

FIDUCIARY DUTY CLAIMS:

Trustees Managing Closely Held Business Interests

An Examination of the Duties of Trustees Managing Closely-Held Business Interests



David F. Johnson, Winstead PC, Fort Worth



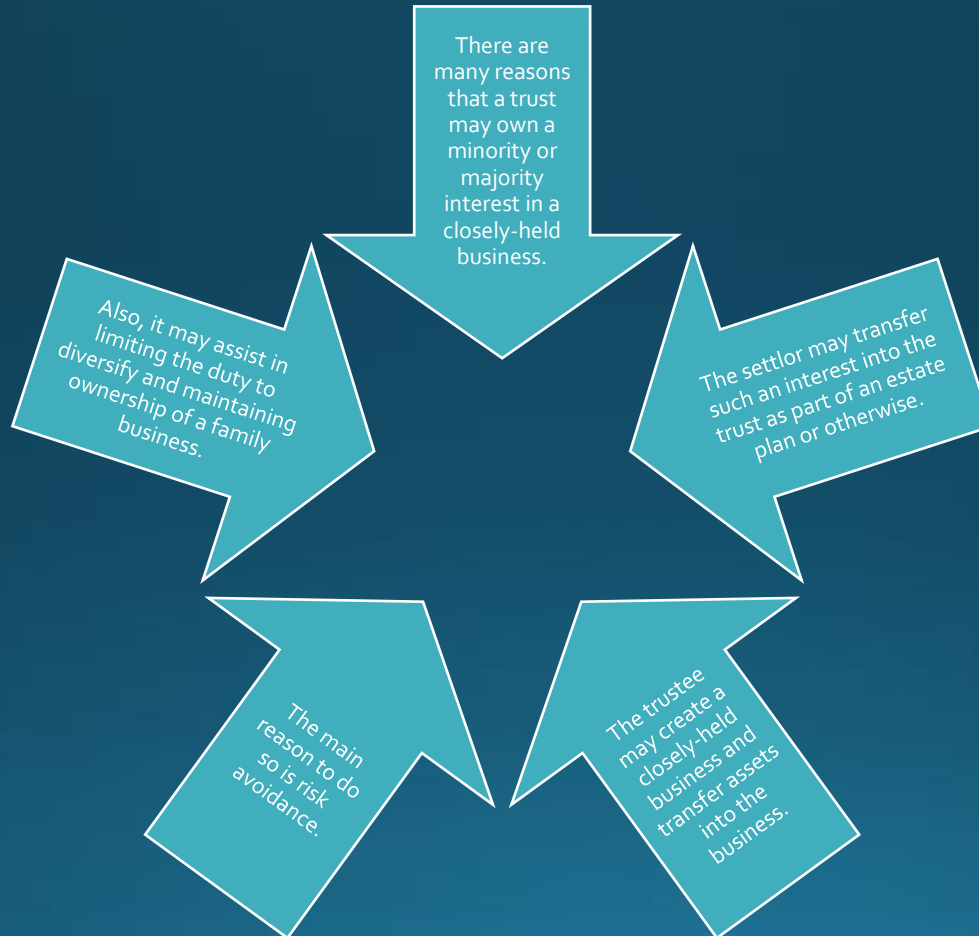
David F. Johnson

- Trust/Estate/Closely-Held Business Litigator
- Head of Winstead Business Litigation Group and Co-Head of Fiduciary Litigation Group
- 817.420.8223 | dfjohnson@winstead.com
- The author has a blog: Fiduciary Litigator (fiduciarylitigator.com)

Introduction

- Trustees have a difficult job in managing assets for the benefit of the beneficiaries.
- Trustees have high fiduciary duties of loyalty, prudence, impartiality, and disclosure.
- Often trusts contain interests in a closely-held businesses.
- This creates unique challenges for trust administration.
- This presentation will address these challenges and offer solutions.

Why a Trust may Own an Interest In a Closely-Held Business



Fiduciary Duties

- A trustee is held to the highest fiduciary standards:
 - Loyalty
 - Administer trust in good faith
 - Administer trust in accordance with terms and purposes of trust
 - Administer trust solely in interest of beneficiaries
 - Impartiality
 - Prudent administration
 - Use special skills or expertise
 - Exercise reasonable care, skill and caution
 - Make trust property productive
 - Keep books and records
 - Inform beneficiaries of material facts
- See Uniform Trust Code §§ 801–13 (2000).

