

Not Your Typical Incentive Trust: The ROTE and FST, Part 1

by Eileen Gallo, Ph.D.; Jon J. Gallo, J.D.; and James Grubman, Ph.D.



Eileen Gallo, Ph.D., is a psychotherapist in private practice in Los Angeles, California, where she works with individuals and families dealing with issues related to money. Along with her husband,

Jon Gallo, she is the co-author of two books on children and money and co-founder of the Gallo Institute. Their websites are www.galloinstitute.org and www.fiparent.com.



Jon J. Gallo, J.D., chairs the Family Wealth Practice Group of Greenberg Glusker Fields Claman Machtinger & Kinsella LLP in Los Angeles, California.



James Grubman, Ph.D., of Family Wealth Consulting, is a psychologist and consultant to families of wealth and the advisers who serve them.

His website is www.jamesgrubman.com.

In January, the three of us introduced the concept of the Results-Oriented Trust Environment (ROTE) and the Financial Skills Trust (FST) at the 45th Annual Heckerling Institute on Estate

Planning of the University of Miami School of Law. Instead of Eileen writing her typical Money & Soul column and Jon writing his Tax & Estate column, we decided we would jointly co-author both columns with James Grubman, Ph.D., and share our concepts with the readers of the *Journal*. This column lays out the problem, and the Tax & Estate column offers our solution.

Most estate planners and financial advisers have listened to clients expressing concern about the possible negative effects their money has or will have on their children. Most of us hear such comments as, “My child doesn’t have the slightest idea of the value of a dollar,” “She will blow through her inheritance in five years,” and, “If I leave my money to my son, he’ll never do anything with his life.”

Because of these reservations, one approach adopted by many estate planners and financial advisers is to suggest that their clients consider the use of an incentive trust. An incentive trust attempts to influence beneficiary behavior through the inclusion of carrot/stick provisions related to trust distributions and trusteeships. Beneficiaries who engage in behavior that the trust creator

seeks to encourage receive money and possibly trusteeships. Behavior that the trust creator seeks to discourage is punished through the withholding of trust distributions and trusteeships.

At first glance, the inclusion of incentive provisions in irrevocable trusts seems a reasonable approach. Why not motivate members of the next generation to engage in behavior the trust creator approves of and to discourage behavior the trust creator wishes them to avoid? After all, people

“It turns out that the behaviors on which incentive trusts typically focus are not reliable predictors of responsible money management.”

typically work for a living with their income contingent upon the satisfactory completion of that work. Doesn’t the business world pay for performance? Aren’t incentive estate plans merely a reflection of real life?

Despite the widely held belief that money makes the world go round, a review of the estate planning literature, as well as major studies in motivational psychology over the last 40 years and

anecdotal evidence, identify four major drawbacks to the use of incentive trusts:

1. Money is an effective incentive *only* if the behavior that is being incentivized is routine and boring, such as working on an assembly line repeatedly engaging in the same procedure hour after hour. It is not an effective incentive if the behavior that is being incentivized involves cognitive skills (memory, judgment, and reasoning). That leaves us with a paradox, demonstrated in more than 100 studies conducted in the last 40 years by institutions ranging from the London School of Economics and the University of Chicago to the Federal Reserve Bank of Boston. Using money as an incentive is typically not effective to develop the very skills incentive trusts seek to encourage in beneficiaries, such as work ethic, responsible money management, and empathy for others leading to involvement in philanthropy. In fact, money incentives actually decrease performance involving such cognitive skills as judgment and reasoning by converting what would otherwise be viewed as an interesting and challenging activity into routine work!
2. In the business world, there are well-documented studies in which using money as an incentive has led to unethical and sometimes illegal behavior by the employees being incentivized. Although unethical behavior by beneficiaries of incentive trusts does not appear to be well documented in the estate planning literature, there is anecdotal evidence that incentive trusts have inspired some beneficiaries to game the system and present the trustee with fraudulent evidence of income or school attendance in order to qualify for

incentive distributions.

3. It appears that many typical incentive provisions—particularly those relating to education and income matching—have little correlation with the ultimate goal of an incentive trust: that the beneficiaries become responsible money managers. It turns out that the behaviors on which incentive trusts typically focus are not reliable predictors of responsible money management. Both the estate planner who drafts the trust and the settlor who signs it most likely assume that such behaviors as graduating from college and being employed full time are evidence the beneficiary has attained a desired level of financial maturity and responsibility so that disastrous financial outcomes are unlikely. As most of us know from our practices, the fact that someone has substantial earned income or a college education is not in the least predictive of whether this person lives within his or her means, makes sensible investments, or avoids abusing credit.
4. Finally, the estate planning literature is filled with articles pointing out that incentive trusts tend to be inflexible and difficult to administer.

