The Intergenerational Transfer of Wealth

Why Fiduciary Status Matters to Asset Managers

By Eugene F. Maloney, Esq., and Daniel M. Miller, Esq.

The “greatest generation,” those Americans who lived through the deprivations of the Great Depression and fought and sustained this country through the unequalled perils and sacrifices of World War II, soon will bequeath upon their offspring, the baby boomers, another monumental achievement—the greatest intergenerational wealth transfer in history. For wealth managers and advisors, the implications of this tsunami of inheritances highlights the need to be prepared to properly administer fiduciary accounts as a significant part of their total product offering not merely to attempt to capture some portion of this wealth to manage, but more importantly, to be able to service the entirety of their existing clients’ portfolios, in whatever form they are held.

Background: Massive Transfer of Wealth to Baby Boomers

According to a study commissioned by MetLife from the Center for Retirement Research (2010) at Boston College, a staggering $11.6-trillion transfer of wealth soon will pass from the greatest generation to the boomers, who were born between 1946 and 1964 and range in age from 47 to 67.

Obviously, the actual amounts that most boomers will inherit vary greatly and mirror the general pattern of wealth distribution in this country. It is well-established that in the United States the top 1 percent of households hold 34.6 percent of the wealth and the next 19 percent own 50.5 percent (Mutnick 2011). Therefore, combined, the top 20 percent of households hold 85 percent of this wealth and their heirs will be the only ones who will receive significant investable amounts as a part of this transfer. In fact, according to the MetLife study, the average inheritance for those in the top 10 percent of households will be $1.1 million. Interestingly, the MetLife study also reveals that these prospective heirs are already rich and that their generous inheritances typically will constitute only 20 percent of the recipient’s net worth.

Given the fact that these heirs are already comfortable, it is reasonable to assume that the vast majority of this $11.6-trillion intergenerational windfall will be invested rather than spent. Furthermore, given prudent financial and estate-tax planning (which this top cohort of Americans can well- afford) it also is likely that the bulk of the $11.6 trillion passing from the greatest generation will be held in tax-saving generation-skipping trusts or similar fiduciary arrangements so that the inheritances will be excluded from their taxable estates. (Up to $5 million from a single grantor or $10 million from married grantors can be sheltered from estate tax through the use of a generation-skipping trust.) Therefore, even if inherited wealth will constitute only 20 percent of a typical client’s net worth, the presence of at least one fiduciary type account will become an increasingly common aspect of the boomers’ financial profile.

Fiduciary accounts, of course, have long been a staple of bank trust departments, which are familiar with fiduciary accounting, tax, and investment standards and are more than willing to seize upon this fortuitous business opportunity. However, this massive transfer of wealth also presents traditional asset managers, in particular investment advisors, with a unique and continuing opportunity to expand relationships with their existing clients (the wealthy boomer heirs) by adding fiduciary accounts to their existing product offerings. However, as always, traps await the unwary who are involved in the administration of fiduciary accounts. Some—but not all—of the most common of these traps are discussed below.

Trustee or Advisor to Trustee?

Only institutions formally chartered as banks, thrift, or trust companies can become trustees in their corporate form. Investment advisors, however, can become involved in the management of fiduciary accounts in two ways: 1) as an individual trustee (or executor) or co-trustee, or 2) as an investment advisor to another individual trustee or corporate trustee.

Asset Managers as Trustees

The first thing an investment advisor should consider before accepting a fiduciary position is whether professional insurance will cover their activities as trustee of a fiduciary account. Often it will not and the advisor must make a business decision as to whether or not to serve in such a fiduciary capacity. For this reason alone, most investment advisors prefer to act only as the investment advisor to a fiduciary account while the office of trustee or executor is held by other individuals such as family mem-
An investment advisor who nevertheless does decide to act as a trustee or executor in an individual capacity must understand that as the fiduciary owner of the account he or she also has assumed the role of the client as well, which leads to an unavoidable conflict of interest if you hire yourself or your firm as investment advisor to the trust. This type of conflict may be permitted by the terms of the trust, other legal doctrines such as implied waiver, or the consent of the beneficiaries, but it must nevertheless be managed in a forthright and fully transparent manner lest the fiduciary be charged with making secret profits or self-dealing. A trustee is not compensated to be an insurer of investment outcomes but will become one if conflicts of interest are ignored or nontransparent investments are used without fulsome disclosure to all stakeholders, including the beneficiaries.

Furthermore, as a compensated fiduciary, an investment advisor serving as a trustee also will confront unavoidable conflicts of interest regarding compensation, the use of affiliated or proprietary investment products, and the possible receipt of product compensation. In the case of a typical investment advisory client, such conflicts are disclosed by delivery of the advisor’s Form ADV to the client and managed by the terms of the investment advisory contract in which the client agrees to both conflicts and compensation. If the advisor is acting as a trustee or executor, however, there is simply no separate client who may consent to these conflicts or elect to take his or her business elsewhere if the terms offered by the advisor are not acceptable.

Finally, trusts and estates are subject to the jurisdiction of the local probate courts and any disputes relating to the investments and administration of the trust are likely to be resolved in that forum. This may be the case even if the investment advisor’s standard management agreement specifies arbitration of disputes because a local probate court is unlikely to agree that the trustee can oust it of jurisdiction over the trust by the terms of a contract made between the trustee and himself as investment advisor.

