THE PRIVATE TRUST COMPANY: *CAN IT RECONCILE THE COMPETING IMPERATIVES OF THE PRUDENT INVESTOR RULE AND THE SETTLOR'S DIRECTION TO RETAIN?*

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1. Overview.

A trustee who is subject to the law of a jurisdiction which has adopted the prudent investor rule (or which will invoke an obligation to diversify on the ground that it is an implicit common law duty inherent in the obligation to protect and preserve trust corpus) must consider carefully (a) whether the trust it is administering is in fact diversified, (b) if it is not, whether the trust agreement speaks to the issue of diversification and if so whether the language directs or merely confers a discretion to hold a concentrated position in an asset, (c) if the trust agreement does direct retention of a concentrated position, whether the direction is enforceable and (d) if the power to direct is conferred upon a third party such as an advisory committee or a protector whether the trustee is entitled to rely upon such directions as it receives without seeking court confirmation.

Responding to the concerns of trust companies and their counsel, several states of the United States have endeavored to isolate trustees from some of the harsher implications of the prudent investor rule, particularly where a trust agreement by its terms discourages diversification, by enacting legislation which holds a trustee harmless from acting on the directions of a protector or an advisory committee; and some states are presently considering the viability of "private purpose trusts" which have been developed and advocated by some of the offshore jurisdictions such as the Cayman Islands, Bermuda and the British Virgin Islands.

The legislation which holds harmless the trustee who acts on the "directions" of another fiduciary is helpful, but such protection may prove illusory in those jurisdictions which continue to hold a trustee liable to intervene when it knows or should know that the directions upon which it is acting endanger the trust corpus. Private purpose trust legislation holds the promise of wiping out the standing of beneficiaries to complain of loss on account of failure to diversify by making the retention of an asset the exclusive objective of a trust, but query (a) whether many

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(if any) American legislatures will endorse legislation which facilitates a perpetual trust for a private purpose which owes no duty to known or ascertainable individual beneficiaries and (b) whether, if they should endorse such legislation, any but the most uncommonly driven settlor will want a trust which is so constructed.

A private trust company ("PTC") does not diminish the relevance of any of the questions raised in the opening paragraph. The PTC does, however, permit a settlor, who wishes to donate in perpetual trust to his family assets which include concentrated positions in private or family controlled companies, to mandate retention with a greater degree of certainty that his mandate will be honored than would be the case if an independent financial institution (which is a more attractive target for second guessing and for a lawsuit by dissident younger generation family members) were asked to hold such assets subject to a trust.

2. To Diversify or Not…That Is the Question.

Forty-five states have enacted the provisions of the Revised Uniform Prudent Investor Act which require diversification, but in the view of many courts the Act's admonition to diversify is much more an evolution than a revolution because the duty to diversify for the purpose of reducing risk can be inferred from the historic common law duty to protect and preserve trust corpus. See, e.g. *Testamentary Trust U/W Dumont*, 4 Misc.3d 1003(A), 791 N.Y.S. 868 (Table at 3-4) (N.Y. Surr. 2004) ("The [Prudent Person Rule] itself did not require a trustee to diversify an estate, but diversification was a factor in the determination of prudence…Liability for lack of diversification is based upon a breach of a fiduciary's duty to prudently manage the estate."); *Rollins v. Branch Banking and Trust Company of Virginia,* 56 Va.Cir. 147, 2001 WL 34037931 (Va. Cir. Ct. 2002) ("By statute and common law, the duty to preserve ordinarily includes the duty to diversify the trusts' investments").

Diversification, when done right, is described as "the only free lunch (or nearly free lunch, at least) in investing…" subject to the caveat that even a well diversified portfolio can lose money. Diversification forgoes "…the occasional wild upside for protection against the inevitable one- or two-stock plunges that wreck undiversified portfolios." Saletta, *When Crystal Balls Break,* The Motley Fool (October 22, 2004).

Such theory is easily applied to a portfolio of investment securities and represents solid counsel to the prospective settlor who is excessively enamored of the stock of a publicly traded company for which he formerly worked as a senior executive or in respect of which he (alone or together with other members of his family) was *formerly* a controlling shareholder involved in management. The diversification theory does not, however, sit easily with prospective settlor who remains a control shareholder in a family company and who sees the company as a legacy for his heirs whom he hopes will join or follow him in the management of the company, as a continuing source of employment for the community in which the business is carried on and as a well spring for the support of civic good works.

So, what is a trustee to do if confronted with a request from a settlor that it accept assets which are concentrated and illiquid? Echoing the sentiments of many of their banking business colleagues Philip Hayes and Kay Henden have recently written that "[h]olding private company stock is fraught with peril: the trustee is holding a concentrated position over which it may have no control. Without supporting state law the trustee is at the mercy of the younger generation." Hayes and Henden, *Realities of the Trust Situs Marketplace,* 11 California Trusts and Estates Quarterly 25, 29 (Fall 2005).

