (now Director) as contrasting South Dakota's "business friendly" system for manageable costs for DTC "startups" to Delaware's rules that ". . . only really allow for big companies". Because in every state the DTC pays the tab for the regulator's examinations, many DTCs that are seeking the lowest cost ongoing supervision are encouraged by the efficiency of the Division's well trained examiners,

regressive trust law jurisdictions that have one-size-fits-all, full-bore regulatory regimes applicable to both depository and nondepository institutions.

Each of the Six Jurisdictions Offers a Friendly State Trust Income Tax Environment to Migrating Trusts.

Finally, many trust situs-seekers and migrators reside or maintain their non-grantor trusts' current situs in states that impose high trust income tax rates on accumulated income and capital gains. They may be seeking state income tax shelter if: (i) the laws defining their home or trust situs states' trust tax jurisdiction are narrowly enough drawn to allow them to achieve that result, and (ii) the destination jurisdiction will not tax the trust after the move.

Here again, all of the six progressive jurisdictions are not created equally concerning their state income tax laws. Some do not tax trust income and capital gains at all. Others will *pro rate* the trust's taxable income based on the percentage of beneficiaries who live in the destination state, exempting from state taxation all trusts having exclusively non-resident beneficiaries.

Directed Trust Platforms and "Creative Disruption" [13]

The remainder of this article will focus not on the unique nature of DTCs, but rather on their impact on the trust industry. In other words the emphasis will be on

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several of whom hold the Commission of State Bank Supervisors' "qualified trust examiner" credential and specialize in examining nondepository DTCs.

[13] Portions of this article dealing with disruption theory have been adapted with permission from the writings of Gregory Curtis, Chairman of Greycourt & Co., Inc., a leading provider of open architecture financial advisory services to wealthy families and select endowments. *See* Greycourt White Paper No. 38: *Open Architecture as a Disruptive Business Model* (October 2006), and No. 48, *Best Practices Trusts* (March 2010), both of which are available for download at www.greycourt.com/white.papers.html.

DTCs and their willingness to unbundle trustee functions and price them accordingly as a disruptive business model.

Wealthy families and their advisors who are searching for trustee and related services today will find that the open architecture trust design revolution has had a profound effect on the way that even the most traditional bundled trustees now do business. Understanding the impact of these fundamental shifts in trust law and practice can help families and their advisors make more informed decisions as they evaluate their options in an increasingly competitive, price sensitive, build-to-suit fiduciary services marketplace.

Creative Disruption Lessons from Other Industries. A "disruptive business model" is one that transforms an industry so completely that existing competitors are largely unable to defend against it, essentially ceding industry leadership to a new generation of more nimble and accommodating providers.[14]

There are many examples of disruptive business models obsolescing existing industry players that previously enjoyed near monopoly positions of dominance. Henry Ford's introduction of the assembly line into the auto industry eliminated dozens of competitors in a matter of a few years. The telephone nearly eliminated the telegraph, humbling then-entrenched Western Union in the process. Upstarts Canon's and Ricoh's introduction of the tabletop copier eventually forced Xerox, IBM and Kodak to conform,

[14] Disruptive innovation in an industry has been described as follows: ". . . a dynamic form of industry change that unlocks tremendous gains in economic and social welfare. Disruption is the mechanism that ignites the true power of capitalism in two ways. First, it is the engine behind creative destruction. . . . Disruption allows relatively efficient producers to blossom and forces relatively inefficient producers to wither. This destruction, and the subsequent reallocation of resources, allows for the cycle of construction and destruction to begin anew, enhancing productivity, lowering consumer prices, and greatly increasing economic welfare." Christensen, Aaron and Clark, *Disruption in Education*, download available at www.educause.edu/Resources/DisruptioninEducation/158712. Harvard Business School Professor Clayton M. Christensen is considered to be the dean of "disruption theory", first identified in Bauer and Christensen, *Disruptive Technologies: Catching the Wave* (Harvard Business Review, 1995).

only after years of sustaining gradual losses of market share. The rise of the personal computer, driven previously by the engineers at relatively under-resourced start-ups like Apple, Wang and Commodore, brought once mighty IBM to its knees (and even marginalized Digital, the firm that had previously help introduce the minicomputer). The advent of discount brokerage, not by the full-service "financial supermarkets" like Citigroup but rather by Schwab and others, caused most of the integrated wirehouses to reconsider their high cost commission-based distribution systems. The smaller, more nimble DTCs chartered in the six progressive jurisdictions pose a similar threat to their larger, more established and better-resourced bundled service providers.

