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# Business Trusts, S-Corp Trusts, Pre-Mortem Planning and Other Recent Developments in Trust and Estate Law

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# Business Trusts, S-Corp Trusts, Pre-Mortem Planning and Other Recent Developments in Trust and Estate Law

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## I. INTRODUCTION

The law of trusts and estates intersects and overlaps with business law and business planning on a frequent basis. The intent of these materials is to outline several of those areas.

## II. BUSINESS TRUSTS

### A. STATUTORY AND HISTORICAL OVERVIEW

The use of business trusts flourished in the nineteenth century because of advantages over the corporate structure. Corporations were creatures of statute with many limitations such as minimum numbers of directors, restrictions on the permissible number of shareholders, prohibitions on owning real property or corporate shares in other firms, and limitations on the purposes for which corporations could be formed -- limitations not present with trusts. The formation of a trust was also easier to accomplish than seeking the state sanction required for the creation of a corporation.

Over time, revisions to state corporation laws gave corporations the upper hand and the use of corporations overtook the use of trusts for business undertakings. Corporate laws became more permissive, while guaranteeing certainty in limited liability protections. Limited liability protections for trusts lagged behind.

The widespread use of business trusts has therefore eroded. Today, however, business trusts are still utilized in a variety of applications, primarily in structuring mutual funds, in real estate investment trusts, and in asset securitization.[1]

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[1] Thomas E. Rutledge and Christopher E. Schaefer, *The Trust as an Entity and Diversity Jurisdiction: Is Navarro Applicable to the Modern Business Trust*, 48 REAL PROPERTY, PROBATE AND TRUST J. 83 (2013).

## 1. SDCL ch. 47-14A

Business trusts are unincorporated associations created by a governing instrument under which property is managed and business activities carried on by a trustee for the benefit of trust beneficiaries.[2] A certificate of trust must be filed with the South Dakota Secretary of State. Beneficial owners are entitled to the same limited liability treatment as shareholders of corporations and the trustee is not personally liable for acts of the business trust when acting in the capacity of trustee.[3]

## 2. Formation and Maintenance Requirements

The certificate of trust to be filed with the Secretary of State's office must set forth the trust's name, the name and address of at least one trustee, and the trust's effective date unless the trust is to be effective upon filing.[4] All of the trustees must sign.[5]

## 3. Uniform Statutory Trust Entity Act

The National Conference for Uniform State Laws enacted a proposed uniform act for business trusts in 2009.[6] About 30 states recognize business trusts, but only two jurisdictions (Kentucky and Washington, D.C.) have enacted the uniform act.

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[2] SDCL sec. 47-14A-1(1)(a).
[3] SDCL sections 47-14A-5, 47-14A-6.
[4] SDCL sec. 47-14A-43.
[5] SDCL sec. 47-14A-49(1).
[6] The NCCUSL website states:

> The Uniform Statutory Trust Entity Act (USTEA) provides statutory validation of the trust form as a mode of business organization. The entity arising under the act, the statutory trust, provides a flexible business entity that can be used as an alternative to the partnership, limited liability company, and corporate forms of organization. The trust form is commonly used in the mutual fund and securitization industries, and it is also used in certain tax-advantaged real estate transactions.
>
> Although 30 states have enacted legislation validating the trust as a permissible form of business or organization, much of this legislation is unclear, out of date, and incomplete. The statutes are also inconsistent across the states, or simply silent, on critical issues such as the applicable underlying source of law, principles of limited liability, and the permissibility of series trusts.
>
> In the last twenty years, most statutory trusts have been organized in Delaware under the Delaware Statutory Trust Act adopted in 1988, and most of the state legislation since then has been patterned on the Delaware Act. For this reason, the USTEA was likewise modeled on the Delaware act, but with a host of important refinements and improvements.

## B. PLANNING OPPORTUNITIES AND PITFALLS

Business trusts have historically been utilized primarily with mutual funds, pension plans and in the structured finance industry. Common law trusts have typically been governed by trust law and a separate body of business law has not kept pace with the use of business trusts as a substitute for corporations or limited liability companies. Primarily, business trusts would be used as a mode of business organizations although there is also the opportunity to use the business trust entity as a substitute for ordinary trusts in a noncommercial context.

## C. JURISDICTIONAL ISSUES

For purposes of diversity jurisdiction in federal court, a corporation is deemed to be a citizen of the state where it incorporated and also the state in which it maintains its principal place of business (assuming that this is a different state) with the result that it can be more difficult to assert diversity jurisdiction against a corporation.[7] With unincorporated associations, the association was deemed to be a citizen of every state in which a beneficial owner lived.