A recent spectacular damage award rendered by a New York Surrogate's Court judge has focused special attention on the perils which confront a trustee who has failed to diversify, but the problem is not a new one. See, e.g. Riley, *Anatomy of an Attorney's Nightmare: How a Misconduct Charge Against Cleveland's Jones Day Got Caught Up in a $1 Billion Lawsuit,* 6 The National Law Journal 1 (November 21, 1983) (Lawsuit by Firestone heirs claiming among other things, that for 40 years the trustee had negligently failed to diversify trust assets by disposing of Firestone Tire stock which had been the source of wealth for the Firestone Family Trusts).

2.1 The Prudent Investor Rule.

The Prudent Investor Rule including the obligation of a trustee to diversify is set forth in the Uniform Prudent Investor Act 1994 §3. The Restatement (Third) Of Trusts, § 227(b) published in 1992 was responsible for the integration of the diversification requirement into the concept of prudent investing. §227(b) provides that "[i]n making and implementing investment decisions, the trustee has the duty to diversify the investments of the trust *unless,* under the circumstances, it is not prudent to do so (emphasis supplied)." Comment a to Restatement (Third) Of Trusts, § 229 allows that a "...trustee's decision to retain or dispose of certain assets may properly be influenced, even without trust terms expressly bearing on the decision, by the property's *special relationship to some objective of the settler* that may be inferred from the circumstances...Examples of such property might be land in a family farming operation, the assets or shares of a family business, or stockholdings that represent or influence control of a closely or publicly held corporation (emphasis supplied)."

Comment d to Restatement (Third) Of Trusts, § 229 acknowledges that the terms of a trust agreement may empower a trustee to retain a particular asset, but it advocates the necessity of distinguishing between a "direction" and a mere grant of "discretion". If a trust agreement clearly directs a trustee to retain investments that are part of the trust property at the inception of the trust, "...the trustee is not liable for retaining them..." unless the investment is illegal or circumstances change in a manner not known to or anticipated by the settlor. Restatement (Third) Of Trusts, § 228, Comment e makes manifest that a trustee is not liable for failure to diversify if the retention of an asset has been directed, but it cautions that if circumstances change and continued compliance with a trust direction to retain an investment would defeat, or substantially impair the accomplishment of the purposes of the trust, "... the trustee may have a duty to apply to the court for

permission to deviate from the terms of the trust." The conundrum for the trustee is of course: at what point does continued compliance with a retention direction defeat or substantially impair the purposes of the trust?

2.2 A Direction To Retain Must Be Grounded on a Proper Purpose.

If a settlor feels a strong personal attachment to an asset, he might provide in the manner of the late Joseph Pulitzer: "This power of sale...shall not be taken to authorize or empower the sale or disposition under any circumstances whatever, by the Trustees of any stock of the Press Publishing Company, publisher of 'The World' newspaper. I particularly enjoin upon my sons and my descendants the duty of preserving, perfecting and perpetuating 'The World' newspaper (to the maintenance and upholding of which I have sacrificed my health and strength) and in the same spirit in which I have striven to create and conduct it as a public institution, from motives higher than mere gain..." *Matter of Pulitzer*, 139 Misc. 575, 578; 249 N.Y.S. 87, 92 (Sur. Ct. 1931). Is an injunction so worded enforceable as a matter of American trust law?

It is important to distinguish as a matter of American trust law between

(A) a settlor direction (such as Pulitzer's) to retain a particular asset as part of the trust fund solely and exclusively because the settlor envisions as the purpose of his trust the perpetual retention of a particular asset such as a family farm or the stock of a family company; and

(B) a settlor direction to retain a particular asset as part of the trust fund so long as it serves the interests of the founding family including such of his children and remoter issue as are beneficiaries of the trust.

It has been a traditional American rule that a private trust (i.e., one which is not for charitable purposes) must be for the benefit of its beneficiaries who must be identified or ascertainable. See Restatement (Third) Of Trusts, § 27. This rule has been slightly relaxed in some states in order to allow trusts for the maintenance of domestic pets (after the death of the owner) and for the maintenance of gravesites.

Where trust terms have deviated from the foregoing rule by, for example, directing that the stock of a company shall be held for the duration of the period permitted by the rule against perpetuities or that during such period no buildings shall be built on an urban parcel in excess of three stories nor shall the space in same be leased for more than one year, American courts have effected modifications to the trust terms by invoking the doctrine of "equitable deviation". See, e.g., *Matter of Pulitzer*, 139 Misc. 575, 249 N.Y.S. 87 (Sur. Ct. 1931), *aff'd mem.,* 237 App.Div. 808, 260 N.Y.S. 975 (1932) and *Colonial Trust v. Brown,* 105 Conn. 261, 135 A. 555, (1926). Critics of these decisions have commented that, though correctly decided, they could more appropriately have been grounded on a violation of the requirement that a private trust must serve the interests of ascertainable beneficiaries.