In the event that, notwithstanding all the caveats discussed above, an advisor does consent to serve as a trustee or executor, at a minimum the following items must be addressed:

1. The investment advisor should provide all adult beneficiaries with current copies of its Form ADV client disclosures, including any periodic updates.
2. Trust investments must be made in accordance with the terms of the governing instrument and the Uniform Prudent Investor Act adopted by the relevant state.
3. The investment advisor should prepare an investment policy statement for the trust articulating the trust’s investment objectives and goals as well as its proposed asset allocation and other relevant factors.
4. All compensation received by the investment advisor should appear in periodic statements submitted to the adult beneficiaries. If indirect compensation is received in the form of product compensation, such as Rule 12b-1 fees or shareholder servicing fees, these amounts (or at least the maximum percentages) also should be disclosed to the beneficiaries.

Disclosure to the beneficiaries is not conclusive as to issues of compensation and self-dealing, but it does provide beneficiaries with the opportunity to object in a timely manner to any action that they find unacceptable; this may well provide an effective defense against later claims made by informed beneficiaries. Ideally, adult beneficiaries should be asked to consent in writing to the investment policy statement and compensation to be received.

**Acting as an Investment Advisor to a Trustee**

In contrast to acting as a trustee, acting as an investment advisor to a trustee is much more congruent with an investment advisor’s traditional business model. Like any other entity, the trust is the client and acts through its management, the trustee or trustees. As such, upon receipt of the advisor’s Form ADV and execution of the advisor’s standard investment management agreement, the trustees can consent to properly disclosed conflicts of interest and compensation in the same manner as a typical client.

**Delegation and the Prudent Investor Standard**

Unlike a typical client, however, the trustees must invest in accordance with 1) the terms of the governing instrument, 2) the prudent investor standard mandated by the relevant state’s enactment of the Uniform Prudent Investor Act, and 3) the exclusive interests of the beneficiaries.

The terms of the modern prudent investor standard permit trustees to delegate all or part of their discretionary investment management activities to others provided certain requirements are met. Specifically, the Uniform Trust Code (UTC) Section 807 provides that:

(a) A trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in: (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) periodically reviewing the agent’s actions in...
order to monitor the agent’s performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with subsection (a) is not liable to the beneficiaries or to the trust for an action of the agent to whom the function was delegated.

(d) By accepting a delegation of powers or duties from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

If the above requirements are satisfied, the responsibility for the exercise of the delegated investment authority devolves upon the investment advisor. However, as subsection (a) of UTC §807 emphasizes, notwithstanding any delegation, a trustee employing an investment manager remains responsible for selecting the investment managers, defining the terms of the delegated authority, and monitoring the manager’s activities (OCC 2011, 119–120; Belcher 2007).

Collaborative Creation of an Investment Policy Statement

As contemplated by the UTC, delegation does not permit a trustee to completely abdicate all investment duties owed to the fiduciary account. Instead, it merely permits the trustees to employ an agent to carry out an agreed-upon investment plan or strategy. Therefore, before an advisor accepts an engagement to act as investment advisor to a trust or estate, the advisor and the trustees jointly should create a detailed investment policy statement of the fiduciary account that articulates a reasonable investment program appropriate to the account.

Ideally, in this document the trustees also should articulate why they believe such a plan satisfies the terms of the governing instrument, the prudent investor standard, and the specific needs of the beneficiaries. The advisor also should meet periodically with the trustees, review the progress of the current investment program, and discuss possible changes or enhancements to the current program. Minutes or summaries of these meetings should be prepared and circulated to create a contemporaneous record of all actions discussed, agreed to, or rejected. Revisions to the investment policy statement also should be dated and noted therein. Compliance with these documentation suggestions should prove extremely useful in the case of any subsequent controversy regarding why certain investment decisions were made.

You May End Up in Probate Court If Your Client Is a Fiduciary

Most investment advisors typically include provisions in their investment management agreements that require the arbitration of disputes that may arise in connection with their management or advice provided to a client’s account. Such provisions, however, may be deemed to conflict with the provisions of subsection (d) of UTC §807, which states that: “[b]y accepting a delegation of powers or duties from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.” This assertion of probate court jurisdiction, however, has not been strongly tested and may face constitutional and other legal challenges. Nevertheless, the possibility of being forced to arbitrate disputes with fiduciary clients as well as their beneficiaries is a business risk that advisors should fully consider before accepting fiduciary clients as clients.

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Endnotes

1 In addition to the matters discussed below, advisors to fiduciary accounts should be aware that the administration of fiduciary accounts also may involve issues relating to specialized fiduciary principal and income accounting and fiduciary income taxes that are beyond the scope of this article.

2 All states now have adopted similar versions of the Uniform Prudent Investor Act for fiduciary investment management activities. Specific state enactments are compiled at http://uniformlaws.org/Act.aspx?title=Prudent Investor Act. The requirements of this standard, diversification, etc., should be familiar to investment advisors.


5 This is a highly unsettled area of the law. Standard investment advisory agreements used by RIAs typically do not contemplate issues confronting fiduciaries such as court accounting or similar actions. See, In re Blumenkrantz, 14 Misc.3d 462, 824 N.Y.S.2d 884 (2006) (Enforcing arbitration provisions). The OCC Handbook on investment management services, however, counsels otherwise: “Leaving the trust beneficiaries without recourse against an agent for the agent’s willful wrongdoing would be a breach of the trustee’s duty to exercise care, skill, and caution in creating the delegation” (OCC 2001, 129).

Resources

Belcher, Dennis. 2007. Not My Fault—The Devil Made Me Do It! Responsibilities and Duties of a Delegating or Directed Trustee, Section

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11, 2007 University of Miami School of Law: Heckerling Institute on Estate Planning.


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