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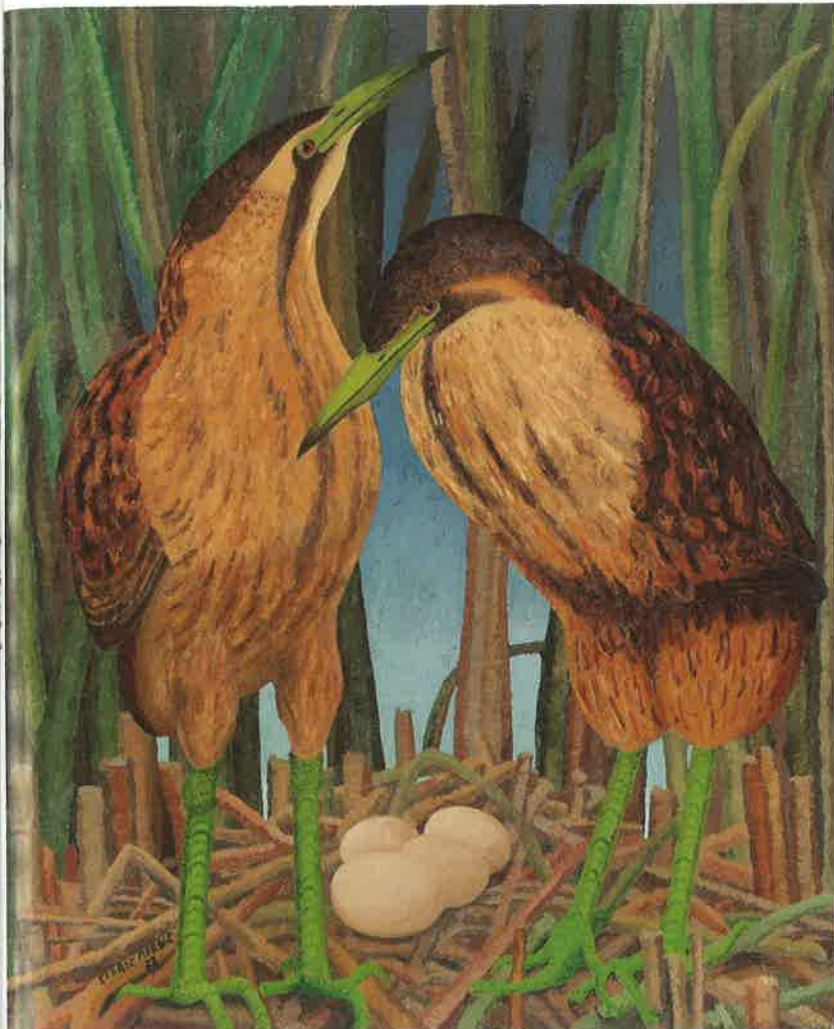

Hatching Ideas—"Bitterns" (35 3/4 in. by 29 3/4 in.) by Sir Cedric Morris, sold for $35,415 at Christie's Modern British and Irish Art Day Sale in London on June 26, 2015, p. 4.

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FEATURE:
FAMILY BUSINESSES

By Amelia Renkert-Thomas & Roy Kozupsky

Inside-Out Succession

Rethinking estate planning for family businesses

Estate planning for family business owners is big business for many wealth advisors. Fueling this area of work is a combination of factors, including the historically large (and at least for now increasing) federal estate tax exemptions. Congressional leaders perennially raise the possibility of changing the estate tax regime. This tumultuous political debate about rates and exemptions is wonderful fuel for those ever-present emotions of opportunity and fear, which seem to be the active ingredients in motivating families to consider transferring their wealth, including the family business, to their descendants.

Unfortunately, this ongoing political debate over taxes has turned the process of family business succession planning inside out. Advisors to business-owning families—attorneys, accountants, wealth managers, etc.—all emphasize tax issues in their promotional materials. Recently, the Obama administration's stated intention to review and limit valuation discounts created a flurry of client communications designed to spur clients to act now. In this environment, business-owning families come to see estate planning as primarily an exercise about reducing taxes, rather than planning for the future ownership and leadership of the business. And, perhaps more problematic, we've found that there's a sedative effect resulting from sophisticated tax and estate planning: Once the documents are signed, the family often assumes the succession planning is complete.

Succession: More Than a Tax Problem

The problem is, estate planning to mitigate anticipated taxes isn't the beginning of the succession planning process; it should instead be the end—the capstone. Why is the succession planning process as undertaken by most business-owning families, all too often, inside out?