2.3 The Risk to the Trustee Who Fails To Diversify.

Numerous cases have dealt with the issue of trustee liability for a failure to diversify, but none has garnered more publicity in the past eighteen months than *Testamentary Trust U/W Dumont*, 4 Misc.3d 1003(A), 791 N.Y.S. 868 (Table) (N.Y. Surr. 2004). The last will of Charles Dumont, an individual who had family history with the Kodak company which had created his family's wealth directed that "…It is my desire and my hope [precatory words as later noted by the Court] that said [Kodak] stock will be held by my said Executors and by my said trustee to be distributed to the ultimate beneficiaries under this Will, and neither my Executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they or it shall be held liable for any diminution in the value of such stock…The foregoing provisions shall not prevent my Executors or my said Trustee from disposing of all or part of the stock of Eastman Kodak Company in case there shall be some compelling reason other than diversification of investment for doing so." *Testamentary Trust U/W Dumont*, 4 Misc.3d 1003(A), 791 N.Y.S. 868 (Table) at 1.

The Surrogate determined that the trustee had failed to adequately construe the meaning of "compelling reason," that protective diversification (which the will enjoined) was to be distinguished from disposition by reason of material changed circumstances, that there was a disturbing deference on the part of the trustee to Eastman Kodak, a company with which the bank had material business relationships, that the trustee failed to appreciate that the trust was set up to benefit the trustor's family, not for the purpose of retaining Kodak stock (a direct allusion to the American rule that the only acceptable purpose of a private trust is to benefit its beneficiaries) and that the trustee had been inexcusably indolent and non-communicative throughout the term of the trust. Chase Manhattan Bank as successor by merger to the Lincoln First Bank (of Rochester New York) was determined liable as of June 25, 2004 for its failure to sell 95% of the trust's Kodak stock on or before January 31, 1974 and was accordingly surcharged $20,958,303.31 (including statutory interest calculated as from January 31, 1974).

The surrogate, in distinguishing the *Dumont* case from the earlier case of *Estate of Janes*, 90 N.Y. 41, 659 N.Y.S. 165 (1997), acknowledged that "vastly different standards for prudence" apply where, as in *Dumont,* the trustee is acting pursuant to a "retention clause". Ultimately, however, the only consolation afforded to the trustee in *Dumont* on account of the retention clause was a determination that the sale of 95% of the Kodak stock should have occurred not later than January 31, 1974 (after a precipitous fall in the value of Kodak stock) rather than in 1958 when the trust was funded. *Compare,* discussion of Restatement (Third) Of Trusts, § 228, Comment e, *supra* at §2.1. The decision of the Surrogate in *Dumont* is on appeal to an intermediate appellate court. Oral argument in the case was heard on September 14, 2005.

3. Statutory Relief for Following a Settlor or Advisory Committee Direction.

The "directed trust" has become commonplace in the United States. A trust is "directed" if the trustee's discretion in one or more respects is circumscribed by a provision in the trust agreement which either reserves to the settlor or grants to an advisory committee or a protector a power to control matters such as disposition of income and principal or the investment of the trust fund. Some states have confirmed by statute that a reservation of powers by a settlor will not render a trust an invalid testamentary instrument by reason of a violation of the statute of wills; others have sanctioned the evolution of the directed trust by judicial decision.

The question presented in America is not whether a state's law recognizes the directed trust as a "trust" but rather what consequences attach to a trustee's acting (blindly or otherwise) on the instructions received. As will be evidenced below, in reaction to the understandable unwillingness of institutional trustees and informed individual professional trustees to accept responsibility for determining that point at which it becomes imprudent to continue to honor the retention direction of a settlor who has renounced his power to revoke or has died, some states have endeavored to confer special protections upon a trustee who acts in an unquestioning manner upon the instructions of a fiduciary identified in the trust instrument as either an advisor or as a protector (which as one commentator has pointedly observed are in essence the same thing).

In evolving English trust practice, directed trusts appear not to have been seen as a solution to the tension between giving deference to a settlor's retention mandate and the risk implied for the trustee by such deference. Directed trusts have been characterized by some English trained commentators and a few courts as shams in form and "mere agencies". Accordingly it is not surprising that one such commentator has advanced the view that "…regardless of the extent of the powers of the protector and the extent of the exculpatory language…the trustee must recognize and honor his fiduciary obligations and question the protector when called for. If we were to hold otherwise, the very premise of the trust would fail, and to paraphrase another author, the trustee would not be a trustee at all but rather an agent for the protector." N. Lupoi, *Trusts: A Comparative Study* 258 (Cambridge Univ. Press 2000). This might explain the greater affinity for English law-influenced jurisdictions for the emerging "private purpose trust" as a solution to the resolution of the tension between giving deference to the settlor's order to retain and obedience to the prudent investor mandate to diversify.

3.1 The Delaware Rule.

Delaware statute law provides that "[i]f a governing instrument provides that a fiduciary is to follow the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act." Del.C. §3313(b). According to an unpublished bench ruling cited by commentary, a defendant trustee has successfully raised the defense of §3313(b) to an alleged failure to act in *R. Leigh*

Duemler v. Wilmington Trust Company (Del. Ch., Oct. 28, 2004) C.A. 20033, V.C. Strine. See Hayes and Henden, *supra*, 11 California Trusts and Estates Quarterly 25, 30.

