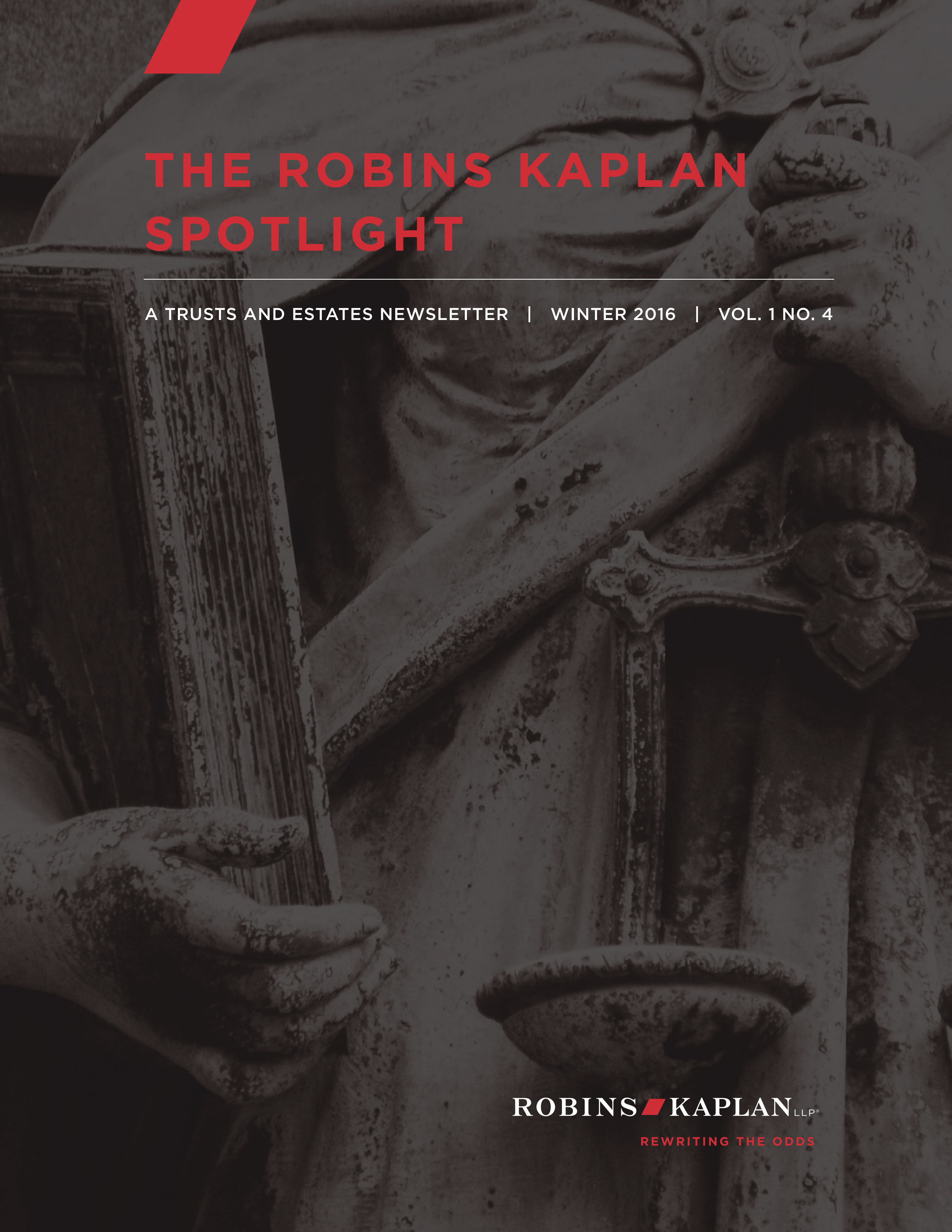

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ROBINS KAPLAN LLP

REWRITING THE ODDS

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LITIGATING TRUST DISPUTES IN SOUTH DAKOTA

BRENDAN V. JOHNSON, ANTHONY A. FROIO, AND MANLEEN SINGH

The greatest wealth transfer in history is underway. Baby boomers are expected to transfer approximately $30 trillion in assets to their heirs and other beneficiaries over the next 30 to 40 years. South Dakota is poised to be a focal point in that transfer. In 2013, 65 trust companies were chartered in South Dakota, authorized primarily over the past 15 years, and total assets surpassed $120 billion. In comparison, Minnesota had assets of just over $7 billion and no new charters since 2005. This article addresses strategies for litigating trust disputes and briefly describes how South Dakota became a magnet for trust assets.