Issues To Consider Before Investing

- There are several main drawbacks to investing in closely-held businesses:
 - Lack of Control: The inability to force dividends, influence board decisions, or dictate exit strategies.
 - Lack of Marketability: The “valuation discount” and the difficulty of finding a buyer for a non-controlling stake.
 - Information Asymmetry: Relying on majority owners for financial transparency and operational updates.
 - The “Locked-in” Problem: When the trust needs cash (for taxes or distributions) but the business refuses to issue dividends. Valuation Strategy:

Issues To Consider Before Investing

- There are other practical issues that may be good or bad depending on the circumstances:
 - Investing will create new duties to properly manage the ownership interests.
 - Investing may create principal versus income issues.
 - Investing may limit a trustee's ability to diversify assets.
 - Having a fractional interest in a business may devalue the business's assets: understanding discount for lack of marketability (DLOM) and lack of control (DLOC).
 - Having an interest in a business may make termination of the trust easier.
 - There may be tax benefits.
 - Placing trust assets in a business may make it easier to avoid probate if a co-owner dies.

Fiduciary Duty vs. Business Judgment Rule

The Conflict Between Standards

The Business Judgment Rule

- The business judgment rule is a standard of judicial review of corporate director conduct.
- It seeks to prevent courts from examining the **wisdom** of a corporate director's decision, instructing them instead to focus on the **process** by which the decision was reached.





The Business Judgment Rule

- The business judgment rule establishes a **rebuttable presumption** that a corporate director's decisions were made:
 - In good faith
 - With the care that a reasonably prudent person would use
 - With the reasonable belief that he or she was acting in the best interest of the company

The Business Judgment Rule

Example: Georgia

- Georgia **codified** its business judgment rule in 2017 :
 - “There shall be a **presumption that the process** a director followed in arriving at decisions was done in **good faith** and that such director has exercised **ordinary care**; provided, however, that this **presumption may be rebutted** by evidence that such process constitutes gross negligence by being a gross deviation of the standard of care of a director in a like position under similar circumstances.”



The Business Judgment Rule vs. Fiduciary Duties

- Directors in most states also have duties of loyalty, care, and good faith
- However, a Trustee's duties are generally seen as more stringent than a director's duties.
 - *See Paddock v. Siemoneit*, 218 S.W.2d 428 (Tex. 1949) ("Acts which might well be considered breaches of trust as to other fiduciaries have not always been so regarded in cases of corporate officers or directors.")

The Business Judgment Rule vs. Fiduciary Duties

- In *Stegemeier v. Magness*, 728 A.2d 557, 562 (Del. 1999), the Delaware Supreme Court held that the standard of fiduciary duty for a corporate director was not that for a trustee.
 - Self-dealing is virtually prohibited for trustees, but not directors (i.e., when a majority of disinterested directors approve the transaction).
 - Directors can be protected by business judgment rule – but not trustees.
- Applicable standard based on the “legal format the grantor chose to accomplish his purposes.”
 - If the grantor chose a trust, “the stricter principles of trust law must apply to the challenged transaction.”

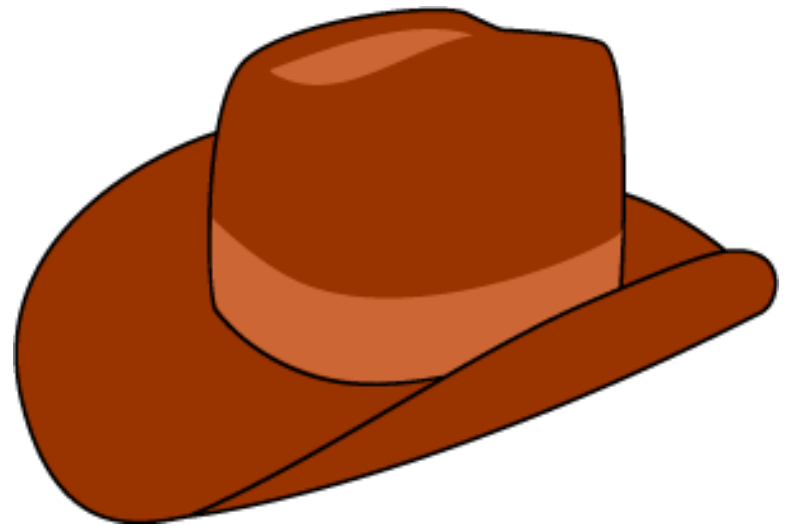
Competing Standards

- Some jurisdictions hold that there is a clear distinction between the person as trustee and as director/officer only where the trust does not have a majority of the corporate stock and does not, therefore, have control over the company.
- So, in these jurisdictions, if the trust has control over the company, the person's conduct regarding the operations of the company may be imputed to the person in his or her capacity as trustee and as an officer/director.
- Similarly, if a trustee has control of the company, some jurisdictions hold that the trustee must disclose company information to a requesting beneficiary.
- An party should be very careful to research the law in the relevant jurisdiction as this can have a drastic impact on the person's liability.