3.2 The South Dakota Rule.

South Dakota statute law provides that "[a]n excluded fiduciary is not liable, either individually or as a fiduciary, for either of the following: (1) Any loss that results from compliance with a direction of the trust advisor; (2) Any loss that results from a failure to take any action proposed by an excluded fiduciary that requires a prior authorization of the trust advisor if that excluded fiduciary timely sought but failed to obtain that authorization. *Any excluded fiduciary is also relieved from any obligation to perform investment reviews and make recommendations with respect to any investments to the extent the trust advisor had authority to direct the acquisition, disposition, or retention of any such investment* (emphasis supplied)." SDCL §55-1B-2.

Commentators have remarked that the italicized language in SDCL §55-1B-2 which expressly relieves a directed trustee of the obligations to perform investment review and to make recommendations, had it appeared in similar form in the Virginia statute, would have "helped" the trustee in *Rollins v. Branch Banking and Trust Company of Virginia,* 56 Va.Cir. 147, 2001 WL 34037931 (Va. Cir. Ct. 2002). Engelhardt and Hayes, *Choice of Situs for Itinerant Trustees and Peripatetic Beneficiaries*, SL003 ALI-ABA 395, 419 (July 2005). See discussion of the *Rollins* case below at §3.4.

3.3 The Uniform Trust Code Rule.

Under §808(b) of the Uniform Trust Code, the trustee is required to follow a power holder's direction, unless it is manifestly contrary to the trust terms or the trustee knows (or should have known) that the direction constitutes a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust. Furthermore, under §§ 808 and 105, the trust terms can provide that the trustee must accept the decision of the power holder without question, and can even provide that the power holder is not acting in a fiduciary capacity. The Uniform Trust Code (UTC), the model trust statute of the National Conference of Commissioners on Uniform State Laws, has been enacted in whole or in part by 15 states. The full text of the 2005 version, the state enactment status and Commissioners' notes are available at www.utcproject.org.

3.4 If the Advisor's Power Is Fiduciary May the Trustee Ignore the Conditions or the Trust and Passively Follow the Advisor's Directions?

In most cases the advisor or protector upon whom a power to direct investment is conferred holds and exercises such power in a fiduciary capacity. Commentary by Alexander Bove has correctly assailed the notion that an advisor or protector is not in most instances a fiduciary. See Bove, *The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet?*, 30 Estate Planning Journal

390 (Aug. 2003); Bove, *Trust Protectors: Are They Friends of Fiduciaries? And Should Every Trust Have One?*, 144 Trusts & Estates 28, 29-30 (Nov. 2005).

If an advisor or protector giving investment directions to a trustee is a fiduciary, what responsibility lies with the trustee for monitoring the consequences of following such directions? Commentary seems to suggest that as a general rule a trustee can not completely divest itself of investment responsibilities even when the trust agreement purports to do so. Cf., Restatement (Third) of Trusts (Tentative Draft No. 4) § 75, Reporter's Notes. But can this be so if a state statute such as Va.Code § 26-5.2 expressly permits the exclusion of a trustee from exercising investment power and makes the excluded trustee "...liable if at all, only as a ministerial agent..."?

In *Rollins v. Branch Banking and Trust Company of Virginia,* 56 Va.Cir. 147, 2001 WL 34037931 (Va. Cir. Ct. 2002) the court acknowledge that as a matter of Virginia statute law it was the duty of the excluded trustee of a directed trust to follow the instruction of the trust's grantors that it not sell the shares of a textile company which had been placed in trust in 1977 but in respect of which catastrophic losses were being suffered by 1997. In what was doubtless however a shock to the trustee, the court held that common law continued to impose upon the trustee a duty to keep itself informed as to the conditions of the trust and an unavoidable "duty to warn" beneficiaries. Commentary advises that the *Rollins* case was settled after the decision, that it is not clear whether any substantial payment was made and that there is on account of the settlement no appellate decision. See Campisi, *Fiduciary Liability Issues,* SK089 ALI-ABA 1, 40 (Feb. 2005).

4. The Non-Charitable Purpose Trust: Redefining What Is a Proper Purpose.

4.1 The Cayman STAR Trust.

The Cayman Islands created a unique new form of trust in 1997 pursuant to the provisions of a statute known as the Special Trusts (Alternative Regime) Law, 1997, better known to international planners as the "STAR" Law. The STAR Law has subsequently been consolidated with the main body of Cayman Trust Law and is now contained in Part VIII of the Trust Law (2001 Revision).

