

**OCTOBER 28, 2021**

**Avoiding  
Litigation in  
Directed  
Trusts**

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# Directed Trusts Are a Positive Addition to Trust Practice

Directed trusts continue to grow in popularity. And with good reason. They allow a trust settlor to direct in advance the management of trust assets and trust beneficiaries. Many states, including South Dakota, have facilitated the growth of directed trusts with broad exoneration statutes. But, these statutes may have an inadvertent downside — complacency amongst directed trustees, seemingly secure that they are insulated from liability. Such complacency, of course, needs to be avoided

# Directed Trusts still Require Vigilance

- Directed trustees have a somewhat diminished fiduciary duty, but it is certainly not negligible. And the more that the directed trustee can demonstrate that it did **something**, the better off it will be.
- In order to avoid liability, directed trustees, and the other fiduciaries that work with them, must be vigilant in adhering to direction and otherwise carefully carrying out their particular role.

# Four Keys to Litigation Avoidance

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Perform your job



Understand everyone else's role



Keep careful records of what you and others are doing



Say something if you see something.  
**But to who and how is the big question.**

# Diversification Problems Are Ripe for Potential Litigation



## Diversification is the Default Rule

- ▶ Courts have found that “the trustee is under a duty to the beneficiary to distribute the risk of loss by reasonable diversification of investments, unless under the circumstances it is prudent not to do so.” *Est. of Collins*, 72 Cal. App. 3d 663, 669 (Ca. Ct. App. 1977).
- ▶ Different States have different rules. You must be cognizant of the rules that apply to your trust.

# South Dakota by Statute Overrides a Diversification Requirement

“The trustee shall diversify the investments of the trust unless, **under the circumstances**, the **trustee reasonably believes** it is in the interests of the beneficiaries and furthers the purposes of the trust not to diversify. Regardless of concentration or lack of diversification, the trustee need not diversify if the trust instrument or court order allows or directs retention of assets forming part of the trust corpus and no trustee is liable to a beneficiary to the extent that the trustee acted in reliance on the provisions of the trust instrument or court order. If a trust instrument or court order allows or directs a fiduciary to invest in a specific investment, type of investment, or investment concentration, no trustee is liable to a beneficiary to the extent that the trustee **acted in reliance** on the provisions of the trust instrument or court order.”

S.D. Codified Laws § 55-5-8 (emphasis added)

## ***Nelson v. First Nat. Bank & Tr. Co. of Williston, 543 F.3d 432, 434 (8th Cir. 2008)***

The trust contained the following provision “any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments.”

Settlor signed an investment authorization document stating that investment in the Company was proper and directed the trust to retain it.

Court found the trustee did not violate any duty by maintaining a high stock concentration.

## *In re Estate of Saxton*, 179 Misc. 2d 681, 689, (N.Y. Sur. 1998)

An investment direction agreement was signed by the life tenant and the two remaindermen acknowledging that the entire corpus of the trust consisted of common stock of IBM, consented and **directed the trustee to continue to hold** the stock rather than following the normal banking procedure of diversification and additionally **held the bank harmless from decreases** in value of the investment.

In subsequent lawsuit Court found the trustee **violated** a duty by maintaining a high concentration in IBM stock.

Court held that the trustee should have considered whether the investment direction agreement was still in effect given its age.

# ***Nelson v. Saxton* – Why was one trustee not liable, while the other one was?**

- ▶ In *Saxton*, the direction was old and outdated.
- ▶ By comparison, in *Nelson*, the over-concentration lasted only for a period of months.
- ▶ In *Saxton*, several other factors might have contributed as well:
  - 2 out of 3 beneficiaries asked for diversification subsequent to signing investment direction agreements.
  - Internal bank memoranda suggested that diversification was allowed under the agreement if there was a change in circumstances, and encouraged diversification of IBM stock in particular.
  - *Saxton* may reflect a situation where the trustee intentionally ignores warning signs, insisting that he/she/it must follow the out of date directions.