Conflicts and Privileges

The Attorney-Client Privilege

- Understand the capacity in which you represent a client who wears different hats.
- “Capacity” is the **legal role in which a person performs an act.** Black’s Law Dictionary 199 (7th ed. 1999).
- Person sued in one capacity is a different legal person from that person in another capacity.
Bender v. Williamsport Area Sch. Dist., 475 U.S. 534, 543–44 & n. 6 (1986); *Alexander v. Todman*, 361 F.2d 744, 746 (3d Cir. 1966).



Representing Different Capacities

Scenario: Trustee of trust owns controlling interest in closely held company, is an officer and director of the company, and beneficiary of the trust.



Capacities you might represent provide representation:

To the person individually (to enforce rights as beneficiary or defend against claims of wrongdoing).

To the person as trustee of the trust.

To the person as director of the company.

To the person as officer of the company.

To the company as its counsel.

Keeping the Capacities Straight

- When suing or defending a fiduciary who wears multiple hats, keep straight which duties tie to which hat.
- *Adam v. Harris*, 564 S.W.2d 162 (Tex. App.—Houston [14th Dist.] 1978, writ ref'd n.r.e.) shows this distinction:
 - Testamentary trust held controlling interest in trucking company.
 - Trustee was made director of company.
 - Company bought truck insurance from insurance company owned by trustee's brothers.
 - Beneficiaries sued trustee for self-dealing.
 - Trial court refused to award damages for self-dealing.

Keeping the Capacities Straight

- Appellate court agreed there was no self-dealing:
The flaw in [beneficiaries'] argument, however, is that whatever breach of fiduciary duty [trustee] committed was in his capacity as director of the truckline corporation and not in his capacity as trustee. [Trustee] did not self-deal with the trust property, the shares in the corporation, but rather with the corporation's property, the monies used to purchase the insurance for the trucks. Section twelve of the Texas Trust Act directs that a "trustee shall not buy nor sell . . . any property owned by or belonging to the trust estate . . . from or to . . . a relative" Here, no property either entered or left the trust res; the trustee neither bought nor sold trust property.

Keeping the Capacities Straight

Two
approaches to
avoiding the
result in *Adam
v. Harris*.

Approach #1:
Breach of
fiduciary duty
suit against
trustee.

- Failure to act as controlling shareholder to supervise board of directors and vote out self-dealing board members.
- Failure as controlling shareholder to bring shareholder derivative suit against breaching board members.
- Failure as trustee to properly manage trust asset.

Approach #2:
“Double
derivative”
suit against
directors.

- Sue derivatively on behalf of trust, since trustee will not sue himself.
- On behalf of trust as shareholder, sue directors derivatively on behalf of corporation.

If a Conflict Arises

- One person may need separate counsel in different capacities.
- For example, a trustee sued for breach of fiduciary duty may need two attorneys:
 - One to advise trustee on trust administration and management of closely held business.
 - One to defend breach of fiduciary duty suit.
- Separate representations help keep trustee's defense privilege intact in states that apply fiduciary exception.

Change in Corporate Management

When an attorney represents an entity, the client is the entity, not the individuals who manage the entity. See ABA Model R. Prof'l Conduct 1.13.

"[W]hen control of a corporation passes to new management, the authority to assert and waive the corporation's attorney-client privilege passes as well." *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 349 (1985).

Types of Closely-Held Entities

Types of Closely- Held Businesses

Corporations

S-
Corporations

Limited
Liability
Companies

Partnerships

Limited
Partnerships

Professional
Corporations

Controlling Law

- Beware the applicable statutory regime.
 - In many cases, the applicable law is set forth in the ownership documents.
 - If not specified in the ownership documents, the law of the state of organization generally governs.
- Statutory regimes contain both mandatory and default rules.
 - Default Rules apply unless an agreement of the parties specifies some other rule.
 - Mandatory Rules apply regardless of attempts to modify or override them.

Minority Shareholder Rights

Minority Shareholder Rights

Vote on Company
Action / Participate
in Management

Inspect Books and
Records

Preemptive Rights

Shareholder
Oppression

Derivative Actions

Receiverships

Petitions for
Dissolution

Limitation on Rights

- Absent a minority owner's having preemptive rights as discussed above, a minority owner has limited power to prevent the dilution of his ownership interest by share issuances or capital raises.
- Percentage ownership matters:
 - Entity documents may require a certain percentage of ownership to take action;
 - statutes may require a certain percentage to take action; and
 - Economics of potential derivative claims.