The STAR trust at its inception was sufficiently exotic to draw protest from many in the English bar that STAR trusts could not be regarded as proper trusts and that they might result in the entire trust assets (thought to be held on trust) passing with the rest of the settlor's estate subject to his home jurisdiction's forced heirship laws and death taxes. See, e.g. Wadham, *Willoughby's Misplaced Trust* 190-191 (2nd Edition 2002); but cf. Hayton, *The Law of Trusts* 39-41 (4th edition 2003) ("Once an otherwise English trust is valid as a non-charitable purpose trust because, say, Jersey law has been made the governing law and an enforcer has been appointed, one wonders why such a trust should not be allowed to develop as a valid English trust *if limited to a valid perpetuity period and the purposes are certain and workable...*(emphasis supplied)."

The STAR Law incorporates the entire body of English trust law as it relates to ordinary trusts and powers but expressly detaches the trust from the inconvenient constraints imposed by the necessity of ascertainable objects. In place of ascertainable objects, there is a declared "purpose" and to ensure that such "purpose" is honored by the trustee, there must be an "enforcer" who is not to be confused with a "protector". See generally, Duckworth, *Protectors and Enforcers Compared*, IBC Offshore Trust Summit (Miami, October 2002).

The elimination of the rights of objects does not preclude a STAR trust from having beneficiaries, but unlike the objects of a traditional trust, such beneficiaries have no right to press the trust for distributions or indeed any right to information about the trust if the trust instrument so directs; and because the trust exists for a purpose rather than for the benefit of objects, the creators of STAR determined that STAR trusts are exempt from the rule against perpetuities and from the need for diversification of assets.

The characteristics attributed to a STAR trust have caused it to be promoted as the ideal vehicle for the settlor who as the patriarch of a family is concerned about who will succeed him in the ownership and control of the family business. In addition it is a viable solution for the ownership of a PTC which has been nominated to act as the trustee of one or more family trusts. See Walkers, *Cayman Islands; The Special Trusts (Alternative Regime) Law* at page 2.

The evisceration of the power ordinarily conferred upon the individual objects of a traditional private trust to insist upon adherence to their own economic interests begs the question: what happens if a STAR trust becomes unsuitable either because (a) it is impossible or impracticable, (b) it is contrary to public policy or (c) it is unsuitable by reason of changed circumstances? The trustee under such circumstances is obliged to make application for a reformation of the trust cy-pres. One fears, however, that by the time a court determines and orders appropriate modifications in the trust terms, the damage to the integrity of the corpus will have been done, particularly if the enforcer is lethargic and the trustee inert.

Antony Duckworth, who had a material role in the drafting of the STAR Law, responds that "[t]he main risk with regard to the enforcers is that through inattention, disinterest or otherwise, they fail to bring the delinquent trustee before the court. The answer may be to give the enforcers a *duty* to keep on eye on the trust [i.e., make the enforcer a fiduciary, but with an obligation to whom?](emphasis supplied)...Another approach is to give enforcement rights to people who stand to benefit from the trust or who have a personal interest in its objectives. Interest may be as powerful an inducement as duty." Duckworth, supra*, at 6.*

If the attainment of a particular purpose (e.g., maintenance of perpetual investment in a particular asset till it becomes so manifestly impossible, impracticable or unsuitable by reason of changed circumstance as to require a court-ordered modification of trust terms) trumps the economic interests and well being of the persons who are incidentally benefited by the purpose trust, the STAR

trust may be a solution (insofar as exclusive jurisdiction rests with the Cayman Islands) to the conundrum of how to accommodate a retention direction without exposing the trustee to surcharge for a failure to properly appreciate when changed circumstances have rendered continued retention of an asset unsuitable.

4.2 The British Virgin Islands VISTA Trust.

On March 1, 2004 the British Virgin Islands ("BVI"), which has subscribed to the conservative English view that excessive reserved powers such as are often associated with an American trust are indicative of a sham or mere agency, took what may be regarded as a very bold step by enacting the Virgin Islands Special Trusts Act, 2003 ("VISTA"). VISTA trusts are a carefully targeted response to what are characterized as the unintended and inappropriate consequences of the duty of prudence which a trustee is held to owe in respect of trust investment. See McKenzie and Glasson, *VISTA Trusts.*

The primary effect of the VISTA legislation is to place in the hands of the directors of a company, whose shares are held in trust, the ultimate prerogatives historically understood to belong to the controlling shareholder(s). This is a materially different approach from the one taken by the Caymans in its STAR legislation and seems fraught with many more policy concerns given the potential that the interests of the directors and officers of a company frequently diverge from those of its shareholders. McKenzie and Glasson advocate with considerable force that, if one is to take the historical perspective, trustees of the original English land trusts did not meddle in the everyday business operations of the land and that the "duty of care" so vigorously advanced by modern jurists is not a core requirement of a trust.

A VISTA trust (a) allows the indefinite retention of the shares of a company, (b) precludes the trustee from any intervention in the management of the company, (c) gives retention of company shares priority over the duty to preserve or enhance the value of the shares, (d) conditions any disposition of the shares by the trustee upon its having first obtained the permission of the company's board of directors and (e) precludes the trustee from exercising any power over the determination of whether and when the company should pay dividends.