Money as a Disincentive

Why does money reinforce simple work tasks but often backfire for complex cognitively challenging tasks like money management? The answer lies in a 1908 study that produced what is known as the Yerkes-Dodson Law. If we view an activity as interesting and challenging, we want to do it. (This is sometimes referred to as the “Tom Sawyer Law” in honor of Tom getting his friends to whitewash the fence that he was supposed to do by convincing them it was fun.) Vice versa, if we view an activity as work rather than something interesting

and challenging, we are less incentivized. How do you turn an interesting and challenging activity into work? You attach money to it!

A fascinating study to this effect was undertaken by the Federal Reserve Bank of Boston in 2005. The Fed underwrote a study by four economists who traveled to a village in India and offered participants enough money that it could materially alter their lifestyle. There were 87 participants divided into three groups. Each group had to accomplish nine goals, six involving cognitive skills and three involving routine activities. Group 1 could earn one day’s pay for achieving the goals. Group 2 could earn two weeks’ pay. Group 3 could earn six months of income. There was no discernible difference at all between Groups 1 and 2. Group 3 did worse in eight of the nine activities, including every one of the activities involving reasoning, judgment, and cognitive skills!

On the most basic level, what do parents typically want for their children? Based on our work with families and estate planners over many years, we believe that most parents want their children to exhibit what psychologists call a strong sense of self-efficacy. Self-efficacy is the belief in one’s ability to succeed in life. It is a can-do attitude.

As advisers, few of us encounter parents who want incentive trusts when their children already possess a can-do attitude and strong sense of self-efficacy. Clients who are interested in incentive trusts are almost exclusively parents who complain about their children’s lack of self-motivation and self-efficacy. These children typically have a corresponding expectation (or need) to be supported financially by their parents.

As a demonstration of this, we encourage you to engage in a brief thought experiment. Make a list of those clients who have expressed an interest in the use of incentive trusts. Draw a

vertical line down the center of a piece of paper. Label the left side “strong self-efficacy” and the right side “poor self-efficacy.” Using the roster of clients from the first step, list those clients whose children exhibit a strong sense of self-efficacy in the left column and poor sense of self-efficacy in the right column. Compare the number of families in each. Typically, when estate attorneys or financial advisers are asked to engage in this experiment, the left column is blank or nearly so. What we take from this is that, often, clients are asking us to create a trust, which, in the words of an anonymous attorney, “makes up for lessons that were not learned as a child.”

Approaches to Incentive Trusts

There are three basic approaches to drafting incentive trusts:

Absolute Discretion. In this approach, settlors select a trustee who is perceived as sharing their values, and they provide the trustee with absolute discretion in making distributions of income and/or principal to the beneficiaries of the trust. In such a situation, the trustee’s discretion is generally tested using a good faith standard.

The Listing Approach. In this approach, behaviors that are incentivized or discouraged, together with the carrots and sticks attributable to meeting or failing to meet the designated criteria, are set forth in varying degrees of detail. Often the drafting attorney will use a restricted definition of ascertainable standards—health, education, maintenance, and support—to prepare the list.

The two most common forms of productive behavior encouraged are graduation from college and full-time employment. Beneficiaries who accomplish these goals often earn the right to receive distributions at an earlier age. Motherhood and caring for the home on a full-time basis are sometimes taken into consideration. Virtually all plans

grant the trustee the discretion to provide benefits if the child is physically or mentally disabled. Some of these plans provide partial or complete forfeitures if the child does not meet minimum standards. For example, current income not distributable to the child might instead be distributed to charity. Other plans provide for termination of the child’s trust and distribution of principal to charity if three to five consecutive years elapse during which the child fails to meet the minimum requirements for income or principal distributions.

The listing approach requires detailed specification of activities and behaviors. Recommended reading for those interested in finding out more about the listing approach to incentive trusts include Nancy Henderson’s *Managing Carrot and Stick Provisions: Selected Fiduciary Issues in Drafting and Administering Trusts with Incentive Provisions*; an ALI-ABA Course of Study, *Representing Estate and Trust Beneficiaries and Fiduciaries* (2008); and Joshua Tate’s “Conditional Love: Incentive Trusts and the Inflexibility Problem”¹ (concluding that incentive trusts pose an inflexibility problem because the settlor cannot foresee all potential eventualities and take them into account).