Many families with significant business interests fail to get the full range of advice they need to understand the complex relationships, structures, governance, forums and policies that may be necessary to perpetuate their legacy. Good tax planning is valuable, but more so when it's combined with a thorough understanding of the needs and objectives of the family and the business. Working with a team of professionals—attorneys, family dynamics specialists, governance consultants and strategic planning experts—can help families create a succession plan that's more realistic, robust and customized to their particular circumstances. Estate planners are particularly well positioned to bring together a group of skilled advisors who can help the family look at the succession planning challenge from multiple perspectives and develop a plan that will work for both the family and the business.

Family and Business Capital

Traditionally, wealth transfer planning for family-owned enterprises focuses on three main questions:

- Which member of the family will run the business?
- Who will own the shares?
- How can we mitigate estate taxes on the transfer?

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But, estate planning, which focuses solely on legal structures, can create unintended consequences of which controlling owners of family businesses and their estate planners will want to be wary, especially for businesses passing from the founder (or a controlling owner) to a group of siblings or cousins. These pitfalls arise because estate planning changes the balance of an existing system—new owners enter the family stage in the form of limited liability companies, trusts, family limited partnerships and even philanthropic foundations. Business decision making both during and after the founder's departure is much more complicated, and yet founders and estate planners alike often fail to appreciate the new and different family-business systems their documents will create. The use of sophisticated trusts, even in the embryonic stages of family wealth planning, hatches unique and complex long-term planning issues that families need to consider.

A founder who takes a wider perspective and considers the financial, human and enterprise capital that's embodied in the business and the family might conclude that identifying a CEO candidate and preparing an estate plan are necessary steps, but by themselves, they aren't sufficient to sustain and grow the business and the capital in the next generation. Leadership succession planning that focuses only on the CEO role ignores other critical cogs in the family business system—director, trustee, owner, forum leader—and fails to consider the work that will need to be undertaken to build a new decision-making system among management, board, owners and family once the controlling owner no longer sits at the center of business decision making. Ownership succession planning that assesses assets purely by their monetary value and focuses on transferring them in the most tax-efficient way ignores human and enterprise capital, resulting in complex ownership structures, such as irrevocable trusts, and may achieve tax goals while missing non-financial objectives entirely.

A founder considering succession planning should instead ask four questions:

- **What's our capital?** What human and enterprise capital have we created that's most important to us? What role does our financial capital play in our business and our family? What's our vision for the future?
- **Who will follow me in the work of sustaining and growing the capital as well as the business?** How can I engage the talents, skills, interests and enthusiasm of my entire family in sustaining and growing the capital and the business?
- **What roles will they play in carrying it forward?** Who has the ability, interest and availability to serve in management? As an engaged owner? As trustee? As a director?
- **How can I help them prepare to take over?**

The keys to enhancing the successful transition of any family enterprise are vision and preparation.

A founder who recognizes all the capital embodied in the business and the family (human, enterprise and financial) and hopes to leave a system that can sustain and grow that capital will conclude that succession planning as it's typically thought of leaves too much of the real work of succession to those who will follow.

Expanding the Team

The keys to enhancing the successful transition of any family enterprise are vision and preparation, and the odds can be improved significantly by expanding the advisory team to include specialists in family relations and governance. This expansion requires a commitment to creating an atmosphere of trust, in which both the family and the advisor team understand the value of collaboration.

All too often, though, collaborative endeavors fail to take root in the estate-planning process. Our hunch is that families don't think about expanding the advisor team mainly because of cost and because they've rarely seen the team used or offered as a comprehensive

service. While families are used to paying for advice, they aren't used to having succession and estate plans reviewed by different professionals who have unique values, skills and perspectives to add to the planning process. So, education about professional collaboration is key, and not just for families: Educating both the family and the advisors right from the inception of an engagement about the need and value of professional collaboration is an important process (and a challenging endeavor) in itself and will hopefully steer the professionals away from their natural tendency of working in isolation. Surgeons don't operate alone. Pilots don't navigate their aircraft in a vacuum. Those professionals that service families in respect to their business planning need to not only recognize, but also adhere to a higher level of collaboration despite the many frustrations that can easily emerge among different service industries.

> The challenge for business-owning families is that estate-planning documents that are fundamentally tax-driven don't begin to address the new complexity of the family business system.

When a founder runs a business, decision making operates like a hub and spokes—with the founder in the center of the action. The system is simple: All questions gravitate to and emanate from the center. But, estate planning, especially wealth transfer planning with family-owned enterprises, invariably builds a new system with multiple decision makers. Once the plan takes effect, the founder will no longer be in the center. Other decision makers will emerge. The board of directors (if there's one) will need to take a new look at finances and strategy. Trustees, suddenly born out of the estate tax planning process and having their own set of fiduciary priorities, are thrust into a family's business ecosystem, all too often without proper training or education. Management will need to adjust to a new leader and new priorities. Family members will be in entirely new roles—one may step up to the CEO position, others may join the board, serve as trustees or even be beneficiaries of new trusts that own illiquid non-voting business interests. As they take these roles, they'll need to ask questions, learn new skills and develop very different ways of relating to each other.