McKenzie and Glasson assert that there is no public policy basis for objecting to a trust which grants to the directors of a company which it owns and controls unhampered management control because the settlor could have made a direct gift of the shares to the directors and because there is no difference between such arrangement and the purchase of an investment policy in respect of which the owner has no control over business conduct. The grant of untrammeled control to the directors of a company is nonetheless fraught with unpleasant possibilities both for the non-director beneficiaries and possibly also for the limited duty trustee unless the directors are themselves the exclusive beneficiaries. Cf., Campisi, *supra*, SK089 ALI-ABA 1,37-38 ("The catastrophes involving Enron, WorldCom and other meltdowns in public and private investments have left beneficiaries...with major losses and a fierce desire to find a deep pocket to fill theirs...The gunsights have

shifted from the malefactors…to the corporate fiduciaries who have served in limited roles in investment programs: custodial trustees in pension plans, directed trustees in private trusts…")

Nothing in the VISTA legislation prevents the trustee from distributing company shares to trust beneficiaries outright and free of the constraints imposed by VISTA, and McKenzie and Glasson advise that the articles of the underlying company should include provisions to insure a free flow of information to the trustee of the VISTA trust regarding the financial state and the activities of the company—information which may in some circumstances give the trustee cause for alarm and activate a duty to warn.

If a trustee is sufficiently concerned about the actions of the directors of a company held in a VISTA trust, it has the option of remaining passive or of proactively distributing the shares to one or more beneficiaries who are not bound by the constraints of VISTA. Depending upon the particular tax circumstances of the beneficiaries and the financial maturity of the beneficiaries, a trustee confronted with the option of either (i) continuing to hold shares of a company which is being mismanaged or is being operated by its directors for their own personal benefit rather than that of the shareholders or (ii) distributing shares to beneficiaries who might be ill positioned or ill suited to receive same is in a position hardly more enviable than that of the trustee who is obliged to determine whether changed circumstances warrant action in contravention of a retention order to protect the reasonable economic interests of the beneficiaries.

McKenzie and Glasson mention, but do not in their memorandum explore, alternative solutions to VISTA including, PTCs. They conclude without elaborating their reasons that all alternatives to VISTA have significant shortcomings. The Guernsey law firm of Ogier & Le Masurier has observed that: "…[VISTA] is designed to stretch the trust concept to its boundaries and has been designed specifically to enable a person to place the shares of a company into trust and at the same time shield the company from any trustee involvement." Ogier & Le Masurier, Ogier Trust Updater (Spring 2004). The option offered by VISTA will be appropriate in some circumstances; particularly it appears in those involving commercial matters, but VISTA's utility in the context of private family estate planning remains to be tested.

4.3 Several American Jurisdictions Have Enacted Purpose Trust Legislation To Accommodate Special or Short Term Interests.

Several American states have enacted legislation to permit trusts for the care of domestic pets that survive their owners and for the maintenance of gravesites. The UTC, which is significantly influencing the current development of trust law of states other than those which have already established their own advanced trust laws, provides in §409 that a non-charitable purpose trust may be created for a period not in excess of 21 years, but comment accompanying such section expressly advises that a period longer than 21 years could be prescribed by a state adopting the UTC if it saw fit.

American jurisdictions, which have been so ready to push the boundaries of trust law in other respects, have seemed reluctant to embrace (or have simply been disinterested in) the concept of an unconstrained private purpose trust. Arguably this is because (a) abolition of the rule against perpetuities has been accomplished without need to invoke the distinction between a trust for known or ascertainable objects and a trust for a purpose, (b) America has long been comfortable with the proposition that a reservation of substantial powers over a trustee is not inconsistent with the core concept of a trust and has accordingly seen the "directed trust" as a reasonable and expedient means to mitigate the conflict between a settlor's retention direction and the prudent investor imperative of diversification and (c) there has been a public policy disinclination to allow the closely focused vision and the strong will of a deceased individual to override the manifest economic best interests of the living beneficiaries (as they subsequently emerge) for a period in excess of 21 years.

The UTC does not alter the basic tenet that in order to be valid, all trusts must have a purpose that is lawful, not contrary to public policy, and possible to achieve. UTC §404. According to §404 and the related official comments, these criteria correspond to the common law cases that invalidated trust provisions that, for example, are purely capricious such that no benefit is provided by performance of the trust terms (e.g., house in trust to brick up the windows and doors for a period of 20 years; Scott, *The Law of Trusts*, Vol.2, Chap.5, §124.7 Capricious Purposes (4th ed. Aspen Publishers, Inc. 2001)).

Thus, the UTC allows a settlor to alter the traditional objective of maximizing trust benefits for the beneficiary, such that the trust terms can serve an intention that puts the trust property at risk. Yet, the tension and ambiguity of what the settlor intended (or can intend) does not disappear if a clear conflict arises between the interests of the beneficiaries and the direction to retain. Since the trust cannot be intentionally designed to create waste or accomplish a frivolous purpose, the private beneficiaries of the trust still have the argument that, at some point, continued retention will lead to waste or serve a frivolous purpose, which goes beyond the permitted intention of the settlor (or else, why are there beneficiaries at all?). This argument can be coupled with allegations of unanticipated changes in circumstances that also warrant divestiture. Accordingly, even a trust term that protects the trustee against personal liability does not eliminate the practical risk of an embarrassing attack on the trustee's continued retention, with the result that a settlement or court order results in divestiture.

