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Trustees' Use Of LLCs and Other Entity Forms To Hold Assets And Mitigate Risk

Texas Bankers Association

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Introduction

- Trusts hold and invest in many assets.
- These assets may include real estate, oil and gas, businesses, etc.
- Trustees may want to create holding entities to own the assets.
- There are many different and varied reasons for wanting to create a holding entity.

Introduction

- This presentation will cover:
- A trustee's duty to create holding companies;
- A trustee's authority to create holding companies;
- Potential reasons that support the creation of holding companies;
- Necessary considerations associated with holding companies; and
- The decision of which holding company to select.

Should a Trustee Create a Holding Entity?

- Like everything in the law, the answer is “depends”
- Ownership by a trust of an interest in a closely-held entity presents significant issues for the Trustee
- The answer for most of the time is “Yes!”
- A Trustee’s authority and duties are found in the trust document, statutes, and common law

Source of Trustee's Duties: Trust Document

- The first place that a Trustee should look in answering any question is the trust document
- Statutes normally provide that a Trustee is to follow the terms of a trust and only except limited issues from this rule. Tex. Prop. Code Ann. 113.051.
- Trust documents normally do not limit a Trustee's power to hold privately held stock (or equity in holding company)

Source of Trustee's Duties: Statutes

- “A trustee shall administer a trust in good faith according to its terms and this subtitle.” Tex. Prop. Code Ann. 113.051.

Source of Trustee's Duties: Statutes

- 44 states have adopted the Uniform Prudent Investor Act
- This provides that a Trustee owes a duty to comply with the “prudent investor rule”
- A Trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust

Source of Trustee's Duties: Statutes

- In making investment and management decisions, a Trustee should consider:
 - General economic conditions;
 - The possible effect of inflation or deflation;
 - Expected tax consequences;
 - The role the investment plays within the overall trust portfolio;
 - The expected total return from income and appreciation of capital;
 - Other resources of the beneficiary;
 - Needs for liquidity, income preservation, appreciation of capital; and
 - Trust asset's special relationship or special value, if any, to the trust or a beneficiary

Source of Trustee's Duties: Statutes

- Trustees have a duty to review the trust assets and implement decisions concerning the retention, disposition, and management of these assets within a reasonable time after receiving them in trust
- Trustees have ongoing duties (annual) to evaluate trust assets

Source of Trustee's Duties: Statutes

- “In the absence of any contrary terms in the trust instrument or contrary provisions of this subtitle, in administering the trust the trustee shall perform all of the duties imposed on trustees by the common law.” Tex. Prop. Code Ann. 113.051.
- So, the Texas Trust Code adopts common law duties.

Source of Trustee's Duties: Common Law

- Trustees have common law duties to:
 - Preserve and protect the assets of a trust; and
 - Administer the trust with the skill and prudence which an ordinary, capable and careful person would use in the conduct of his or her own affairs
- Trustee has a duty to immediately evaluate assets and make decisions that a prudent person would make
- Trustees with certain expertise may be held to higher standard
- So, normal business people who own real estate create entities to hold the asset ---> complies with a Trustee's duty

Authority to Create A Holding Company

- A trustee must look to the trust document to see if there are any limitations on the ability to create or invest in certain business entities. Tex. Prop. Code 113.001 (power given to the trustee under statute may be limited by the trust document).
- A trustee may exercise any powers in addition to the powers authorized in the Trust Code that are necessary or appropriate to carry out the purposes of the trust. Tex. Prop. Code 113.002.
- A trustee may manage the trust property and invest and reinvest in property of any character on the conditions and for the lengths of time as the trustee considers proper. Tex. Prop. Code 113.006.

Authority to Create A Holding Company

- The powers, duties, and responsibilities under this subtitle do not exclude other implied powers, duties, or responsibilities that are not inconsistent with this subtitle.” Tex. Prop. Code Ann. 113.024.
- “By statute and common law, a wide measure of discretion is accorded a trustee in the prudent operation of a trust.” *Tomlinson v. Tomlinson*, 960 S.W.2d 337, 339 (Tex. App.—Corpus Christi 1997, pet. denied); *Taysum v. El Paso Nat. Bank*, 256 S.W.2d 172, 176 (Tex. Civ. App.—El Paso 1952, writ ref’d) (There seems to be no question that the settlor of a trust may leave the trustee a wide discretion as to the mode of realizing the end sought).

Authority to Create A Holding Company

- “A trustee may invest in, continue, or participate in the operation of any business or other investment enterprise in any form, including a sole proprietorship, partnership, limited partnership, corporation, or association, and the trustee may effect any change in the organization of the business or enterprise.” Tex. Prop. Code 113.008.
- Note: this does not expressly include LLCs.