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- Unambiguous entity status – Under the USTEA, a statutory trust can hold property, sue and be sued in its own name, and provides investors with limited liability akin to that in a corporation or limited liability company.
- Flexibility for commercial needs – Under the USTEA, a statutory trust can be adapted for use by any type of business, large or small; can have one or more trustees, various classes of beneficiaries; and can have any characteristics set forth in the governing instrument, subject to several mandated prohibitions grounded in public policy, such as a proscription against indemnification for bad faith or willful misconduct.
- Series trusts – The USTEA provides comprehensive statutory guidance on the use of series trusts, including notice provisions to protect third parties, clarification of the relationship of each series to the statutory trust, and clarification of liability rules for a series trust. Series trusts are used throughout the mutual fund industry.
- Separation from donative trusts – The USTEA prohibits the use of a statutory trust for donative purposes, protecting the integrity of the state's laws regulating the use of trusts in donative transfers.
- Clarity and simplicity – The USTEA addresses public filing rules; the operation of foreign statutory trusts; conversion, merger, and dissolution of statutory trusts; and the relationship between the common law trust and statutory trust entities.
- Uniformity – The USTEA reconciles the varying and often inadequate existing state laws pertaining to business trust entities, promoting interstate commerce and bringing to rest the legal uncertainty surrounding the use of the trust form as a mode of business organization.

http://uniformlaws.org/Narrative.aspx?title=Why States Should Adopt USTEA (visited October 1, 2013).

[7] 28 U.S.C. sec. 1332(c)(1).

In the case of *Navarro Savings Association vs. Lee*, the United States Supreme Court held that the trustees of a business trust, being the real parties in interest, would be looked to for purposes of determining diversity of citizenship.[8] This holding ran counter to the accepted rules for unincorporated association where the citizenship of all its individual beneficial owners is considered (thereby defeating, in many cases, diversity jurisdiction).[9] Arguably, the Uniform Statutory Trust Entity Act departs so markedly from the old model of business trusts that the accepted rule for unincorporated associations would apply in states which have adopted the act.[10]

## III. **S CORPORATION SHAREHOLDER-ELIGIBLE TRUSTS**

S Corporations may have as many as 100 shareholders, but only certain types of shareholders.[11] In general, a trust may not be a shareholder of an S corporation. However, there are certain specific and limited exceptions for grantor trusts (also known as Subpart E trusts), qualified subchapter S trusts, electing small business trusts, testamentary trusts, and voting trusts.[12]

### A. ELIGIBLE TRUSTS

#### 1. **Grantor Trusts**

Some – but not all – grantor trusts are permissive S Corporation shareholders. A trust may hold S corporation stock only if all of a trust is treated as being owned by an individual who is a United States citizen or resident.[13] Typically, a revocable trust will qualify as an eligible grantor trust so long as the grantor is a U.S. citizen or resident. No special election for the trust is required. If, however, more than one person is deemed to be a grantor of the trust (such as may be the case with the release of a withdrawal power in an ILIT), then the trust will be ineligible as an S Corporation shareholder unless some other exception described below applies.

#### 2. **QSSTs**

The requirements for a qualified subchapter S trust (QSST) are: (1) there can be only one lifetime income beneficiary; (2) distributions can only be made to that beneficiary[14] and all trust income must be distributed at least annually; (3) the lifetime beneficiary's income interest must terminate at death or, if the trust terminates prior to death, upon trust termination; and (4) if the

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[8] Navarro Sav. Ass'n v. Lee, 446 U.S. 458 (1980).

[9] *See* Thomas E. Rutledge and Christopher E. Schaefer, *The Trust as an Entity and Diversity Jurisdiction: Is Navarro Applicable to the Modern Business Trust?* 48 REAL PROPERTY, TRUST AND ESTATE L.J. 83 (2013).

[10] *Id.*

[11] IRC sec. 1361(b)(1)(A)-(C).

[12] *See generally*, Laura Howell-Smith, *What Types of Trusts Are Permitted Shareholders of an S Corporation?,* ESTATE PLANNING (June 2007). Your author relied to a large extent on this excellent overview.

[13] IRC sec. 1361(c)(2)(A)(i).

[14] Distributions to a minor's custodian are permissible.

trust does terminate during the beneficiary's lifetime, all S corporation shares, along with any other trust assets, must be distributed to that beneficiary.

Typically, a QSST will have only one lifetime beneficiary, although a trust with multiple beneficiaries can qualify as a QSST if each beneficiary has a separate and independent share of the trust, each of which is treated as a separate trust for purposes of the federal income tax. A timely QSST election by the trust beneficiary with the IRS is required.