## **Bad Facts Make Bad Law**

Even in South Dakota, there is wiggle room for Courts to find Directed Trustees liable.

## *Jo Ann Howard & Assocs., P.C. v. Cassity*, 868 F.3d 637, 647 (8th Cir. 2017)

- ▶ Trustee argued there was no liability because there was an Investment Advisor who made the investment decision.
- ▶ Court disagrees - “We reject that contention because it gives no effect to the requirement that assets remain invested in a manner that is within the authority of a reasonably prudent trustee. A trustee always has a duty to ensure that trust assets are invested prudently, whether the trustee is investing the assets himself or monitoring the investment decisions of an investment advisor.”
- ▶ Missouri’s statutory regime is certainly not as progressive as South Dakota. But, Court’s can find against directed trustees if warranted by the facts.

## ***Duemler v. Wilmington Trust Co., No. 20033NC, 2004 WL 5383927, at \*1 (Del.Ch. Nov. 24, 2004)***

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Delaware's statutory regime is progressive, like here. But even in Delaware a trustee **may** be liable. Food for thought here in South Dakota.

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“The Court further finds that section 3313(b) of title 12 of the Delaware Code insulates fiduciaries of a Delaware trust from liability associated with any loss to the trust where a governing instrument provides that the fiduciary is to follow the direction of an advisor, the fiduciary acts in accordance with such direction and the fiduciary **did not engage in willful misconduct**. . . . In connection with Plaintiff's decision not to tender the securities in the Exchange Offer, Wilmington Trust acted in accordance with Plaintiff's instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and **had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information** concerning the Exchange Offer.”

# ***Rollins v. Branch Banking, Tr. Co. of Va.,*** **56 Va. Cir. 147 (2001)**

- Beneficiaries were responsible for investment decisions.
- Beneficiaries claimed the trustee improperly administered and managed the trust.
  - Failure to diversify the trust assets – highly concentrated holding in one stock.
  - Failure to secure approval for the sale of the declining stock.
- Trustees claimed that when the trust vests the power to make investment decisions exclusively in persons other than the trustee, the trustee cannot be liable for the loss resulting from the retention of the investment. Va. Code § 26–5.2.
- Court was faithful to this statute but still warned of potential liability and denied motion to dismiss.
- Even though the Trustee was not responsible for investment decisions, it still had other duties, which the Court said the Trustee may have breached

# Statutes Will Not Protect Against Bad Acts

- No matter how broad a statute, no matter how much it protects a trustee, there will be a court that will come-up with a work around, especially if the court thinks the trustee should have protected the beneficiary.



# Even Here in South Dakota

- S.D. Codified Laws § 55-5-8 (see page 7).
- The powers and discretions of an investment trust advisor shall be as provided in the trust instrument and may be exercised or not exercised, **in the best interests of the trust**, in the sole and absolute discretion of the investment trust advisor and are binding on any other person and any other interested party, fiduciary, and excluded fiduciary.

S.D. Codified Laws § 55-1B-10.

- The powers and discretions of a distribution trust advisor over any discretionary distributions of income or principal, including distributions pursuant to an ascertainable standard or other criteria and appointments pursuant to § 55-2-15, shall be provided in the trust instrument and may be exercised or not exercised, **in the best interests of the trust**, in the sole and absolute discretion of the distribution trust advisor and are binding on any other person and any other interested party, fiduciary, and excluded fiduciary.

S.D. Codified Laws § 55-1B-11



# How Can Directed Trustee Protect Itself?

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Challenge the Investment Advisor to support its investment decision.

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Document your challenge – a memo to files at the time you made the challenge.

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Depending upon many factors, consider having a third-party expert/consultant look at the investment decision.

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Revisit these issues instead of letting many years pass.

