Considerations for Administering Closely Held Business Assets in Trust

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Trustees face a number of complexities when administering a trust that owns interests in a closely held business. This article focuses on two of those complexities:

(1) Which standard of care applies to the trustee's business decisions: the fiduciary or the corporate standard of care?

(2) What is the trustee's obligation to produce information about the business to the trust's beneficiaries?

Because there is no national consensus on either of these issues, this article will first provide an overview of each issue and then review leading cases exemplifying the different approaches taken by courts.

STANDARD OF CARE

The standard of care that typically governs a trustee's conduct is among the highest under the law. It is perhaps stated best in the seminal case *Meinhard v. Salmon*:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[1]

1 164 N.E. 545, 546 (N.Y. 1928).

This heightened duty of care for a trustee exists because of the imbalance of power between trustees and beneficiaries, which does not exist in an arm's-length business relationship.

The fiduciary standard of care is generally set forth in the Uniform Trust Code (UTC), which has been enacted by the majority of states.[2] In adhering to the proper standard of care, a trustee must act in accordance with a variety of fiduciary duties, including the duties to act prudently,[3] loyally,[4] impartially,[5] and in the best interests of the beneficiaries.[6]

In contrast, the business judgment rule, which guides the conduct of corporate officers and directors, is relatively more lenient and provides a measure of protection to those acting on behalf of the business. While the laws of each state may vary, corporate law generally provides that officers and directors owe a duty of care to the business to act in good faith, in a manner reasonably believed to be in the best interests of the business, and with the care that a person in a like position would reasonably believe to be appropriate under similar circumstances.[7] Under this standard, courts will consider circumstances such as a director's responsibilities to the corporation, the information available at the time the action was taken, and a director's special background knowledge or expertise.[8]

The corporate standard of care is moderated, however, by the fact that courts are hesitant to second-guess business decisions and are instead more concerned with a director's decision-making process and whether the director used reasonable care to make an informed decision.[9] This judicial standard of review, which is more lenient than that applied to actions taken by a trustee, is commonly known as the business judgment rule. Under the business judgment rule, officers and directors have broad discretion in making business decisions, and courts typically defer to the officers' and directors' exercise of business judgment as long as they used a minimum level of care and there was some rational basis for the decision.[10] In Delaware and many other states, the business judgment rule creates a presumption that a business decision was made in good faith, on an informed basis, and with an honest belief that it was in the best interests of the business.[11] A party challenging a corporate decision must show one of the following to overcome the presumption of the business judgment rule: (1) no business decision was actually made (i.e., the directors are liable for an omission, not an action), (2) the decision was not made on an informed basis, (3) the directors were not disinterested (e.g., self-dealing transactions), or (4) the directors were grossly negligent.[12]

When a trust owns an interest in a closely held business, a question arises as to which standard—fiduciary or corporate—governs the trustee's conduct with respect to that business and the business decisions made by the trustee. The UTC provides some guidance and states that the corporate form cannot shield a trustee from the duty to act in the best interests of the beneficiaries:

> In voting shares of stock or in exercising powers of control over similar interests in other forms of enterprise, the trustee shall act in the best interests of the beneficiaries. If the trust is the sole owner of a corporation or other form of enterprise, the trustee shall elect or appoint directors or other managers who will manage the corporation or enterprise in the best interests of the beneficiaries.[13]

The comments to section 802 of the UTC state that "[t]he trustee may not use the corporate form to escape the fiduciary duties of trust law." For example, the trustee cannot hide behind corporate discretion to avoid the duty of impartiality.[14] The *Restatement (Second) of Trusts* also explains that a trustee's responsibility is heavier if the trustee holds a large proportion of shares in a corporation or if the trustee is in control or substantially in control of the corporation.[15] This position is consistent

2 *See Trust Code*, Enactment Map and Legislation, Unif. L. Comm'n, https://my.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d (last visited August 2, 2021).
3 Unif. Tr. Code § 804 (Unif. L. Comm'n 2000) (amended 2005).
4 *Id.* § 802.
5 *Id.* § 803.
6 *See id.* §§ 801–804.
7 3A Fletcher Cyclopedia of the Law of Corporations § 1032, Westlaw (database updated Mar. 2021).
8 *Id.*
9 *Id.*
10 *Id.* § 1036.
11 *Id.*
12 *Id.*
13 Unif. Tr. Code § 802 (Unif. L. Comm'n 2000) (amended 2005).
14 *Id.* cmt; *see also* Colo. Rev. Stat. § 15-5-803 (Westlaw through First Reg. Sess. of 73rd Gen. Assemb. 2021 legislation).
15 § 193 cmt. a (Am. L. Inst. 1959) (cited in the comments to section 802 of the Uniform Trust Code).