UNDERSTANDING SOUTH DAKOTA DYNASTY TRUSTS

Most states still honor remnants of the arcane “rule against perpetuities,” a legal mandate essentially requiring a trust be extinguished and its funds distributed within a finite time period. In some instances, the rule involves many complexities that risk trust effectiveness and minimize available tax savings. In 1983, South Dakota abolished this rule, allowing trusts to last in perpetuity. See SDCL 43-5-8. The popularity of South Dakota dynasty trusts is also due to the state’s tax code. Of all the states that allow perpetual trusts, only South Dakota refrains from imposing any tax on trust assets. A South Dakota dynasty trust can be a powerful estate-planning tool.

LITIGATING TRUST DISPUTES IN SOUTH DAKOTA

As South Dakota's trust industry matures, the state will also become home to high-stakes trust disputes. The challenge for students of South Dakota's trust litigation practice is in understanding that, in South Dakota, the court is required to seal court filings and orders relating to trust actions if requested by a living trustor or by any fiduciary or beneficiary, and those documents are protected in perpetuity and unavailable to the public. See SDCL 21-22-28. Accordingly, the remainder of this article focuses on examples of our involvement in trust litigation and the lessons we've learned from serving those clients.

EXAMPLES OF TRUST DISPUTES

We represented a trustee of a trust with two categories of beneficiaries. Class A beneficiaries (charitable entities) received the proceeds of the sale of real estate, while Class B beneficiaries (settlor's heirs and friends) received the remainder of trust assets after payment of specific distributions and trust expenses. After the settlor's death, the trustee discovered an environmental hazard on the real estate that required cleanup before the property could be sold. The trustee allocated this cost as a general trust administration cost. Class B beneficiaries argued that it should have been charged against the proceeds from the sale of the real estate. Despite the trustee's numerous attempts to reach an out-of-court settlement, Class B beneficiaries filed suit in a court of general jurisdiction for breach of fiduciary duty for such allocation of clean-up costs, misappropriation of trust assets, and several other claims. While ruling that the trustee did not breach his fiduciary duty, the court held that the clean-up costs should have been deducted from the sale proceeds.

In another matter, a couple created a testamentary trust with their two sons as co-trustees. Upon the death of the surviving spouse, their sons would inherit the family business, and their three daughters would receive reasonably equivalent value from the sale of all remaining assets. Not only was there a dispute over "reasonably equivalent value," but the co-trustees had competing claims regarding business operation. Because of this, the three daughters and one co-trustee filed separate suits in different courts. For the other co-trustee, we filed suit in probate court, seeking instructions on asset valuation, which the parties mediated. The co-trustees disagreed on business operation, however, risking liquidation. Ultimately, on the eve of trial, they settled with the operational brother buying out the other.

We also represented a trustee facing allegations of breaches of fiduciary duty and unfair dealing. The wife died first, and the husband created an estate plan whereby he deliberately disinherited one child and bequeathed his assets in trust for the benefit of his remaining five children. His assets, among others, included three beachfront properties. The trustee was authorized, to the extent all beneficiaries agreed, to sell the beachfront properties to one or more beneficiaries. A dispute arose as to the trustee's attempt to sell the beachfront properties, and the trustee faced accusations that the sales were not arms' length and of preferential treatment to certain buyers.

LESSONS LEARNED

When a trust involves asset valuation, a trustee should commission an appraisal completed by a reputable appraiser using commercially acceptable valuation methods. Without it, disputes will arise questioning the reasonableness of the trustee's actions, whether the sale price represented fair market value, and the delay of distribution payments, to name a few.

Trustees should be wary of a catch-22 situation when the trust comprises multiple beneficiaries. Trustees have several duties with which they must comply, including the fiduciary duty, the duty to treat all beneficiaries equally, and the duty to strictly follow the trust terms. But, compliance with all duties may force a trustee into a situation where any decision could lead a beneficiary to raise an issue. Take the first example above: The trustee reasonably allocated the clean-up cost as a general trust administration cost, since the trust required her to sell the property and distribute the proceeds. Yet it would have been equally reasonable for the trustee to charge the costs against the sale proceeds, since the two were intertwined. The trustee's decision inevitably impacted the amount of distributions. Whichever allocation the trustee chose, one class of beneficiaries could argue that the trustee failed to treat them equitably, follow the trust's terms, or act as intended by the settlor.