The Evolution of Unbundling Trustee Functions.

Fully bundled trusteeships began to lose some of their luster in the trust services industry in the mid-1990s. The first wave of disruption was driven in part by the popularity in the early part of that decade of open architecture investment advisory platforms. Those models shed a harsh light on the conflicts of interest inherent in closed architecture shops that sought to push a broad array of proprietary products and services and offered the promise of one-stop shopping. Sophisticated investors began to realize that an advisor pushing his firm's offerings to customers could not remain objective in evaluating competing outside offerings. Savvy investment professionals began leaving the large closed architecture financial supermarkets in favor of smaller firms whose sole "product" was to vet, recommend and monitor best-in-class advisors across multiple styles and asset classes.

Trust law reformers recognized the adaptability of the open architecture approach to the trust industry as an alternative to closed firms offering only bundled trust services and non-negotiable fee schedules. Reacting to the emerging open architecture trust designs, in 2000 the drafters of the Uniform Trust Code added many then-novel provisions recognizing the interrelationships and responsibilities of multiple trustees and non-trustee participants among themselves and the trusts' beneficiaries. This was only the first step in the process of codifying a default rule regime applicable to multi-participant trust structures. The more elaborate reforms in the six progressive trust jurisdictions mentioned earlier in this article have improved on the UTC model. The law continues in those states to grow and evolve to address issues as they arise and make trust governance more labor and cost effective. As a result, more families and their advisors are accessing these laws and slicing and dicing the trustee functions among multiple trustees and non-trustee participants beyond the few affluent clients and their big firm lawyers who were among the early adopters.

The DTC Discovers its Niche: Trust Administration as a Commodity, and Why the Incumbents are Slow to Adapt.

As is usually the case with disruptive models, the enormous popularity of the new directed trust governance structures has been driven not by the traditional competitors in the professional fiduciary business -- traditional banks and trust companies, but by previously unknown start-up DTC boutiques. The existing firms began to hear from dissatisfied consumers and their attorneys that bundled trust service models were in some circumstances not optimal in providing state-of-the-art technological and investment management services across the board. Yet, like the dominant firms in other industries that had come to grief at the hands of earlier disruptive models, the trust industry elites initially did nothing (or very little) to unbundle their trust service offerings, while the aggressive new DTCs continued to earn market share.

Big Firms Have Trouble Doing Small Things, and Lack the Institutional Agility to Change Course.

When a disruptive business model is in its infancy, it stays below the radar for a while. It is initially introduced on a small scale. Even though existing competitors may be vaguely aware of it, they do not perceive the innovators as a threat to their market share. By the time it has become clear that the market for the new model is scalable and in demand, it is too late for some existing competitors -- the early adopters have co-opted the business.

This situation has prevailed in the directed trust space from the beginning. In the mid 1990s, the market for new trust governance structures was simply too small to be appealing to the huge financial powerhouses that then dominated the institutional fiduciary services business. Many of these firms didn't just ignore this disturbing trend. Rather, they saw no reason to offer a service that they felt couldn't possibly boost their gross revenues or bottom lines. The "white shoe" firms may have been blinded by a desire to protect their gilt-edged brands by resisting any request that they go "down-market" for fear of being perceived as a low-cost provider. Meanwhile, the directed trust business was largely "branded" by a group of still-boutique-sized DTC providers that will likely dominate the market by the time the traditional players have taken a serious interest.

Sometimes a new business model simply can't be adopted by existing competitors because their cost structures are not built to suit it. Sears was an American retailing icon that was undercut by Wal-Mart's far lower costs, revolutionary "big box" approach, sophisticated just-in-time inventory management, and ruthless negotiations with its suppliers. Perhaps Sears, Nordstrom and others initially assumed that all of their customers would not go down-market for lower costs and more efficiency. They learned the hard way that their brands and customer loyalty alone could not stand-up to a compelling alternative value proposition.

Because full service trustees' profit margins had for decades been unusually high, cost structures in the industry grew correspondingly. Large salaries were paid to in-house investment personnel, and low-margin back-office tasks such as trust administration were often conducted out of Class A real estate space in money centers. The management to directed trusts disrupted the big providers' comfortable existence in at least two ways. First, by controlling their costs, the early DTCs were able to operate profitably in a business the traditional firms had priced themselves out of. Second, facilitated by the six progressive states' laws that eliminated the need for DTCs to embed a prudent investor risk surcharge premium, the DTCs usurped the pricing power and monopoly position of the bundled trustees. The traditional 100 basis points-based fee schedule used for so long by corporate trustees seemed confiscatory in comparison to the DTCs' custody-type charges.