4.4 Should American Trust Law Be Made More Permissive than the UTC in respect of Purpose Trusts?

Recent commentary has called for the introduction into the United States of broad-based purpose trust legislation similar to that adopted during the last fifteen years in various offshore jurisdictions, and it has recommended that in the interim estate planners consider (where the purpose of a trust is the achievement of a private object of the settlor with benefit to persons being

incidental) establishing the trust subject to the law of an offshore jurisdiction. See Bove, *Rise of the Purpose Trust,* 144 Trusts & Estates 18 (Aug. 2005).

Importation of such private purpose trust legislation into the United States either (i) by judicious and well-planned application of foreign situs law or (ii) by the enactment of private purpose trust legislation in the U.S. comparable to the Cayman Islands STAR Law would appear to make possible an unconditional trust directive such as Pulitzer's that a company and its newspaper should not be sold under any circumstance, *but would it really*?

Critics of the *Pulitzer* decision "...have suggested that the holding [in *Pulitzer*] could more candidly have been explained by recognizing that the settlor's direction in question was clearly not beneficial to the beneficiaries and served no proper trust purpose, private or charitable." Restatement (Third) Of Trusts, §27, Reporter's Notes. The court in *Pulitzer* in fact, however, grounded its holding upon the power of a court of equity to vary the terms of a trust to prevent ruinous economic consequences to the trust beneficiaries and indulged in the supposition that "[a] man of [Pulitzer's] sagacity and business ability could not have intended that from mere vanity, the publication of the newspapers, with which his name and efforts had been associated, should be persisted in until the entire trust asset was destroyed or wrecked by bankruptcy or dissolution." *Matter of Pulitzer*, *supra,* 139 Misc. 575, 580; 249 N.Y.S. 87, 95.

By such reasoning, a court sitting in the United States could as easily upset on equitable grounds a private purpose trust (under the terms of which the trustee is permitted to bestow benefit upon individuals) as it could a traditional trust for the benefit of known or ascertainable objects, the primary difference being that in the case of a purpose trust (conceived under legislation such as the STAR trust law), it would be the enforcer who would have the authority (and very arguably the duty) to make application for a variation of trust terms rather than the beneficiaries. If the enforcer should fail in such duty, is the trustee under a "duty to warn" such as was found in the *Rollins* case? Professor Hayton implies a similar caveat as a matter of English law in his qualified endorsement of non-charitable purpose trusts. See Hayton, *supra*, The Law of Trusts at 40 (discussed above in §4.1).

Alexander Bove asks rhetorically "...if an individual wished to provide for the long term maintenance of a private building without mingling that asset with other assets in a "person trust" (one that provided for individual beneficiaries, in which dispositive disputes could arise and restraint on sale of property could be overridden), *why* should he be limited to 21 years [the period during which a purpose trust is permitted to exist by UTC §409] (emphasis supplied)?" Bove, *supra,* 144 Trusts & Estates 18.

An answer to Bove's question is implicit in a decision rendered by the Connecticut Supreme Court of Errors in 1926 in response to an attempt by a testator to accomplish something similar to what Bove suggests should be permitted by the law. A trust declaration premised upon a private purpose may come to represent a violation of public policy if the purpose is not charitable and

the protracted (or under modern statutes, perpetual) maintenance of the building in its unaltered state may, in addition to benefiting no individual, threaten adverse effects upon "...the proper growth and development of parts of the city in which the lands in question are situated..." *Colonial Trust Co. v. Brown*, 105 Conn. 261, 286, 135 A. 555, 564 (1926).

The potential shortcomings and pitfalls of an unrestrained private purpose trust should not be invoked as a bar to further expansion of purpose trust legislation for specifically targeted needs. Purpose trust legislation can and should be expanded to include more than the care of surviving pets and the maintenance of gravesites. The use of a private purpose trust to solve the question of what to do with the shares of a PTC charged with administering dynasty trusts is but one example.

Close analysis of the implications of a private purpose trust as means for bolstering a retention direction in respect of a private company strongly suggests, however, both (i) that the purpose trust can not guarantee that a settlor's declared private purposes whatever they might be (in respect of real property or a family controlled company) will be honored in perpetuity (or at least until the forces of economics destroy the trust corpus) and (ii) that if the real object of introducing unrestrained purpose trust legislation into the United States is to accommodate the concerns of trustees regarding risk (without placing the trust beneficiaries in an untenable economic position or violating public policy), a PTC offers a better solution.