One potential resolution of this catch-22 is going to court early. Seeking instructions early from the probate court, or other specialized court, may be the most cost-effective way to resolve disputes. This may seem counterintuitive, since formal court proceedings typically are lengthy and expensive. But, if done with careful thought and consideration, going to court early may avoid a lengthy and expensive trust administration process. Early is key. Trustees tend to wait too long before going to court, allowing disputes to simmer. But, trust disputes are not like red wine – they do not improve with age.

Going to court early is most effective when a trustee faces particularly aggressive beneficiaries focused only on dollars

Going to court early is most effective when a trustee faces particularly aggressive beneficiaries focused only on dollars. With a court order, such beneficiaries must accept the distributions rather than refusing to assent to accounting and forcing the trustee to continue to manage the trust assets and incur cost. If the trustee does not go to court first, she risks being taken there by these beneficiaries, who may deliberately choose a court of general jurisdiction, not a specialized court with the relevant experience. Such proceedings are almost always unduly prolonged and costly.

Trustees must also carefully choose litigation counsel. While a trust typically allows a trustee to hire counsel, the trustee must still act reasonably. A trustee cannot accrue substantial legal fees on the assumption that the trust will cover the cost. Instead, the trustee must carefully choose a law firm, with legal fees reasonable and proportionate to the dispute at issue. Trustees should insist on a reasonable budget and ensure that counsel does not exceed it. Consequences of a trustee's failure to check growing legal fees include being found guilty of breaching fiduciary duty and liable for payment.

PROPOSED IRC SECTION 2704 WOULD CURTAIL VALUATION DISCOUNT PLANNING

STEVEN K. ORLOFF, MATTHEW J. FRERICHS, AND NICOLE S. FRANK

The proposed regulations under section 2704 of the Internal Revenue Code (IRC) would significantly impact succession-planning strategies for family-controlled entities by reducing and restricting currently available valuation discounts. While the recent election outcome raises new questions regarding the future of this proposal, the current proposed rule, if finalized, would restrict the ability to take lack of marketability and minority interest valuation discounts, thereby constricting the ability to reduce federal estate and gift tax on intra-family transfers of closely held corporations and partnerships. Translated into numbers, the proposed regulations seek to reduce sustained valuation discounts of approximately 30 to 45 percent, to between 5 and 10 percent (or, in rare instances up to 15 percent) under the limited surviving theories of valuation discounts, such as a cost-of-liquidation discount.

The proposed regulations would make a number of changes to existing valuation methods, including: (1) For transfers made within three years of death, treat as an additional transfer the lapse of voting and liquidation rights of interests in a family-controlled entity (thereby eliminating or substantially limiting the lack of control and minority discounts for these transfers); (2) eliminate any discount based on the transferee's status as a mere assignee (and not a full owner and participant in the entity); (3) disregard the ability of most nonfamily-member owners to block the removal of covered restrictions unless the nonfamily member: has held the interest for more than three years; owns a substantial interest in the entity; and has the right, upon six months' notice, to be redeemed or bought out for cash or property (not including a promissory note issued by the entity, its owners, or anyone related to the entity or its owners); (4) disregard restrictions on liquidation that are not mandated by federal or state law in determining the fair market value of the transferred interest; and (5) clarify the description of entities covered to include limited liability companies and other entities and business arrangements, as well as corporations and partnerships. Perhaps most concerning for many is the proposed "three years within death" rule which applies to transfers that: (a) occurred within three years of the transferor's death; and (b) resulted in the transferor's loss of a liquidation right. The result is that the liquidated value of that transfer would be included in the transferor's gross estate for purposes of federal estate taxation. In addition, proposed § 2704(a) provides, in general, that the lapse of a voting or liquidation right be taxed as a transfer subject to gift or estate tax in instances where voting or liquidation control is held by an individual and that individual's family. As a consequence, the value of the lapsed right may be considered an additional transfer under the IRC.

In the short term, despite the current political climate and related uncertainty regarding the future of existing discount practices, clients with a known desire to make future intra-family transfers of non-controlling interests, or interests with a lack of marketability, in closely held corporations and partnerships may want to revise their timeline and make those transfers as soon as practicable in order to take advantage of the valuation discounts that are currently available. Unfortunately, even for transfers made today, if the client dies within three years of the transfer and after the date that the regulations are finalized, it is possible that the proposed "three years within death" rule could still reduce or eliminate the valuation discounts taken. Going forward, these clients and their attorneys should carefully consider how best to plan for gifts of closely held business interests.