Limitation on Rights

- A minority owner may want to exit a business by simply selling their interest to a third party.
- This is rarely a viable option, however.
 - First, independent third parties would rarely want to pay adequate consideration to enter into a business when they have few management rights.
 - Second, even if such a third party could be found, there are normally restrictions in the governing documents that preclude an owner from selling his or her interest to a third party without the consent of the other owners.
- If done correctly, transfer limitations are enforceable.

Buy-Sell Agreement

- A contract (or provision in the governing documents) specifying how a member's interest may be liquidated.
- Well-drafted buy-sell agreements should specify:
 - Triggers activating a buy-sell right;
 - A method for determining price;
 - Payment terms and conditions;
 - Restrictive covenants; and
 - Remedies for non-performance.

Buy-Sell Agreement

The Buy-Sell Agreement should specify when a minority member or the company may exercise its rights under the buy-sell provision



Common Triggers:

Pure Option;

Death/Disability;

A Minority
Owner's Petition
for Dissolution;

Deadlock;

A Minority
Owner's
Voluntary or
Involuntary
Alienation of her
Interest;

Retirement,
Termination of
Employment;
and

An Offer to
Purchase all or
Part of the
Company.

Buy-Sell Agreement

- Methods for setting price:
 - Formula-Based Buy-Sell Agreements
 - Certificate of Value Buy-Sell Agreements
 - Appraisal-Based Buy-Sell Agreements
 - Shotgun Buy-Sell Agreements
 - Insurance-Funded Agreements
 - Right of First Refusal, with or without a discount

Buy-Sell Agreement

- A well-drafted buy-sell provision specifies additional terms material to the transfer of ownership interests:
 - Payment terms and conditions
 - Financing, earn-out options
 - Buyer's assumption of loans and liabilities
 - Indemnification
 - Confidentiality
 - Restrictive covenants on Seller
 - Employees and Board Members
 - Remedies for non-performance

Buy-Sell Agreement

- Best Practices:
 - Select a buy-sell agreement that addresses specific concerns of the owners: Deadlock, Retirement, Outside Ownership, Dissolution
 - Know where the money is coming from.
 - Financing, Payment Terms, Insurance Proceeds
- Account for changes and potential changes in the Company.
 - A fair valuation method in year 1 may not be fair in year 15.
- Specify material terms and conditions other than price.
- Beware of complications caused by family ties and personal relationships

Buy-Sell Agreement



GET TO A LAWYER *BEFORE*
PROBLEMS ARISE.



PREPARE A COMPREHENSIVE
OWNERS AGREEMENT.



A GOOD LAWYER CAN HELP
SAFEGUARD A COMPANY AND ITS
MEMBERS FROM DISPUTES
BETWEEN THE MINORITY AND
MAJORITY OWNERS WITHOUT
COSTLY LITIGATION OR A MATERIAL
IMPACT ON THE BUSINESS.

Strategic Management Approaches



Navigating Disputes & Exit Strategies

When Interests Diverge:
Dealing with “oppression”
of minority shareholders.



Exit Mechanisms:

Forced buyouts
(trigger events in
the shareholder
agreement).

Negotiated
redemptions.

Third-party sales (if
permitted).

Litigation as a Last
Resort: The high
cost and potential
for destroying
business value.

Best Practices for Trustees

Policies: Create trust policies for investments and communicate same to beneficiaries.

Documentation: Documenting the process of decision-making to protect against future beneficiary claims.

Communication: Setting expectations early with beneficiaries regarding the liquidity constraints of the asset.

Professional Counsel: When to involve corporate counsel vs. trust counsel.

Delegation: Using investment advisors or business consultants to satisfy the duty of prudence.



Written consents and direction from beneficiaries



Release agreements based on full disclosure



Modification of trust to create directed trust for investments and/or exculpatory clauses for concentrations or investments in closely-held businesses.



Suit for declaratory relief and judicial release.

Best Practices for Trustees

Conclusion



Summary: It is a marathon, not a sprint; patience and documentation are the trustee's best tools.

Final Thought: The goal is to maximize value for the trust while maintaining the integrity of the business entity.

Visit Blog:
www.iduciaryliterator.com

David F. Johnson

Winstead PC

300 Throckmorton, Suite 1700

Fort Worth, Texas 76102

(817) 420-8223

dfjohnson@winstead.com