The challenge for such families is that estate-planning documents that are fundamentally tax-driven don't begin to address the new complexity of the family business system. Founders and their family members need help understanding the new roles that the documents will create. They also need help designing and implementing the new decision-making systems that family, board and management will need to steward the business after the founder is gone.

Decision-making Challenges

Here are just a few of the decision-making challenges that can arise from estate-planning transactions:

- **Who's the leader?** Most estate plans sprinkle ownership among a group of diverse family members, oftentimes in trust. As a result, ownership power that was originally held by a single individual (the founder) may now be held by a group of individuals and entities. Questions will naturally arise: What powers will the owners (or trustees) exercise? If the new CEO is a family member, will he assume he's stepping into the shoes of the founder and has all the same powers that the founder had? At the same time, will the non-managing owners and directors feel that they instead should hold much of the power that the founder held? Who's right? The estate-planning documents typically won't resolve this issue. However, a business advisor, who understands enterprise governance and collaborates in the estate-planning process, can add immense value to help clarify and articulate a new balance of power.
- **That's not fair!** Often, the demise of the founder creates a power vacuum that stokes discontent and animosity among family members. The estate plan may spell out who gets what, but it rarely explains why. Parents assume their motives are transparent and

that their children will understand that they acted out of love, but children don't always see it that way. An advisor who specializes in family dynamics and relationships can help the founder and spouse clarify their intentions before beginning the estate-planning process and can help family members sort through the emotions and work together constructively after the founder's passing. Creating a forum for family members to come together—a family assembly—can provide a place for family discussions that might otherwise flare up in the office.

- **Outside, looking in:** When the family business is transferred in trust, the biggest challenge for the next generation of owners is that the trust distances the beneficiaries from the business. Choosing the wrong trustee can unintentionally enhance this alienation.

Practitioners need to pay careful attention to frictions that can be ignited when clients carelessly nominate trustees in wills and family trusts, particularly when these same trustees occupy board of director positions of the family enterprises that comprise, in whole or part, the corpus of the trust. Most clients know intuitively that trustees must act solely in the interests of all trust beneficiaries. It goes without saying that a trustee can't transact business with trust property for any personal benefit. Family enterprises that don't have many trusted advisors who are willing or able to serve as a fiduciary may be tempted to simply default to a director who's also a family member, to serve as a trustee. After all, that individual knows the most about the business and the family, right?

But query if it's prudent to name the same individual as trustee and director. Directors owe fiduciary duties of loyalty and impartiality to the shareholders and the business; trustees owe fiduciary duties to the beneficiaries. Without a basic system of checks and balances, the appointment of an individual who's also a director or CEO as trustee of a trust that owns or operates a family business can easily put that individual in an impossible situation or a conflicting position.

It's not hard to imagine situations arising in which the course of action that's best for the business may not be best for a beneficiary of the trust. What then? How will the family member holding multiple titles balance these duties? Spending time developing a roster of knowledgeable, capable individuals to serve so that no individual must occupy more than one role; building governance mechanisms into the trust agreement; training trustees and directors to recognize situations in which conflict is possible; and developing effective communication and decision making between the board and owners—all can improve decision making and reduce the risk of a family member getting caught in the web of conflicting duties.

In the same vein, it's important to note that multiple duties don't automatically imply a conflict of interest. Rather, it's the individual's actions in his dual capacity that may be harmful to other family members, thus creating a conflict of interest for the entire family to ponder and plan around.

- **Beneficiaries left out.** Beneficiaries may feel that they have no role, and their interest in the business turns to apathy or even anger. A beneficiary who lacks any control over the business is far more likely to seek an exit than one who's engaged in the business in some fashion. If the founder's desire in setting up the trust is purely tax-driven, and the founder wants the beneficiaries to have a say in enterprise decision making—that is, if the founder would have given the shares outright but for taxes—then the trust instrument must allow and encourage the trustee to seek the beneficiaries' input on shareholder decisions. An advisor who understands fiduciary obligations as well as family business systems can assist all parties—the founder, trustee and beneficiaries—in constructing a governance structure that balances the competing interests that naturally emerge in family enterprises.

Increasing the Odds of Success

Estate planning is intended to prevent a number of undeniably bad outcomes—a large tax bill or a claim by an angry creditor—at a critical moment in time. By contrast, the human and financial consequences of estate-planning transfers of control will linger over decades and generations. Succession planning for family businesses needs to be turned right side out. When there's a team of skilled advisors working alongside the estate planner and founder who can help the family think more deeply about the future of the family and the business, the odds of long-term success will increase exponentially.