### 3. **ESBTs**

Electing small business trusts (ESBTs) have less onerous requirements than QSSTs.[15] Income can be accumulated and multiple beneficiaries are acceptable, although a timely election (by the trustee, not the beneficiary as with a QSST) is still required.

An ESBT must be a domestic trust with all beneficiaries who are individuals, estates, or certain types of charitable organizations. No beneficiary may acquire a trust interest by purchase. ESBTs are treated as two separate shares for federal income tax purposes: an S portion consisting of the S corporation stock and a non-S portion consisting of other trust assets.

One potential trap with ESBTs, however, is that each potential current beneficiary (or PCB) is treated as a shareholder for purposes of determining whether the corporation has exceeded the numerical shareholder limit.

### 4. **Testamentary Trusts**

The estate of a deceased S corporation shareholder is treated as the shareholder starting on the date of death. A testamentary trust receiving S corporation stock under the terms of a decedent's Last Will and Testament is a permitted S corporation shareholder for two years only.

### 5. **Voting Trusts**

A voting trust means a trust created primarily to exercise voting power over S corporation stock.[16] The beneficial owners must be treated as owners of their respective trust shares under the grantor trust rules and the trust must have been created by a written declaration of trust by the shareholders which (a) delegates the right to vote to the trustee; (b) requires all dividends to be paid to the shareholder/beneficiaries; (c) requires the shares to be distributed to the shareholders when the trust terminates; and (d) terminates on a specific date.

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[15] IRC sec. 1361(e).
[16] Reg. 1.1361-h(1)(v).

## B. PLANNING OPPORTUNITIES AND PITFALLS

### 1. **Comparing and Contrasting**

The taxation of an ESBT is quite complicated and will likely cause additional accounting and tax preparation costs. An ESBT may convert to a QSST and a QSST may convert to an ESBT. An ESBT is typically more flexible because multiple current beneficiaries are allowed.

If the sole current income beneficiary of a QSST dies during the trust term, the IRS allows a two year grace period to transfer the shares to a new qualified S corporation shareholder. With the termination of an ESBT, by contrast, the shares must be immediately transferred to a new qualified S corporation shareholder (and if the new shareholder is itself an ESBT or QSST, the election must be made within just two and a half months of the transfer).

### 2. **Timely Elections**

QSST and ESBT elections must be timely filed with the IRS. The income beneficiary must make the QSST election within just two and one half months of the effective date of the transfer to the trust. An ESBT election has the same deadline. The election may be revoked only with the consent of the IRS. Protective QSST elections are allowed in certain circumstances.

### 3. **Monitoring for Loss of Trust Status**

Relying solely on the grantor status of a trust runs the danger of overlooking the need for a timely election when grantor trust status is lost (either because of "toggling" by the trustee or the death of the grantor).

# IV. **ETHICAL ISSUES INHERENT IN THE REPRESENTATION OF A TRUSTEE**

## A. THEORIES OF TRUSTS

Although trusts have existed in the law since at least the time of the Crusades,[17] the fundamental idea or theory of a trust has never been truly resolved. Several conflicting theories abound and, in fact, it may be necessary to employ several theories to truly describe the functioning of a trust.

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[17] Roman law recognized testamentary trusts arising out of a Will, but not inter vivos trusts. Trust law as we know it today developed in the 12th century out of the need for landowners leaving England to fight in the Crusades with the understanding that a trustee could manage their lands and pay and receive feudal dues until the Crusader's return. Trusts evolved parallel to principles of equity. Returning knights would often encounter a trustee who refused to re-convey the owner's property and the King's Courts recognized no remedy at law. Disgruntled knights who petitioned their King would be referred to the Lord Chancellor, who could decide the matter based on his own conscience, giving rise to the idea of courts of equity, as compared to courts of law.

### 1. **Bifurcation of Property Interests Theory**

Under one theory, property includes two primary interests or rights: the right to legal title and and the right to enjoy and benefit from property (legal title and beneficial enjoyment). Generally, these two interests are unified in the owner of the property. The owner holds title and thereby may enjoy, use, possess, transfer and benefit from the property.

When a grantor conveys property to a trustee to hold for the benefit of a trust beneficiary, however, the property is essentially bifurcated. The trustee holds legal title but has no right to personally benefit from or enjoy the property, while the beneficiary lacks any true ownership in the property but has the sole and exclusive right to benefit from and enjoy the property (subject to the terms of the trust and the trustee's proper exercise of discretion). In a very real sense, the trustee holds legal title while the beneficiary holds beneficial (or equitable) title to the same property.