In the less competitive pre-open architecture trust governance world, any bank trust department with a brand name could charge high fees for bundled personal trust services and encounter little if any resistance from trust settlors and beneficiaries. In the more competitive post-open architecture world, directed trustee services began to be perceived more as a commodity to be priced accordingly.

Corporate Cultures Resist Change

Any new business model that requires existing firms to adapt their cultures in radical ways has a gestation period before it gains traction. When Schwab and the other discount brokers launched their discount brokerage disruptive business models, many observers assumed that the old-line wirehouses would quickly follow suit. But in fact the wirehouses couldn't change, and their armies of brokers disappeared, changed careers or went "independent". Many offered expensive "wrap" products in a thinly-veiled effort to create an appearance of objectivity.

Open architecture-friendly DTCs and old-line bundled trustee firms are both engaged in the trust services businesses. But that's where the similarity ends. Like the old-line wirehouses and the discount brokers, the cultures of these two fundamentally different models could hardly diverge more. The traditional bundled model is all about investment performance and enhancing their number of "wealth management" services to compete with the RIAs, MFOs and other wealth managers. DTCs, on the other hand, are concerned exclusively with offering the best administrative services and technological platforms available. For the old-line firms, adapting to these secular changes in the marketplace requires nothing less than a top-down reengineering of the corporate culture.

A Large Embedded Customer Base is a Short Term Blessing But May Be a Long Term Curse

Like firms in other industries that were undone by new disruptive business models, bundled trust service firms have thousands of legacy trusts and clients who are indentured to the relationship because of the difficulty in securing the involuntary removal of an incumbent trustee. Or even in some cases many traditional consumers of personal trust services and their advisors are satisfied with the value of the comprehensive services they are receiving or are unaware that there are any alternatives (or just do not care to know of them). Since the old firms may not in many cases actually have been *losing* accounts except by natural attrition, they might fail to notice that their businesses are *failing to grow* as fast as they historically have. Eventually the bundled service firms' revenues will reach a tipping point. Existing customers who ultimately come to see the light will demand a more flexible approach, voting with their feet by abandoning many traditional providers in favor of the DTCs.

Incumbents' Responses to the Forces of Creative Disruption. The traditional providers of personal trust services have several options available to them:

Stick to Their Knitting, but Raise the Level of Their Games

Multi-participant governance structures will not serve every family's needs. Some will continue to be well-served by the high-touch approach and integrated offerings of elite bundled trust service providers that are committed to providing excellent service across all trustee functions. There will always be a demand for such "elite" full service corporate trustees.[15] Those who survive and prosper must, however, make an especially compelling case for their value propositions.[16]

Leave the Business

There will, however, be no seat left at the table for those traditional providers that are unwilling or unable to compete on the new playing field. The decisions by many firms over the last few decades to exit the personal trust business will seem astonishing to anyone not familiar with the open architecture phenomenon. But to those who understand the current dynamics in the industry, it was clear that these firms simply could not both compete effectively in the business and also manage their core banking, custody, global investment management, mutual fund, ETF and other operations.

Adapt to the New Model

A few of the traditional bundled service firms, especially those who were already second-tier providers, may convert themselves to true open architecture platforms. Some may eliminate their investment services altogether in favor of the potentially higher volume, lower cost directed trust business, and reduce their overhead by

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[15] The case for the continuing viability of full service corporate trustees is well-stated in Hauser, *Appreciating Corporate Trustees*, 32 Trusts & Estates 52 (August 2005), and Kurlander and Orazem, *The Shrinking Trustee*, 31 Trusts & Estates 33 (June 2004).

[16] Consulting firms studying the industry have issued dire warnings: (i) from Celent's November, 2007 report, *Trust Companies: Firms, Products, and Clients and Technologies --* "Trust Companies must either shake-up the business model or decline into irrelevance [if they remain] hostage to the old ways of doing business . . . [they must] blow up the investment management model [in favor of open architecture] and reposition those trusted investment officers into . . . the sales and service team . . . ."; (ii) from Tiburon Strategic Advisors' Managing Director Chip Roame, commenting on Tiburon's 2011 report and research findings on the trust industry -- "Banks have lost huge market share", and are spending too much time optimizing a "dead" business model, Trust Advisor, *infra*, note 12, www.thetrustadvisor.com/news/tiburon; (iii) from Trust Performance Report editor Bernard Garbo: "There are definitively some bank trust departments that have picked up on the [unbundled service] model, but they're still a little behind", *id*.

outsourcing their investment management and/or operations functions.