Authority to Create A Holding Company

- “A beneficiary who has full legal capacity and is acting on full information may relieve a trustee from any duty, responsibility, restriction, or liability as to the beneficiary that would otherwise be imposed on the trustee by this subtitle, including liability for past violations.” Tex. Prop. Code Ann. 114.005.
- “A written agreement between a trustee and a beneficiary, including a release, consent, or other agreement relating to a trustee’s duty, power, responsibility, restriction, or liability, is final and binding on the beneficiary...” *Id.* at 114.032.
- *Slay v. Burnett Trust*, 187 S.W.2d 377, 390 (Tex. 1945) (when a beneficiary has full knowledge of all material facts, he or she can consent to an act by a trustee that would otherwise be a breach of duty and the trustee will not be held liable for same).

Why a Trustee Should Create a Holding Entity

- A judgment against an owner of real estate is not confined to the value of the property
- If a trust owns property and has a judgment against it, the judgment creditor can reach other assets to satisfy judgment
- If the formalities of a holding company are maintained, its primary purpose is to limit risk exposure for other trust assets
- Should create a separate holding entity for each asset to maximize liability protection

Why a Trustee Should Create a Holding Entity

- LIABILITY EXPOSURE!
- Environmental claims are a perfect example:
 - CERCLA imposes joint and several liability for hazmat clean up of contamination caused by multiple parties, including current owner
 - Recoverable items include cleanup and necessary response costs, natural resource damages, and costs of health assessments/studies
- Other potential liabilities include:
 - Tort claims for accidents on property (public access property has higher risk);
 - Nuisance claims due to activities on the property; and
 - Deficiency suits for loans where property was collateral

Other Issues To Consider: Trustee Duties

- New Duties?
- A Trustee should exercise control for the benefit of the beneficiaries – supervise corporate management to ensure that the best interest of the beneficiaries is being realized
- Duty to scrutinize distributions/dividends to make sure that beneficiaries are being treated evenly and fairly
- Duty to bring shareholder derivative and other similar claims if necessary

Other Issues To Consider: Principal v. Income

- Trustee has a duty to be fair and impartial to all beneficiaries
- Example: a trust that owns energy assets has to allocate some portion of royalty payments to principal (maybe 80% under uniform act)
- A trust receiving a distribution from an entity (that holds royalty interests) may all be income (depending on trust document and statutory guidelines)
- This can affect beneficiaries rights to distribution

Other Issues To Consider: Duty to Diversify

- A Trustee has a general duty to diversify (though that can be overridden in trust document)
- If the trust is the controller of the holding company, this is not an issue as the Trustee has the ability to sell real estate and invest in other assets
- But, if the Trustee does not have control, there is a potential to lose ability to diversify trust assets due to decreased market for ownership interest in closely held holding company

Other Issues To Consider: Fractional Ownership

- Fractional ownership of asset complicates the issue
- By creating a holding company, must be careful to retain control of the asset
- Potential to lose right to partition assets with use of holding company

Other Issues To Consider: Fractional Ownership

- Placing fractionalized ownership into a holding company may protect assets if other owners have a bankruptcy or lender claim
- Other owners will not own the real estate; they only own equity interests of holding company
- So, bankruptcy trustee or lender may have no right to partition real estate, whereas they would with a TIC situation

Other Issues To Consider: Fractional Ownership

- By placing fractionalized ownership in holding company, it may devalue the market value of the asset
- This may be a good thing if the Trustee distributes equity interests of holding company to beneficiaries
---> lowers tax obligations

Other Issues To Consider: Trust Termination

- Minimize effects on beneficiaries upon termination of trust
- Use of LLC may decrease taxable events and taxable values
- If trust is a revocable trust, creating a holding entity may create another wall that a settlor's creditors will have to break through to reach assets

Other Issues To Consider: Change in Ownership

- If co-owner dies, a probate in the county in which the property is located is necessary – not so with equity interests of holding company
- Continuity of management exists with holding company – not so with TIC ownership
- With holding company, rights of members to assign interests may be restricted by agreement and may establish right of first refusal for sale of equity interests of holding company

Other Issues To Consider: Dual Trustee Roles

- Trustee serving as board member, officer, etc. in holding company can create issues
- Trustee has a duty to not profit from a transaction, so the Trustee should probably not receive additional compensation in that additional role
- Serving in dual role can also create conflicting duties
- A director/officer has the duties of:
 - Care (business judgment rule);
 - Loyalty (act in good faith and not allow other interests to prevail over interests of entity); and
 - Obedience (avoid ultra vires acts beyond scope of the powers)

Other Issues To Consider: Dual Trustee Roles

- Can limit some of these duties via proper documentation
- In Texas, actions as Trustee are legally separate from actions as officer/director
- But, in other jurisdictions, actions are separate only where Trustee does not hold a controlling interest in holding company
- Should not really be an issue if trust owns all of the entity – really just an issue to watch when there is fractionalized ownership

Other Issues To Consider: Duty To Disclose

- Full disclosure is very important on all material decisions.
- “Trustees and executors have a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries’] rights.” *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996).
- The Restatement (Third) of Trusts, Section 82(1) provides that a trustee has a duty to keep beneficiaries reasonably informed of about significant developments concerning the trust and its administration, particularly material information needed by beneficiaries for the protection of their interests.