The bifurcation theory nicely describes the nature of trust property, but fails to adequately describe the relationship of the trustee, grantor, and beneficiary, or the ways in which a trust can act or be acted upon.

### 2. **Contract Theory**

Trust law originally grew out of contract law. Indeed, trust instruments are often called "trust agreements" and read similarly to a contract, with a grantor and a trustee agreeing on how property will be managed and administered. In this sense, a trust is nothing more than a certain type of contract with express third party beneficiary rights held by those persons (the beneficiaries) that the grantor intends to benefit.

The shortcoming of the contract theory is that a trust may in fact act – and is expected to act – as a separate legal person with its own legal existence.

Contracts, by contrast, have no life of their own and are merely a nexus of duties between a promisor and promisee.

### 3. **Entity Theory**

The entity theory holds that a trust is an artificial legal person like a corporation. Trusts do have characteristics similar to a corporation insofar as they can sue and be sued, hire and fire advisors or agents, and file tax returns under the trust's own tax identification number assigned by the IRS. In some ways, a trust is like a corporation and its trustee similar to a corporation's officers or directors who act on behalf of the entity.

The primary shortcoming of the entity theory is the long-standing legal theory that a trust does not own property, rather, the trustee herself holds title in the capacity of trustee.

These contrasting theories may not be problematic in most circumstances, but can create real difficulties for attorneys in representing a trustee.

## B. ETHICAL APPROACHES

Attorneys owe to their clients the duty to act with the utmost loyalty. Attorneys must maintain confidentiality and preserve the attorney-client privilege. Attorneys must "act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf."[18] Identification of the client, clearly, is critical to carrying out the duties and responsibilities of an attorney. When an attorney represents a trustee or other fiduciary such as a personal representative, executor, guardian, conservator, or agent under power of attorney, identification of the client ought to be straightforward.

Unfortunately, the different theories concerning trusts have given rise to very different guides to identifying the client when attorneys represent a trustee or a trust.[19]

### 1. **Traditional Theory**

Under the traditional theory, the attorney for a trust represents only the trustee. This is the most prevalent approach in those states which have affirmatively adopted a theory. The traditional theory holds that when an attorney is retained by a trustee, the attorney represents the trustee, and not the trust, its beneficiaries, its creditors, or anyone else interested in the trust.

The clarity of this approach deserves praise and it has also been expressly adopted in California, Florida, South Carolina, and Michigan, and by the American Bar Association.[20]

Although the trustee typically does not pay trust-related attorneys' fees from her own pocket, but rather from the trust, the trustee herself is nevertheless the client. And although the trustee – in her capacity as a fiduciary – owes duties of loyalty and care to the trust beneficiaries (and the attorney will advise and counsel her on the proper discharge of those duties), the lawyer's client is the trustee herself, and not the beneficiaries to whom the trustee (though not the lawyer) owes duties.

Under this theory, the trustee's attorney owes no duties to the trust beneficiaries beyond those duties imposed on an attorney to any third party (such as the duty not to make false or misleading statements and the duty not to assist a client in committing fraud or a breach of the trustee's fiduciary duties). The trustee and attorney's communications with one another are protected by the attorney-client privilege. And the attorney can navigate and avoid conflicts of interest by representing only the trustee and not the trust's beneficiaries or creditors.

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[18] South Dakota Model Rule of Professional Conduct 1.3, cmt. 1.

[19] Kennedy Lee, *Representing the Fiduciary: To Whom Does the Attorney Owe Duties?,* 37 ACTEC L.J. 469 (2011). Your author relied heavily on Kennedy Lee's article for the substance and content of this discussion.

[20] ABA COMM. ON ETHICS AND PROF'L RESPONSIBILITY, Formal Op. 94-380 (May 9, 1994).

### 2. **Joint-Client Theory**

Under the joint-client theory, the attorney for a trust represents both the trustee as well as the trust's beneficiaries. Some courts have concluded that attorneys for a trust owe additional duties to trust beneficiaries, and accordingly a beneficiary, in these jurisdictions, is entitled to the same attorney duties that the trustee enjoys, effectively making the trust beneficiaries additional clients of the trust's attorney.[21] The scope and breadth of those imposed duties, however, is unclear and unsettled.