5. The Private Trust Company: Keeping It in the Family.

The private or restricted purpose trust company has emerged as a solution to the question of where a family of wealth turns if its asset base consists of concentrated positions in illiquid assets and if there is a desire on the part of the founder not to have such assets sold or liquidated upon his demise for the purpose of diversifying into a portfolio of passive financial assets. The following excerpt from a *Forbes* magazine article published in 1998 is illustrative:

> "Buffet demi-billionaire Stewart Horejsi of Salina, Kans. ..., founded Badlands Trust Co. In Sioux Falls, S.D. last year [1997]. Before that, he oversaw six trusts loaded with Berkshire Hathaway stock for the benefit of himself, his wife Fran, his grown children, John and Susan, and his 4-year-old grandson and 2-year old granddaughter. Then 60, Horejsi knew it was high time he named a successor but feared ceding control to a trust company
>
> 'I think they play defense more than offense,' says Horejsi, recalling that his company's $27 million profit-sharing plan was once 'mismanaged by a New York City trust department.' Horejsi also knew a corporate trustee would balk at holding almost nothing but Berkshire Hathaway, as he does: 'They'd want to diversify.'" McMenamin, *Trust Yourself*, 162 Forbes 400 62, 64 (Oct. 12, 1998)

A Notice of the Annual Meeting of Shareholders for the Boulder Growth and Income Fund, Inc. of Boulder, Colorado issued March 25, 2003 confirms that as of such date "Badlands is a trust company organized under the laws of South Dakota and is wholly owned by the Stewart R. Horejsi Trust No. 2, an irrevocable trust organized by Stewart R. Horejsi for the benefit of issue.

5.1 To What Standard Are PTC Directors Held re Trust Investment.

Two authors have commented that because the PTC board of directors is governed by the "business judgment rule" in making decisions, its members may make "bolder investment decisions on the investment of individual trusts than they could make if they were trustees of those individual trusts...[because as individual trustees they would be governed by the 'prudent investor rule.']." Hughes, *Family Wealth—Keeping It In The Family* 151 (Bloomberg, 2004); see also McMenamin, *supra*, Forbes 62.

Cautious reasoning suggests that being a board member of a trust company acting on behalf of such company in the discharge of its duties as trustee does not in and of itself permit one to act pursuant to the business judgment rule rather than the prudent investor rule. Antony Duckworth has argued persuasively in his writing on PTCs that it can not be a source of comfort to the directors that the fiduciary duty (however it might be defined) lies with the trust company rather than with themselves because "...equity may look through the corporate veil and fasten its rules upon those individuals who speak and act for the corporate trustee... [citation to *In re French Protestant Hospital* [1951] 1 Ch. 567]." Duckworth, *Private Trust Companies: Part 1,* Private Client Business [1997] 353, 358.

For the protection and comfort of the PTC board members, if it is the settlor's command that the trustee and the advisor (if any) should not be constrained in the discharge of their duties by the prudent investor rule, the trust agreement should expressly exempt both from a duty to act in accord with the prudent investor rule when administering the trust.

5.2 Prudent Risk Taking by the Family for the Family.

The most persuasive rationale for why the PTC can succeed in retaining concentrated and illiquid positions in family controlled companies and in real estate where the institutional trustee can not, or dares not try, is that the PTC has limited assets, is dedicated to the service of the family and is managed by members of the family. To borrow an observation of Duckworth in his comments on the wisdom and advantage of choosing as an "enforcer" of a STAR trust a person with an interest in such trust, "[i]nterest may be as powerful an inducement as duty."

Family members acting for a PTC will have the incentive of self interest (and a sense of obligation to the founder) to take the risks inherent in the retention of concentrated asset positions at least so long as they or other members of the family are involved in the management of such assets. Yes, if things go badly with

a concentrated position, some in the family will inevitably complain; but for the complaining family members to sue the PTC would be for them to sue the family itself.

Of course, the PTC should not be permitted to become a vehicle for advancing the personal interests of some family members over others. When fiduciary duty is confused by some dominant family members with entitlement, only bad can come of it. See Fitch, *Pritzker v. Pritzker*, 172 Forbes 142 (Nov. 24, 2003) and Maremont, *Pritzkers Settle Family Lawsuit; Cost: A Fortune*, The Wall Street Journal B1 (Jan. 7, 2005). Duckworth correctly observes that if a PTC (by action of its board of directors) commits a breach of trust and the PTC is sued, this may lead to "...a civil war in the family." Duckworth, *The Trust Offshore*, 32 Vanderbilt Journal of Transnational Law 879, 914 (1999).

5.3 The Tax Consequences of Family Members Who Are Beneficiaries Possessing Fiduciary Investment Powers Through a PTC.

Treasury Regulations clearly acknowledge that "[t]he mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements between income and principal, *exercisable in a fiduciary capacity*, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a [general] power of appointment..." which would render the power holder subject to gift or estate tax by reason of the possession or exercise of such power. Treas. Reg. §20.2041-1(b)(1); 25.2514-1(b)(1).

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This article should not be construed as legal advice, since legal opinions are only given to clients in response to inquiries involving specific facts.