Behavioral Benchmarking. In the article “The Case for Principle Trusts and Against Incentive Trusts,”² David Handler and Alison Lothes argue against a rigid listing of behavioral benchmarks, such as graduation from college or full-time employment, and in favor of using what they refer to as principle trusts. In a principle trust, the trustee is provided with guidance embodied in a list of what the article describes as positive behaviors the client wishes to encourage. The article provides examples of various behaviors that might be on the list, such as pursuing an education at least through college, pursuing “gainful employment with a view toward being self-sufficient,” becoming “a productive

member of society by making meaningful and positive contributions to family, community, and society,” and handling “money intelligently and avoiding wasteful spending.”

The increased flexibility of the Handler and Lothes approach and its focus on behavioral benchmarks is a welcome contribution to the literature of incentive trusts. However, we believe that some of the benchmarks are so subjective that both the trustee and the beneficiaries lack guidance as to how the benchmark is to be met. For example, the trustee is to consider whether the beneficiary is “avoiding wasteful spending.” The application of this criterion appears to be entirely dependent on the trustee’s value system and not on the settlor’s values. Is a beneficiary engaged in “wasteful spending” if he purchases a 60-inch TV but not the 42-inch version? Moreover, many of the behaviors the trustee is asked to take into consideration are not necessarily indicators of the beneficiary’s ability to manage money responsibly. Being a college graduate does not guarantee that one is neither a miser nor a spendthrift.

Results-Oriented Philosophy

We believe it is possible to create behavioral benchmarks that are clear, objective, and more highly correlated with the beneficiary’s ability to manage money responsibly. We believe this can be accomplished based on a recent innovation in management practices known as a ROWE—Results-Oriented (or Results-Only) Work Environment. The ROWE was invented by Cali Ressler and Jody Thompson, executives who worked within the human resources department of BestBuy. They subsequently formed their own company and wrote *Why Work Sucks and How to Fix It*,³ in which they describe the concept as follows: “In a Results-Only Work Environment, people can do whatever they want, whenever they want, as long as the work gets

done.” Because there are no fixed hours but rather fixed goals, employees in a ROWE are evaluated entirely on their results.

The core principle of a ROWE is that those who possess the financial rewards (the managers of a company) should focus on and reinforce the goals or results desired, not necessarily any predetermined structure, methodology, or pace of how the results are achieved. In doing so, a ROWE encourages the development of necessary skills and behaviors in employees as well as their autonomy and their growth. Those with good intrinsic motivation and self-efficacy tend to rise to the challenge and perform well. Those who lack these important characteristics typically don’t sustain their work performance and do not get rewarded.

Suppose that the underlying concepts of a ROWE are applied to trust

drafting. If the primary goal of the typical incentive trust is to encourage responsible money management by the beneficiary, the focus in a ROWE would be on the goal—responsible money management—and not on the process by which the beneficiary achieved that goal, especially highly unreliable and indirectly connected activities such as going to college or full-time employment. It would be possible to identify behavioral benchmarks or component skills that are not only objective but that correlate directly with the beneficiary’s ability to manage money responsibly.

With a bow to Ressler and Thompson, we therefore suggest the outcome would be the creation of a ROTE: a Results-Oriented Trust Environment. Although incentive trusts may work for some beneficiaries who need just that little extra push that an incentive trust provides in order to get motivated to lead

happy, productive lives, most of the time and for most people, incentive trusts do not produce that result. We do not view the ROTE as an improved version of an incentive trust; it is an alternative, and its use is discussed in detail in our companion column in this issue.



Endnotes

1. Tate, Joshua C. 2006. “Conditional Love: Incentive Trusts and the Inflexibility Problem.” *Real Property, Probate, and Trust Journal* 41.
2. Handler, David A., and Alison E. Lothes. 2008. “The Case for Principle Trusts and Against Incentive Trusts.” *Trusts & Estates* (October).
3. Ressler, Cali, and Jody Thompson. 2008. *Why Work Sucks and How to Fix It: No Schedules, No Meetings, No Joke—the Simple Change That Can Make Your Job Terrific*. New York: Portfolio.

FPA
FINANCIAL PLANNING ASSOCIATION

DON'T JUST MAINTAIN YOUR CREDENTIALS. ADVANCE THEM.

FPA’s Virtual Learning Center provides solutions you need when you need them. We offer convenient continuing education opportunities through weekly live sessions and archives available when it’s best for you. With timely, compelling presentations by experts in a variety of relevant fields, we can help you meet your continuing education requirements, address your business management needs, and customize your learning to the way you practice planning.

- Take part in 1- to 2-hour live audio and web-based presentations
- Participate in a 10 to 15 minute Q&A period with expert speakers
- Qualify for CFP Board-approved CE credit and have it reported automatically for you by FPA
- Access popular past sessions through the VLC Class Archives

VIRTUAL LEARNING CENTER

Visit www.FPAnet.org/VLC to learn more!

VIRTUAL LEARNING