One approach holds that the trustee and beneficiaries are essentially equal clients based on the theory that the attorney owes duties not only to the trustee but also to the beneficiaries.[22]

According to another approach, the trustee is the primary client and the trust beneficiaries are derivative clients.[23]

According to a third approach, the trust beneficiaries are the primary clients, and the trustee is the derivative client; the attorney's duties to the trust beneficiaries actually "overshadow"[24] the attorney's duties to the trustee.[25]

It seems clear, despite this confusion, that if the trustee is the primary client (which seems the better approach among the varieties of the joint-client theory), then the trustee would be entitled to duties of confidentiality and loyalty from her attorney. But if the beneficiaries are "derivative clients" it is unclear exactly what (presumably lessened) duties the trustee's attorney owes to them. Is there a duty of competence, of diligence, of communication, or confidentiality, and/or loyalty to a "derivative client?"[26] Can an attorney have communications with a beneficiary which are protected by the attorney-client privilege? Or do communications with the trustee which include a beneficiary waive the privilege as to the trustee?

Many very important questions are left unanswered.

### 3. **Entity Theory**

Under the entity theory, the attorney does not represent the trustee or the trust beneficiaries, but instead represents the trust as an entity. The entity theory essentially adopts the corporate model for representation of a trust. The trust's counsel represents the entity, which speaks through its representatives (a board of directors in the case of a corporation; a trustee in the case of a trust). The attorney's allegiance runs to the trust.

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[21] *See, e.g.*, Charleson vs. Hardesty, 839 P.2d 1303 (Nev. 1992).
[22] In re Estate of Larson, 694 P.2d 1051 (Wash. 1985).
[23] In re Dolan, 384 A.2d 1076, 1082 (N.J. 1978) (Pashman, J., dissenting).
[24] Fickett vs. Superior Court, 558 P.2d 988 (Ariz. Ct. App. 1976).
[25] Riggs National Bank vs. Zimmer, 355 A.2d 709 (Del. Ch. 1976).
[26] Lee, *supra,* at 479.

A trust acts through the actions of its trustee. As an agent for the trust, the trustee would engage an attorney as a co-agent for the trust, and the attorney would be responsive to the trust rather than directly to its trustee. The trust's attorney, as a co-agent, would have duties to the trust (along with all its interested parties and beneficiaries).[27]

The entity theory relies on an established body of law in entity representation cases. Conflicts of interest are easier to navigate and avoid under the entity theory, and the payment of attorney fees by the trust are more in alignment with the theory of representation, but the entity theory lacks much case law in support of it and is decidedly the minority approach.

### 4. **South Dakota's Approach**

#### a. ***Model Rule 1.7***

The comments to South Dakota Model Rule of Professional Conduct Rule 1.7 (Conflicts of Interest General Rule) state:

> [C]onflict questions may arise in … estate administration. … [D]epending upon the circumstances, a conflict of interest may be present. In estate administration the *identity of the client may be unclear* under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. In order to comply with conflict of interest rules, the lawyer should make clear the lawyer's relationship to the parties involved.[28]

Thus, the Model Rules merely acknowledge that there are different views on who the client is when an attorney represents a trust or estate. The comment acknowledges one view (the traditional view) where the trustee is the client; and another (the entity and joint-client theories) where the trust itself, along with its beneficiaries (along with the trustee) are all deemed to be clients.

Actually, the comment seems to describe a fourth theory by outlining a situation where the attorney, by virtue of representing the trust as an entity, also jointly represents the trustee and all beneficiaries (i.e., a kind of hybrid entity-joint-client theory).

Without even a trace of sarcasm, the comment concludes by impressing upon attorneys the duty of having clarity with regards to the identity of the client in the same breath as acknowledging that no such clarity can be found in the Model Rules.

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[27] Steinway vs. Bolden, 460 N.W.2d 306 (Mich. Ct. app. 1990). Michigan has since amended its probate rules and a subsequent Michigan Ethics Opinion has undermined the holding of *Steinway*.

[28] Cmt. 27.

b. ***Ethical Op. 95-1***

In 1995, the South Dakota State Bar Ethics Committee published Ethical Opinion 95-1 which wrestled with the question of which theory of fiduciary representation should apply to South Dakota lawyers. The request for an opinion from the Ethics Committee originated with a law firm which seeking guidance on whether to disclose – against the client's wishes – information relating to the administration of an estate to the heirs.[29]

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[29] The entire recitation of facts from the opinion were:

> A number of years ago, your partner performed estate planning work for a husband and wife. Husband had two daughters who were stepdaughters to the wife. When husband died, the stepdaughters, who were named as co-executrixes of their father's estate, hired your partner to handle the father's estate. Before husband's death, wife became incompetent. Husband created a trust for the wife which trust was to terminate at the death of wife and any property in the trust was to be distributed to the stepdaughters.
>
> After husband's death, stepdaughters petitioned the court to become stepmother's co-guardians. They assumed responsibility as co-guardians in September of 1986. Your partner had represented the stepdaughters at all stages of the proceedings and filed accountings on behalf of the stepdaughters until your partner's death in 1989. Thereafter, you were retained by the stepdaughters to file annual accountings.
>
> The final accounting filed during the year 1994 reflected that the co-guardian stepdaughters had expended all of their stepmother's personal funds on her behalf. Since stepmother had been a long-term nursing home resident, the co-guardian stepdaughters fulfilled their obligation under the trust, contributing from the trust assets $18,000.00 for the stepmother's care. As a result of stepmother's death and according to husband's will provisions, the trust terminated upon the stepmother's death and the balance of the trust funds were distributed to the stepdaughters as their own property.
>
> Prior to the stepmother's incompetency, she executed a will which provided, among other things, that after payment of funeral expenses, debts, etc., the sum of $10,000.00 was to be paid to her cousin (an individual not related by blood to father or stepdaughters).
>
> At the time you were preparing the stepmother's final accounting, the individual identified as the cousin in stepmother's will called you and asked you whether or not stepmother had any assets remaining in her estate, as he believed he was named in her will to receive property. At that time, you advised the cousin that the stepmother had no assets in her estate since they were completely used up for her care and that, in fact, the sum of $18,000.00 had been contributed by the stepdaughters from trust funds for stepmother's care.
>
> Approximately one month after you spoke with the cousin, stepdaughter's advised you that stepmother had two old life insurance policies, each with the value of $1,000. The original application on those insurance policies identified the deceased husband as the beneficiary of those policies. The policies were silent as to contingent beneficiaries. At the direction of stepdaughters, you wrote the insurance companies asking them to advise as to whom the beneficiaries were under the policies. The insurance companies responded by informing you that since the primary beneficiary (stepfather) was deceased,

The facts involved a man who had two daughters from a prior marriage who were not the children of his wife. When the husband died, he left his estate to his wife in trust, with the remainder to his daughters at the wife's death and named his daughters as co-trustees. The wife's estate plan left a bequest to the wife's cousin and nominated her stepdaughters as co-executrixes.

Later, the wife (now widow) became incompetent and her stepdaughters were appointed as her guardians. The guardians expended all of the widow's personal assets on her care and some $18,000 from the husband's trust before the widow obtained Medicaid eligibility through the South Dakota Department of Social Services.

The widow then died. Whatever assets remaining in the husband's trust were presumably distributed in accordance with the trust provisions to the widow's two stepdaughters.

Next, the deceased widow's cousin (the heir under the widow's will) contacted the attorney to ask whether anything remained in the widow's estate to be distributed. The attorney confirmed, based on his knowledge at the time, that there were no assets in her estate, her net worth having been depleted by long term care costs.

One month later, one of the stepdaughters contacted the attorney to advise that she had discovered two $1,000 life insurance policies on the deceased widow's life which were payable to the widow's estate. The stepdaughter instructed her attorney *not* to contact the widow's cousin to advise him of the existence of the policies.

At the time, no probate had been filed, the stepdaughters had no authority to take control of the policies, and, it seems, the attorney had not been engaged to represent the estate or the co-executrixes in that capacity (although they were nominated in the widow's will). It is unclear from the opinion whether the attorney was still engaged at the time as counsel for the stepdaughters as co-guardians or whether they had completed their final accountings to the court and been discharged as guardians.

The question posed was whether the attorney had an affirmative ethical obligation to disclose the existence of the insurance policies to the cousin that would be payable to the widow's estate after the attorney's clients had directed the attorney not to.

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> the policy proceeds were payable to the stepmother's estate. After stepdaughters were advised of the insurance companies response, they advised you to do nothing further as far as attempting to collect the proceeds of the insurance policies on stepmother's life. Stepdaughters also directed you not to contact the cousin to advise him of the insurance policies. Stepmother's will identified and nominated stepdaughters as co-executrixes.
>
> You believe that even if the cousin were advised and obtained authority through the stepmother's estate to claim the insurance proceeds, the stepdaughters could seek reimbursement to themselves for having purchased a prepaid burial plan for the stepmother, as well as claiming trustee compensation which previously had been waived.

S.D. Ethics Op.95-1.

The answer, the Committee observed, would depend on a determination of who the attorney's client was. If the stepdaughters were the attorney's clients, then disclosure would violate the attorney's duty of confidentiality[30] – as well as the duty of loyalty, the attorney having been specifically instructed not to make the information known to the cousin. "This is not an easy question to answer," began the Committee, noting that the Model Rules of Professional Conduct themselves do not provide any kind of definitive answer and that several different theories had been adopted by different jurisdictions.