FINANCIAL PLANNING AFTER A FAVORABLE VERDICT OR SETTLEMENT

MATTHEW J. FRERICHS

The conclusion of a lawsuit, whether through settlement or jury verdict, often signals the end of a hard-fought battle and may also mark the completion of legal work for that particular client. If the final resolution of the lawsuit involves a monetary award for the client, his or her need for legal advice and services may extend beyond the resolution of the claim. In these instances, a lawyer still may have some challenging legal work ahead in helping the client properly plan for and make use of his or her funds flowing from successful litigation efforts.

Many injured clients, particularly those who have sued in their personal capacity (e.g., a personal injury or medical malpractice action), may not have previously experienced wealth or relative wealth, much less instant wealth that may result from litigation. These clients may be unprepared to make appropriate decisions with a large sum of money. In addition, the client may be receiving public benefits or other assistance that could be jeopardized by the receipt of money from a settlement or verdict. Even financially sophisticated clients would likely benefit from some sound planning advice. No matter the particular client's situation and background, as a lawsuit approaches an end, involving an estate planning attorney to assist with proper planning can be an invaluable service to the client.

Settlement planning for clients who have been injured, or who have a family member who has been injured, often entails the use of a trust vehicle to hold the monetary award. The type of trust appropriate for a client depends upon his or her individual circumstances. The discussion below outlines three types of trusts commonly used in connection with settlements or verdicts.

SPECIAL NEEDS TRUST

A special needs trust (SNT) is a type of irrevocable trust frequently utilized when the injured party is receiving Medicaid or other public benefits. When properly drafted and administered, an SNT can hold assets for the benefit of the injured party and still not count against his or her asset limits for the purposes of Medicaid or Supplemental Security Income (SSI) eligibility. Under current law, only the beneficiary's parent, grandparent, legally appointed guardian, or the court can create an SNT. Further, the trust beneficiary must be "disabled" as defined by the Social Security Act[1] and must be under age 65 when the trust is created. Only the beneficiary's own assets can fund the trust (including, for example, structured settlement payments), and any distributions from the trust must be for the beneficiary's sole benefit. Upon termination of the trust (usually at the beneficiary's death), and prior to any other distributions, the remaining trust assets must first reimburse the state(s) for Medicaid benefits the beneficiary received during his or her lifetime. In addition to those mentioned above, the law places many other restrictions and prohibitions on the language used in the provisions of an SNT and regarding how and for what purposes the trust assets can be distributed.

SUPPLEMENTAL NEEDS TRUST

Like a special needs trust, a supplemental needs trust (SuppNT) is an irrevocable trust commonly utilized when a person is receiving public benefits. As with an SNT, the beneficiary of a SuppNT must be "disabled" as defined by the Social Security Act or the SMRT. When properly drafted and administered, the assets held in a SuppNT will not count against the trust beneficiary's asset limit for the purposes of Medicaid or SSI eligibility. Unlike an SNT, a SuppNT is funded with the assets of a third party (e.g., the beneficiary's parents). Upon termination of a SuppNT, there is no requirement to reimburse the state for Medicaid benefits that the beneficiary received during his or her lifetime.

For an injured person who is not receiving public benefits, an irrevocable support trust can be an effective settlement-planning tool

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IRREVOCABLE SUPPORT TRUST

For an injured person who is not receiving public benefits, an irrevocable support trust can be an effective settlement-planning tool. Sometimes called a "Settlement Trust" or a "Settlement Preservation Trust," the purpose of such a trust is to preserve and protect the beneficiary's assets and ensure appropriate use of the trust for the beneficiary's needs. Estate planning attorneys can draft these types of trusts in much less restrictive ways than SNTs or SuppNTs and tailor them to permit a wide range of permissible distributions for the benefit of the trust beneficiary.

There are many other planning and drafting considerations, legal requirements, and restrictions involving each of the trusts described above—far too many to address here. In particular, SNTs and SuppNTs are heavily regulated, and attorneys must be familiar with the relevant laws, rules, and regulations governing these trusts. In addition, attorneys must consider the relevant income and estate tax laws and prepare themselves to offer the client practical advice, such as how to choose a suitable trustee.

If a practitioner is considering utilizing any type of trust to hold a monetary award for a client or family member of a client, he or she should consult with an experienced estate-planning attorney to assist in selecting the appropriate trust vehicle, drafting the trust, funding the trust, and advising on proper trust administration.

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1. In Minnesota, a disability determination may also be made by the State Medical Review Team (SMRT).

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