Try to have it both ways

This group will continue to offer high-profit-margin trust portfolio management services while also discretely offering some directed trust services – sometimes protecting the full service brand by "siloing" the directed trustee business in a separately-branded affiliate domiciled in a progressive trust state.[17]

How Creative Disruption Will Benefit Consumers of Personal Trust Services and their Advisors

What is the impact of all this ferment in the trust services marketplace on families and estate planners searching for new approaches to governance for their trusts? The main challenge for them is to learn enough about the available alternatives to the bundled model to be able to both evaluate them objectively and design them properly.[18] In a free-market economy, innovation and change are typically offer long-term benefits for consumers. But it can be confusing in the short term for people grappling with the new concepts. Here are a few suggestions for families and their advisors who may be searching for the right mix of corporate fiduciary services in a rapidly evolving industry.

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[17] An example is Wilmington Trust's 2008 acquisition of formerly closely-held directed trust provider AST Trust Company, which now operates as a Wilmington Trust subsidiary under the name Advisory Trust.

[18] Properly defining the role and potential liabilities of the multiple participants in a directed trust arrangement and coordinating their activities will be a challenge to trust attorneys. Some helpful trust drafting and modification suggestions appear in Diamond and Flubacher, note 1, *supra*, at 28-29, and in Duncan and Sarafa, *Achieve the Promise -- and Limit the Risk -- of Multi-Participant Trusts*, 36 ACTEC Law Journal 769 (2011).

More Flexibility to Negotiate for A La Carte Service Levels and Pricing Offerings

The most important casualty of the open architecture trust revolution will be the monopoly position occupied by institutional fiduciaries and the historic inflexibility of the fixed fee schedule. There is ample anecdotal and empirical evidence that this process is already well under way.[19] The early DTCs offered custody-type fee-schedule pricing (25 – 50 basis points) to reflect the relatively labor-intensive responsibility of executing the investment and distribution directions of the empowered parties. As directed trustee the DTC held legal title to trust assets and the third party asset custodians stubbornly refused to accept instructions from anyone other than the trustee holding legal title to the trust assets. This required the DTC to be compensated for the time and expense of its personnel executing investment and distribution directions and any risk (however negligible) of liability for improper execution.

Lately, however, DTCs in the preferred jurisdictions have been quoting very modest annual flat fees of $3,500 to $10,000 for trusts holding the equity interests of an unregulated “special purpose entity” (“SPE”) (typically a manager-managed LLC) established in the DTC’s home jurisdiction, irrespective of the value of the SPE’s assets. The SPE is the investment and/or distribution fiduciary holding legal title to the trust assets. The SPE contracts with third parties (often registered investment advisors and other professional managers) for investment management services. Although there

[19] *See* Hauser, note 13, *supra*, 32 Trusts & Estates at 53 (“Most firms are [now more] willing to depart from their fee schedules,” and offer *a la carte* menus of services and fees). *See also* Nesvold, *How to Make Money in Wealth Management*, 31 Trusts & Estates 42, 47 (August 2004) (describing Northern Trust’s program for offering unbundled services and flexible pricing, both basis points and fixed fees).

remain some unanswered regulatory issues concerning the use of these SPEs[20], they offer tremendous promise for families and their advisors looking for the minimal and least expensive connections to a progressive state to justify the application of that state's favorable trust laws.

Conclusion

For families and their advisors who are willing to do their homework on prospective new DTCs and the open architecture trust governance alternatives available to them in the progressive trust jurisdictions, and for traditional bundled service providers willing to consider serving in directed trustee roles, the new unbundled trust governance models offer the promise of vastly greater choice and many attractive possible permutations that can deliver best-in-class trust service across all trustee functions at a reasonable overall cost.

[20] The question is whether a SPE holding assets and administering them in a fiduciary capacity might be charged by the state's banking department with engaging in a regulated activity without trust powers. There is a bill pending before the South Dakota legislature that would establish the parameters of a regulatory exemption for such SPEs. *See* House Bill 1155, introduced in the 2011 session that would, among other reforms, add a new "Section 7" to S.D. Codified Laws 512A-6A to exempt certain SPEs from the necessity of seeking a trust charter, but would require each unregulated SPE to make annual reports to the Secretary of State and the Banking Department, and give the South Dakota Banking Department the discretion to examine the SPE. The author is unaware of any similar statutes or administrative pronouncements in any of the other five progressive states that address this issue.