# How and When Should a Directed Trustee Go to Court?

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# South Dakota Direction Statute

- ▶ “The trustor, a fiduciary, or a beneficiary of any trust under court supervision may **at any time petition** the court for its action **as to any matter relevant to the administration of the trust**, including particularly the requiring of special reports from a fiduciary, **the exercise of any discretion** vested in a fiduciary, and as to any matter as to which courts of equity have heretofore exercised jurisdiction over fiduciaries. Upon the filing of the petition the court shall fix a time and place for hearing unless the conditions of § 21-22-21 have been met and cause notice to be given as required by this chapter. Upon the hearing **the court shall** make such order, **give such directions to a fiduciary as the court shall determine**, or resolve objections filed by an interested party pursuant to § 21-22-16.”

SD ST § 21-22-13

## *In re Rivas*, 30 Misc. 3d 1207(A), 958 N.Y.S.2d 648 (Sur. 2011), aff'd, 93 A.D.3d 1233 (2012)

- Trust Agreement created a three-member Investment Advisory Committee: two from the University, one from the trustee.
- The Two members from the University made a motion (that passed by a majority, not unanimously) that the Advisory Committee direct the Trustee to invest all of the trust assets in the University's long-term investment pool (LTIP).
- Trustee concerned with the agreement and goes to Court.
- Court held
  - “As the Trustee is now concerned that following the directions of the Advisory Committee may result in a breach of fiduciary duty, the Trustee is required to come before the Court **for instruction**, just as in a case where two fiduciaries do not agree upon how to administer an estate.”
- Trustee wins.

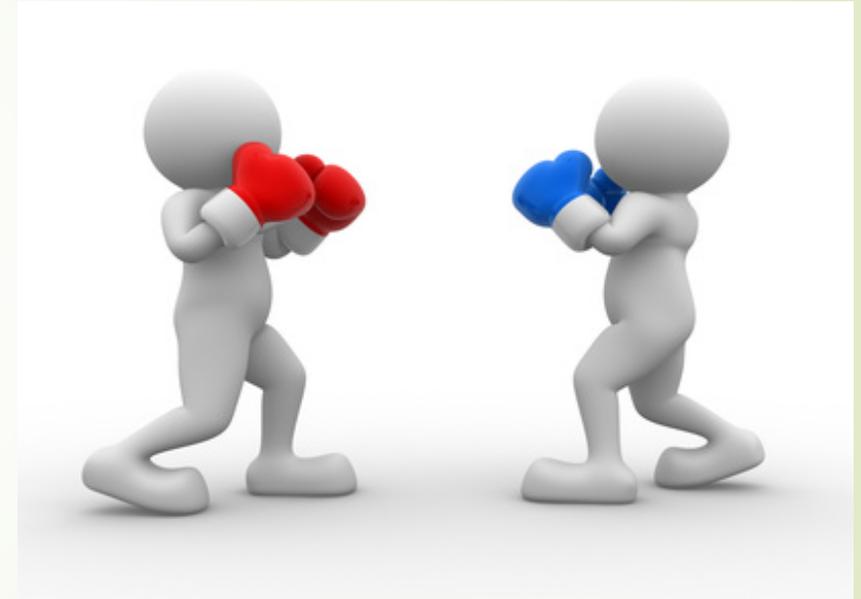
## *Shelton v. Tamposi*, 164 N.H. 490 (2013) – New Hampshire Supreme Court

- ▶ The Trust Agreement appointed two people (one of them the Settlor's son) to serve as investment directors of the twelve trusts. The third amendment to the trust “confer[red] certain fiduciary responsibilities on the investment directors that are more commonly vested in a trustee.”
- ▶ The Investment directors had “unequivocal authority to make investment decisions and rendered their decisions neither reviewable nor reversible by the trustee.”
- ▶ Trustee concerned about insufficient liquidity for distribution and **sues** investment directors.



# Trustee Gets Hit Hard

- Trial Court and Supreme Court held in favor of the Investment Directors.
- Supreme Court held that Trustee should be removed for having brought suit, which forced the Trust to incur litigation expenses.
- Supreme Court also held an award of attorneys' fees *against the trustee* was appropriate.