In most cases, the Committee reasoned, the sole client is the executor (or co-executrixes, as here). But the Ethics Committee ultimately concluded that both the fiduciary as a "primary client" as well as the cousin/heir were the attorney's clients, although the heir was a "secondary client."[31] The Committee suggested that if the executor was acting in the best interests of the

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[30] *See* Model Rule 1.6:

> Rule 1.6. Confidentiality of Information.
> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent except for disclosures that are impliedly authorized in order to carry out the representation or the disclosure is permitted by, and except as stated in paragraph (b).
> (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
> (1) to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm;
> (2) to secure legal advice about the lawyer's compliance with these Rules;
> (3) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;
> (4) to the extent that revelation appears to be necessary to rectify the consequences of a client's criminal or fraudulent act in which the lawyer's services had been used; or
> (5) to comply with other law or a court order.

South Dakota Model Rule of Professional Conduct 1.6. Disclosure would not be authorized under Rule 1.6(b) because there is no criminal act that the executors are contemplating and disclosure would not be authorized under Rule 1.6(4) unless it can be argued that the clients are committing a fraudulent act in which the lawyer's services had been used. One would have to conclude that on account of the lawyer's prior communications to the cousin that there were no assets of the estate could rise to the level of fraud once the lawyer learns that this communication was, in fact, incorrect.

[31] The opinion concluded:

> [I]t is the opinion of this Committee that if you believe the action which the stepdaughters have instructed you to take is not in the best interest of the estate and its beneficiaries then you have a duty to make a disclosure to the cousin of what you have learned pertaining to the insurance policies. Whether the conduct of the stepdaughters is

estate, then only the executor was the client, but if the executor "engaged in conduct which may be not in the best interest of the estate and its beneficiaries," then the estate and its heirs become secondary clients to whom the attorney owes duties.

The attorney-client privilege, the duty of loyalty and the duty of confidentiality thereby undergo a significant shift. The Ethics Committee thereby directed the attorney to "make disclosure to the beneficiaries of what you currently know and what you learn from your investigation."

Although the opinion addressed duties in the context of representing executors (or personal representatives in today's vocabulary), the same duties would likely apply to the representation of trustees.

It is both inappropriate and unfair to criticize the aggressively deconstruct the opinion but one could certainly conclude that greater clarity for attorneys representing fiduciaries in the form of amended Model Rules or statutory enactments would be beneficial to the Bar as well as the public.

## IV. **HOT TOPICS AND LEGISLATIVE UPDATES**

### A. DIGITAL ASSETS

Digital assets are all the rage in estate planning nowadays. Attempts to codify digital assets for purposes of trust law, wills and agency powers under powers of attorney have yet to reach coherency, however, largely on account of the various rights granted to digital assets.[32] The Uniform Law Commission will likely generate a proposed model or uniform act.

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> not in the best interest of the estate and its beneficiaries is a question that you must answer based upon all of the facts, including, but not limited to, the fact that if the stepdaughters could successfully make claim for reimbursement for the prepaid burial plan and for trustee compensation there would be no insurance proceeds payable to the cousin.

*Id.*

[32] Jamie P. Hopkins, *Afterlife in the Cloud: Managing A Digital Estate*, 5 HASTINGS SCI. & TECH. L.J. 209 (2013); Claudine Wong, *Can Bruce Willis Leave His iTunes Collection to his Children: Inheritability of Digital Media in the Face of EULAS*, 29 SANTA CLARA COMPUTER & HIGH TECH. L.J. 703 (2013).

## B. PRE-MORTEM REVOCABLE TRUST CHALLENGES

### 1. **Other States' Approaches**

Other states have taken tentative steps towards allowing pre-mortem challenges to testators' wills.[33] Generally, only a judicial proceeding is adequate to pass upon whether a will is invalid for fraud, undue influence, or lack of execution formalities.[34] Key differences among states allowing pre-mortem will challenges include notice requirements, identifying precisely what determinations a court can make, preserving the testator's ability to revoke or modify a judicially-approved will, ensuring confidentiality, and clarifying who has standing to commence a pre-mortem will proceeding.

Ohio, for example, provides that the testator himself "may file a complaint in the probate court of the county in which the person is domiciled . . . for a judgment declaring the validity of the will."[35] Alaska, Arkansas and North Dakota have also enacted statutory frameworks for pre-mortem will proceedings.