Other Issues To Consider: Tax Issues

- A flow through entity is not taxed at the entity level, the taxes are paid by the owners (here, the trust)
- But, just because an owner may have “taxable income,” it does not mean that it will get a distribution
- So, need to ensure that entity distributes at least enough money to cover tax obligations

Consent/Release

- Whether a Trustee is concerned about creating a holding company or not doing so, the Trustee can always seek a consent and release agreement from all beneficiaries after providing full disclosure

Which Entity? (Some Preliminary Questions)

- Who controls the property?
- What . . .
 - are the essential property characteristics?
 - are the short-term and long-term goals?
 - is the proposed ownership structure?
- Where is the property located?
- When does an entity need to be implemented?
- Why do I need professional advice?

Why Use a “Real Estate Holding Company”?

- Isolate assets (internal liability protection)
- Isolate liabilities (external liability protection)
- Facilitate more efficient transfers of property title
- Restrict transfers of equity ownership of property
- Separate ownership from management
- Possible modification of manager fiduciary duties

Holding Company Vehicle

- Primary entity options:
 - No Entity
 - Corporation
 - Limited Partnership
 - Limited Liability Company
- Choice of entity factors:
 - Owner liability
 - Management structure
 - Taxation
 - Cost

Option #1 - No Entity

Advantages:

- Complete discretion in management matters
- No formation costs
- No additional entity-level taxation
- Rely on trust documents

Disadvantages:

- Unlimited liability (insurance can fill in some of the gaps)
- Not accommodating for additional owners, exit opportunities, etc.
- Commingling of assets and liabilities
- Rely on trust documents

Option #2 - Corporation

Advantages:

- Limited liability for shareholders
- Centralized management structure (SHs → Ds → Os)

Disadvantages

- Statutory formalities (bylaws, notices, meetings, voting, etc.)
- Double-taxation for federal income tax purposes (C-Corps)*
- Fiduciary duties for directors (well-established jurisprudence)

* S Corporation may eliminate double-tax issue, but shareholders are limited to individuals and certain types of trusts

Option #3 - Limited Partnership

Advantages:

- Limited liability for limited partners (so long as not participating in the control of the business and no third party reliance)
- Most management decisions vested in general partner (good/bad?)
- Pass-through entity for federal income tax
- Possible state-level tax benefits

Disadvantages

- Unlimited liability for general partner
- No control for limited partners
- Highest formation costs
- Multiple tax filings on federal and state level

Option #4 - Limited Liability Company

Advantages:

- Hybrid of Corp/LP structure
- Limited liability for members (even if participating in the business, except as otherwise provided in company agreement)
- Flexible management structure (managers v. members)
- Principally governed by contract with minimal statutory formalities
- Pass-through or disregarded entity for federal income tax purposes
- Charging order may be sole remedy for creditors

Disadvantages

- Limited history and jurisprudence
- Possible member liability for self-employment taxes
- Not subject to statutory indemnification provisions
- Possible disclosure of member identities

Owner Liability

**Least
Desirable**

**Most
Desirable**



No Entity

Corporation

LP / LLC

Management Structure

**Least
Desirable**

**Most
Desirable**



Corporation

LP

LLC

No Entity

Taxation

**Least
Desirable**

**Most
Desirable**



Corporation

LLC LP

No Entity

Cost

Least
Desirable

Most
Desirable



LP

LLC

Corporation

No Entity

... and the winner is ...

???

New Entity Filings (Texas)

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Corp	22,563	23,750	22,755	22,407
LP	5,650	5,888	5,676	5,054
LLC	110,876	126,091	135,250	150,266

Source: Texas Secretary of State, Business & Public Filings Division

Forming the Holding Company

- Select form of entity and jurisdiction of formation
- Confirm name availability
- File certificate of formation with Secretary of State
- Finalize remaining formation documents
- Obtain federal tax ID number
- Consider ancillary filings (assumed names, business licenses/permits, foreign qualifications, etc.)
- Consider IP issues (trademarks, domain names, etc.)
- Issue equity to initial owners (securities issues)

Maintaining the Holding Company

- Establish and adhere to entity's legitimate business purpose
- Adequately capitalize entity (also consider insurance)
- Maintain independent nature of entity
- Follow prescribed procedural and documentary formalities
- Timely submit necessary regulatory filings
- Authority issues (members, managers, officers, employees)



Avoid piercing the corporate veil concerns

Hire A Lawyer!

- To take advantage of this idea, you should hire a law firm with experience in estate planning, taxation, and business formation
- The attorneys would assist you by selecting the best entity option for the jurisdiction in question and creating the entity
- Ask others in your organization that have experience managing ownership interests in closely held businesses

Conclusion

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