# Considerations Before Going to Court

- Investment Advisor's identity relevant to the analysis.
- Your level of concern (and whether to go to Court) should depend in part on who the Investment Advisor is:
  - Corporate fiduciary  
(least level of concern)
  - Settlor
  - Family/Friend
  - Beneficiaries  
(greatest level of concern)

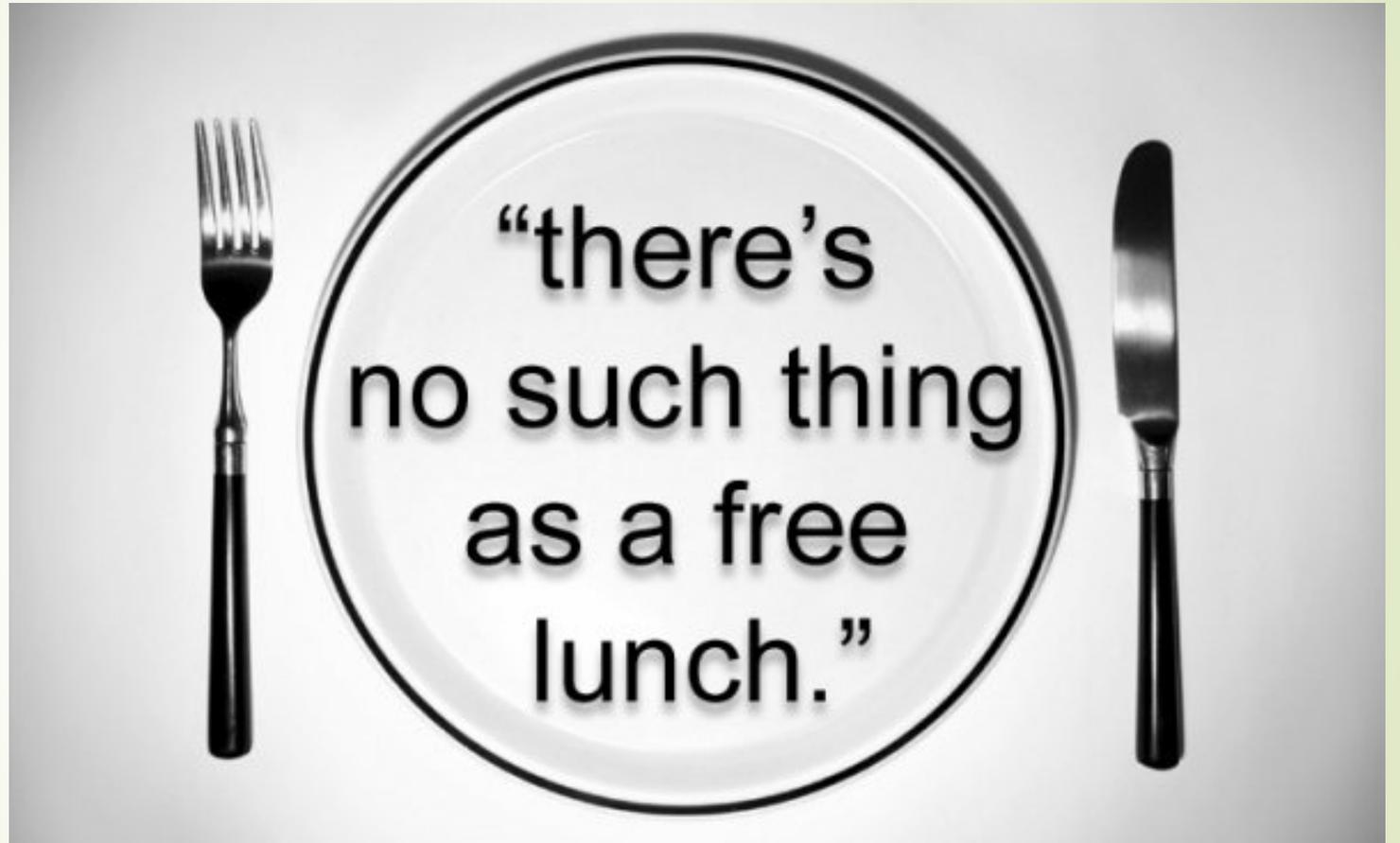




- When in doubt, going to Court might be your best option.
- Do not fiddle while Rome burns.
- But do so seeking direction and not with aggressive litigation.