### 2. **SDCL 55-4-57**

Recently enacted South Dakota law provides a mechanism for pre-mortem revocable (as well as irrevocable) trust validation procedures:

> SDCL 55-4-57. Time for commencing judicial proceeding to contest whether trust validly created--Distribution of trust property--Recovery of improper distribution--Notice
>
> (a) A judicial proceeding to contest whether a revocable trust or any amendment thereto, or an irrevocable trust was validly created may not be commenced later than the first to occur of:
>
> (1) One year after the settlor's death;
>
> (2) Sixty days after the trustee, trust advisor, trust protector, or the settlor sent the person who is contesting the trust a copy of the trust instrument and a notice informing the person of the trust's existence, of the trustee's name and address, and of the time allowed for commencing a proceeding;
>
> (3) Upon notice of entry of an order of adjudication of the trust's validity as a result of a petition filed before the settlor's death by any fiduciary of the trust or the settlor of a trust;

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[33] *See* Note, Forrest J. Heyman, *A Patchwork Quilt: The Case for Collage Contest Model Ante-Mortem Probate in Light of Alaska's Recent Ante-Mortem Legislation*, 19 ELDER L.J. 385 (2012).
[34] *See id.*
[35] Ohio Rev. Code sec. 2107.081(B).

(4) Upon notice of entry of an order of any other adjudication of the trust's validity or the date the person's right to contest was precluded by consent or other limitation;

(5) The last date a petition for review of a will could be filed under South Dakota law, if the trust was revocable at the settlor's death and the trust was specifically referred to in the settlor's last will; or

(6) Upon notice of entry of a court's order approving a conservator's proposal to create a trust or amendment thereto if the trust or trust amendment was created pursuant to and in conformity with section 29A-5-419 or 29A-5-420.

(b) Upon the death of the settlor of a trust that was revocable at the settlor's death, the trustee may proceed to distribute the trust property in accordance with the terms of the trust. The trustee is not subject to liability for doing so unless:

(1) The trustee knows of a pending proceeding contesting the validity of the trust; or

(2) A potential contestant has notified the trustee of a possible proceeding to contest the trust and a proceeding is commenced within sixty days after the contestant sent the notification.

(c) A beneficiary of a trust that is determined to have been invalid is liable to return any distribution received for proper distribution. If the beneficiary refuses to return the distribution, the beneficiary may be liable for all costs, including attorney fees, incurred for the recovery of the distribution.

(d) Notice given by the trustee, trust protector, trust advisor or settlor under this section shall be given to all beneficiaries of a trust and all heirs at law of the trust settlor.

(e) With respect to notices to beneficiaries and potential contestants under this section, if personal service is not made, then the notice shall be mailed certified or registered mail, postage prepaid, to the last known address of the person, and absent evidence to the contrary, notice to the person is presumed to have been made on the date of delivery to the last known address of the person, when there is proof of delivery.

(f) No trustee, trust advisor, or trust protector may incur any liability to any person or otherwise for failure to provide any written notice discussed above.[36]

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[36] SDCL sec. 55-4-57.

Arguably, the provisions regarding wills and trusts should mirror one another, given the similar use of each in estate planning. A revocable trust is often no more than a will substitute. Perhaps a similar statute for pre-mortem will challenges will be adopted in the near future.

## C. OPTIONAL TRUST DECANTING NOTICE

### 1. **Decanting**

Decanting is an inherent trustee power first codified in South Dakota in 2007 with amendments in 2008, 2009, 2011, 2012 and 2013. The power of a trustee to carry out discretionary distributions to or for the benefit of a beneficiary impliedly also includes the power to distribute to the trustee of another trust (the "second trust" in the language of the statutes) for that same beneficiary's benefit. This implicit trustee power was recognized by several states as existing in common law prior to statutory enactments.

### 2. **SDCL 55-2-18**

Previously, the statutory South Dakota framework for exercising the power to decant, or distribute to a second trust, required advance written notice to the trust beneficiaries at least twenty days prior to the effective date of the trustee's exercise of the power. Beginning in 2013, the legislature substituted the word "may" for "shall" and made advance notice discretionary.[37]

## D. LOSER-PAYS DAPT CHALLENGES

Lastly, although this final noted legislative change to South Dakota trust law is some four years old, having been enacted and effective in 2009, it is still noteworthy and merits mention. South Dakota's Domestic Asset Protection Trust (also known as DAPTs or APTs) statutes were first enacted in 2005. Challenges to an individual's transfer of assets to the trustee of a DAPT are governed by relatively short statutes of limitations. Beginning in 2009, the express authority of a court to award attorneys' fees and costs to the prevailing party in a fraudulent transfer attack was enacted.[38]

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[37] SDCL sec. 55-2-18.

[38] SDCL sec. 55-16-13. "A court of this state may award attorneys' fees and costs to the prevailing party in such an action." *Id.*