with the UTC in that, if the trust holds the entire corporation, the "corporate assets are in effect trust assets."[16]

Although an initial reading of section 802 and its comments might suggest that the fiduciary standard of care applies to all business decisions made by a trustee, it is not an open-and-shut case. For example, as the cases discussed below indicate, there has been much litigation about the applicable standard of care, and states have developed different rules and exceptions. In addition, some state statutes specifically recognize the business judgment rule as the applicable standard. For example, Colorado law provides that the business judgment rule is the standard of care for a fiduciary's formation of a successor entity.[17]

DUTY TO INFORM AND REPORT

In addition to questions surrounding the applicable standard of care when a trust owns an interest in a closely held business, a question also arises as to the trustee's duty to inform and report to the beneficiaries about the business entity owned by the trust. There is no consensus on the scope of a trustee's duty in this situation. As explained by the treatise *Bogert's The Law of Trusts and Trustees*,

> [m]any cases have held that beneficiaries of the trust are entitled to information about the business entity, especially when the trustee is an officer or director of the entity or, with the trust's interests, controls the entity, while other cases have held beneficiaries are not entitled to such information or have limited their right to receive it.[18]

Typically, the trustee of an irrevocable trust must "keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests."[19] This duty is fundamental, subject only to certain exceptions. As explained by *Bogert's,*

> [a]lthough the duty is fundamental and widely if not universally recognized, it is subject to several limitations. First, the duty extends only to information requests that are reasonable. Second, generally, while a trust is revocable, only the person who may revoke it is entitled to receive information about it from the trustee. Third, in many jurisdictions the duty may be modified by the settlor in the terms of the trust. Fourth, in limited circumstances, the trustee may properly deny certain information to beneficiaries who request it.[20]

These standard exceptions do not, however, address whether a trustee may withhold information about a business owned by a trust:

> The UTC does offer some guidance in this regard, explaining that a trustee is justified in not providing . . . advance disclosure [of a transaction involving a company owned by the trust] if disclosure is forbidden by other law, as under federal securities laws, or if disclosure would be seriously detrimental to the interests of the beneficiaries, for example, when disclosure would cause the loss of the only serious buyer.[21]

The UTC's guidance is limited, however, because it does not address the scope of a trustee's duty to disclose information about the business generally.

LEADING CASE LAW AND DIFFERENT APPROACHES

The leading authority addressing these issues comes from New York and Georgia, and the two states take different approaches.

The New York case *In re Shehan*[22] addresses both the applicable standard of care and the trustee's duty to produce information to the beneficiaries. *Shehan* involved a fiduciary who served not only as the executor but also as an officer and director of a related corporation and as a voting trustee of voting trusts with control of the corporation. The court held that the fiduciary should be held to the higher fiduciary standard of care even when acting in a business capacity and that he had to produce the corporate books and records to the trust's beneficiaries.

In reaching this decision, the court examined the precedent and concluded that, regardless of whether a trust, an estate, or a fiduciary owns a majority or minority stake in the corporation, a fiduciary with dual roles will be held to the higher fiduciary standard of care even when acting with respect to the business.[23] The court explained its understanding of the precedent as holding that

> a trustee whose conduct as officer and director is motivated by self-interest, to the injury of beneficiaries whose welfare

16 Unif. Tr. Code § 802 cmt. (Unif. L. Comm'n 2000) (amended 2005).

17 Colo. Rev. Stat. § 15-1-702 (Westlaw through First Reg. Sess. of 73rd Gen. Assemb. 2021 legislation).

18 George G. Bogert et al., *Bogert's The Law of Trusts and Trustees* § 962, Westlaw (database updated June 2020).

19 Unif. Tr. Code § 813 (Unif. L. Comm'n 2000) (amended 2005).

20 Bogert et al., *supra* note 18 (internal citations omitted).

21 Unif. Tr. Code § 813 cmt. (Unif. L. Comm'n 2000) (amended 2005).

22 141 N.Y.S.2d 439 (App. Div. 1955).