# Trustee Fees For Directed Trusts

- ➔ Directed Trustees, just like all trustees, need to earn their fees.



## SDCL § 55-3-14

Compensation of trustee. When a declaration of trust does not specify the rate or amount of the trustee's compensation the trustee is entitled to and shall receive **reasonable compensation** for the performance of his duties. If such declaration specifies the amount or rate of his compensation, he is entitled to the amount or rate thus specified and no more.

# *In re Est. of Zeid*, 2017 IL App (1st) 162463-U, ¶ 32

- Directed Trust, and plaintiff had limited responsibilities as a trustee. Defendant's argument:
  - Plaintiff's fee schedule did not properly factor in its diminished liability.
  - Plaintiff's fee schedule failed to factor in plaintiff's level of responsibility as trustee.
- Court held that the fees were reasonable.
  - But only after requiring Trustee to provide evidence of the reasonableness of its fees.
  - The court held that **in determining what is a reasonable fee, there is no clear-cut rule**. Rather, the determination must be **based on the facts and circumstances of the particular case**.

## ***Matter of Joan T. Goetzinger Living Tr. Dated May 30, 2014, 949 N.W.2d 444 (Iowa Ct. App. 2020)***

- Trustee's legal fees **denied** because trustee's "foot-dragging in providing such basic things as the hearing aids, lift chair, and stair lift, even after being repeatedly directed to provide those items, resulted in numerous unnecessary hearings and time investment by [trustee] and was a failure to fulfill her duties as trustee."
- Putting trustee's fee interests over beneficiaries distribution interests is a sure-fire way to get hit on fees.

***San Pasqual Fiduciary Tr. Co. v. Holt,***  
**No. G054571, 2018 WL 6333733, at \*7**  
**(Cal. Ct. App. Dec. 5, 2018)**

- In the case, the trustee was found to have breached a fiduciary duty (including claims of self-dealing), and the Court awarded more than \$5 million in damages. Nevertheless, the Court still found that the trustee was still entitled to fees.
- Court considered ***the fidelity or disloyalty shown by the trustee.***

# Conclusions

- South Dakota has a very flexible, pro-trust statutory regime. But even in this regime, fiduciaries involved with South Dakota directed trusts must still adhere to rules applying to all trustees.
  - Know your trust instruments.
  - Know your role.
  - Do your job.
  - Be mindful of the roles and jobs being done by your co-fiduciaries.
  - Document your process.



# Jay W. Freiberg

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## Partner

Jay is laser-focused on efficiently obtaining wins for his clients, who hire him for his seasoned judgment in dispute resolution both in and out of the courtroom. A trusted counselor, he has deep expertise representing all types of stakeholders in all manner of sophisticated and complex trust and estate disputes. As part of this practice, he counsels private clients in potentially contentious business and personal matters regarding, among other areas, closely-held businesses, real estate, tax and insurance. A carefully aggressive advocate, Jay's clients look to him for their thorniest matters.

Jay is admitted in numerous courts, and understands the hurdles, pitfalls and opportunities within the courtroom setting. Partnering with local counsel, notably in Delaware and in Florida, Jay is able to provide seamless counsel to his multi-jurisdictional clientele.

In the community, Jay is an adjunct professor at Fordham University School of Law, where he has taught legal writing for over 10 years, and is *pro bono* trust and estate litigation counsel to the New York Public Library.

Prior to forming Elman Freiberg, Jay was the chair of Katten Muchin Rosenman's New York Fiduciary Litigation practice. He also served as a law clerk for the Honorable Diane Weiss Sigmund, judge for the US Bankruptcy Court in the Eastern District of Pennsylvania.

Jay resides in Manhattan with his wife and two children. When not with his family or in the office, he can be found training for his next race. Jay is a veteran of numerous road races and triathlons and, on happy occasion, makes the podium.



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