23 *Id.* at 447.

> should be his sole concern, is guilty of a breach of trust . . . [And the holding] does not depend on majority ownership. . . . The corporate entity has always been disregarded where necessary to prevent fraud.[24]

The *Shehan* court also analyzed the trustee's duty to inform and report. When considering a fiduciary's obligation to account, the court summarized the precedent as follows: "[B]efore a trustee must account or submit to examination regarding the general business affairs of a corporation, he must be dependent upon the estate stock for his connection with the corporation,"[25] meaning that a fiduciary's individual interest in the business would not typically trigger an obligation to account. However, because the case involved a claim of fraud against the fiduciary, the court concluded that there was no reason to insist on this showing under the circumstances and ordered the fiduciary to produce the corporate books and records for the time he was acting as executor and trustee, even though the estate did not wholly own the corporation.[26]

In addition to *Shehan*, other New York cases support the position that a trustee has an obligation to disclose at least certain information about the business. In *In re Witkind's Estate*, for example, the court discussed the rules for disclosure when an estate wholly owns a corporation as opposed to owning only a minority interest in a corporation.[27] When the estate wholly owns the corporation, a fiduciary may be required to account for the corporate transactions. In contrast, when the estate owns a minority interest and does not have access to the full financial records of the business, the fiduciary may not be required to account for corporate transactions because doing so would be impossible.[28] In *Witkind*, the fiduciary controlled a corporation and was therefore obligated to account because he had the ability to do so.[29] Although the fiduciary's control was obtained only by combining his individual interest in the corporation with the estate's interest (which he controlled in his fiduciary capacity), the court explained that this fact did not obviate the fiduciary's obligation to account because the fiduciary could nonetheless derive an individual profit from the business as a result of the fiduciary position.[30] Similarly, in another New York case, the court held that if trustees become corporate directors only because of the trust's ownership interest in the corporation, they must still account for their actions as directors.[31] This is true even if, as directors, they would not otherwise have to account unless they were charged with wrongdoing. The court reasoned that this was the rule because otherwise their wrongdoing would be concealed and they would be relieved from any substantial accountability.[32]

Georgia takes a different approach to these issues. Building on New York case law, Georgia courts developed an exception to the New York position that the fiduciary standard of care governs trustees acting in a business capacity. The exception applies where (1) the settlor indicates an intent that the corporate standard of care should control and (2) the trust owns a minority interest in the business. In such a situation, the corporate standard of care will apply to the fiduciary's corporate actions and duties.[33] The Georgia Supreme Court later clarified that the appropriate standard of care should be determined according to the capacity in which the fiduciary was acting and that both standards can apply to the same person in the same transaction depending on the particular role the person is playing.[34] For

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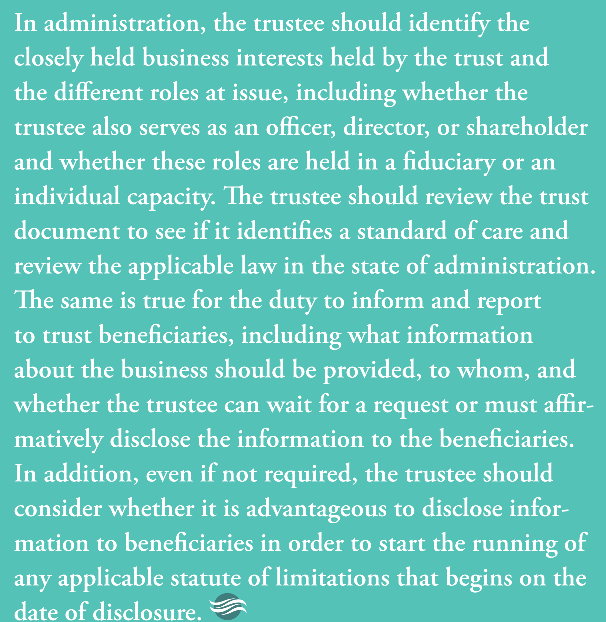
24 *Id*.
25 *Id*. at 446.
26 *Id*. at 449.
27 4 N.Y.S.2d 933 (Sur. Ct. 1938).
28 *Id*. at 945.
29 *Id*.
30 *Id*. at 946.
31 Farmers' Loan & Tr. Co. v. Pierson, 222 N.Y.S. 532 (Sup. Ct. 1927).
32 *Id*. at 546.
33 Rollins v. Rollins, 755 S.E.2d 727, 731 (Ga. 2014).
34 Rollins v. Rollins, 780 S.E.2d 328 (Ga. 2015), *vacated*, Rollins v. Rollins, 790 S.E.2d 157 (Ga. Ct. App. 2016) (applying the rule).

example, in the breach of fiduciary duty case at issue in *Rollins v. Rollins* (one in the series of cases that addressed these issues), the defendants served as partners of a family partnership in both their individual capacities and in their capacities as trustees of certain trusts.[35] At issue was the fact that the defendants amended the partnership agreement to name themselves managing partners and change the distribution scheme, which also impacted the trusts' beneficiaries. In addressing the defendants' conduct, the court found that, with respect to a claim that the defendants had breached their duties when they voted in their individual capacities to amend the partnership agreement, the conduct would be judged by the corporate standard of care.[36] On the other hand, with respect to a claim that the defendants had breached their duties when they voted as trustees of the trusts to amend the partnership agreement, the conduct would be judged by the fiduciary standard of care.[37] In reaching this decision, the *Rollins* court considered the settlor's intent and the nature of the business interest to determine what standard of care applied to a fiduciary acting in a corporate role.

Also in contrast to the New York cases, the Georgia cases support an argument for more limited disclosure of business information. While the Georgia Supreme Court did not articulate a standard for when business information must be disclosed by a trustee in *Rollins*, it did recognize that there may be circumstances where limited disclosure is appropriate. In reversing the Georgia Court of Appeals decision finding that the trial court had erred by not ordering an accounting of the business entities controlled by the trustees, the supreme court found that the court of appeals "failed to give due deference to the discretion of the trial court" and noted that "in determining whether a trustee's accounting is sufficient under a given set of circumstances, an appellate court must consider whether a trial court properly exercised its equitable discretion; and the decision of the trial court should be sustained where such discretion has not been abused."[38]

In addition, while many New York cases hold that a trustee must disclose business information, New York courts have also held the opposite in certain circumstances. In particular, if the fiduciary's individual interest in the business can be separated from the estate's or trust's interest, the court cannot compel the *individual* to account for the business. Similarly, if the estate holds less than a controlling interest in the stock of a corporation, there is a strong factual inference that the only authority over the corporation that the fiduciary possesses in a representative capacity is the usual one of receipt in the form of dividends.[39] Furthermore, if the trustee obtained information about a corporation as a result of roles held in an individual capacity, a beneficiary cannot require disclosure of such information when the trust owns only a minority interest in the same corporation.[40]



CONCLUSION AND PRACTICE TIPS

Because the governing statutes and case law may not provide clear guidance, the applicable standard of care and the fiduciary's duty to inform and report should be considered by both estate planning attorneys and those administering estates and trusts. As an initial matter, estate planners should determine the settlor's intent on these issues and provide guidance in the governing documents where possible. For example, the trust could include a specific reference to the standard of care applicable to the trustee's corporate decisions and a description of the types of business information the trustee is required to disclose to beneficiaries, particularly in states that allow the settlor to override any statutory standards of care and duties to inform and report.

In administration, the trustee should identify the closely held business interests held by the trust and the different roles at issue, including whether the trustee also serves as an officer, director, or shareholder and whether these roles are held in a fiduciary or an individual capacity. The trustee should review the trust document to see if it identifies a standard of care and review the applicable law in the state of administration. The same is true for the duty to inform and report to trust beneficiaries, including what information about the business should be provided, to whom, and whether the trustee can wait for a request or must affirmatively disclose the information to the beneficiaries. In addition, even if not required, the trustee should consider whether it is advantageous to disclose information to beneficiaries in order to start the running of any applicable statute of limitations that begins on the date of disclosure.

35 780 S.E.2d at 336.
36 *Id.* at 337.
37 *Id.* at 336.
38 *Rollins*, 755 S.E.2d at 730.
39 *In re* Sullivan's Estate, 6 N.Y.S.2d 783 (Sur. Ct. 1938).
40 *In re* Sylvester's Estate, 172 N.Y.S.2d 57 (App. Div. 1958).