The Unintended Consequences of Ownership Transfer Planning

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Passing a family business successfully across generations is a dauntingly complex undertaking.

Typical executive succession challenges-such as identifying the business' leadership needs, finding the right person, preparing the organization and executing the handoff are amplified by the infusion of emotion into the process. Decisions about who gets what and who's in charge are tied into complicated family relationships and have long-lasting effects on self-worth, in addition to net-worth. It's no wonder that the rate of successful cross-generational transfers in family companies is so low (about 30 percent, according to widely accepted figures).

Estate-planning attorneys play a critical role in the continuity challenge. Especially in the United States, passing down ownership of a family business is a complex endeavor. The tax laws in the United States provide strong incentives to pass shares via trusts, rather than directly, and require business families, especially those with little wealth outside the business, to employ creative measures to assure that estate taxes can be paid without draining the business. In addition, those families with little liquidity are highly motivated to pass shares to all their children, rather than concentrating ownership in the hands of the one or two most committed to the business. Estate plans are essential vehicles for minimizing estate tax burdens and preserving the desired legacy of the founders. Yet, we often see that the plans created to achieve these purposes have unintended consequences for subsequent generations. Too often, the ownership structures instituted in transfer plans compromise the successors' ability to run their family businesses. As advisors to the owners of family

businesses, we often encounter these unworkable situations with second, third and further generations, and we work with them to find solutions. We can see the positive intent of the founders and their planners, but we also see different choices that would have met the owners' objectives, while better serving the needs of subsequent generations of business owners.

Three Scenarios

Below are three scenarios. While we've disguised them to protect client confidentiality, they represent actual situations that we've encountered. In each, we've described the goals that the founders sought through their transfer planning, the unintended consequences of the plan their advisors created and the advice we gave the business family to remedy them.

My Siblings' Keeper

When family businesses are born out of an entrepreneur's need to survive in a new country, the founder is, often motivated to assure that all his children reap the economic benefits. Jose came to the United States from Mexico as a young man. Good with his hands, he worked as a mechanic, living in a room with other immigrants as he tried to build a stable economic foothold. Jose began working a second job as a truck driver, delivering pro duce from local farms to distribution points. When the opportunity arose, he borrowed $3,000 to buy a delivery truck; 10 years later, Jose had a successful trucking business with 20 employees. By the age of 65, he owned a complex logistics empire worth tens of millions.

Jose had five children with his wife Rene, who unfortunately passed away when the children were teenagers. As he built the business, Jose was focused on one goal: He wanted his children to enjoy a more comfortable life than he had as a young man. He was also painfully aware that he had neglected them in his single-minded focus on the business when they were young. He told his estate planners that he wanted, above all, to take care of his children and treat them equally. As all Jose's wealth was tied up in the company, his advisors created an ownership plan providing for the transfer of non-voting shares to the five siblings in equal amounts.

Unintended consequence. The owner's desire to treat his children equally undermined their ability to run the business competently, and this resulted in family gridlock. Neither Jose nor his advisors thought about how difficult it would be for the five siblings to make decisions together. One of Jose's two sons – Jose Jr. (Junior) had run the business since a health crisis sidelined Jose at age 55, but none of the other children had worked in the business. Two of the three sisters had no business experience. Their father had bailed their other brother out of gambling debts. Family relationships were difficult. All of Junior's siblings resented him for his compensation package; Junior felt unappreciated for his hard work by his siblings and by his stubborn and relentlessly critical father. Compounding the challenge, the founder refused to pass the voting shares until he was assured that his successor son had the backing of his siblings and that the siblings could work together.

Remedy. The family needed to create an ownership governance structure. Before the ownership transition, Junior ran the business with authority derived from his father. When Jose dies, Junior will need a different kind of authority, especially because he's a minority owner and can't exercise majority control, except through a coalition of his siblings. That authority will come from a process in which his siblings and their father create an ownership governance structure – a shareholders council – and agree on bow that entity will make decisions.

We worked with this family to clarify decision rights that had never been questioned while Jose was in charge. As the owner-manager, Jose made all the decisions! But post-Jose, this family business needed a board of directors, a shareholders council and a CEO with clear delineations of authority. And they needed to set this up before Jose died, so that authority could transition smoothly.

Three Smart Brothers

Many times, business owners simply don't pay attention to the transfer plans that their advisors create. They are busy with other things and view estate planning as a technical "fix" that's best left to the experts. As a consequence, surprisingly, even smart and well-educated business owners often don't understand what will happen to the ownership of their business when they're gone.

Here's an example: Three brothers never considered working anywhere but their father's clothing manufacturing and import business, which he built from nothing. Working together after his death, they leveraged their first-rate educations and their father's legacy business to create a diverse international portfolio of operating companies. Despite the trust documents said. Once the brothers gave us per mission to investigate, they were shocked to learn that their intelligent and well-prepared children would never get to vote the shares held in trust for them. The trusts were generation-skipping, providing that the shares passed to the three brothers' grandchildren. The brothers were trustees of each other's childrens' trusts, along with the attorney who created the structure. The seven cousins couldn't be trustees of their own trusts. And, there were no provisions for trustee succession, so that when the brothers died, the attorney could have voting control of the company.

It was a relief for them to be able to let their attorney take care of the paperwork necessary to create a tax-efficient transfer strategy. Focused on their entrepreneurial ventures, they didn't want to bother with the details. But for G3, who would have unequal ownership (one of the brothers had three children while the other two had two), the formal mechanics of ownership mattered greatly. And, of course, it mattered hugely to them to be able to exercise their ownership right to vote their shares.

Remedy. We, as advisors, needed to help the brothers hear and understand the G3 perspective and to see that their children's wishes needed to drive a revision of their estate plans. The family took advice to seek a technical remedy and found an attorney experienced with this dilemma. He proposed decanting the trusts to create new entities that gave the G3 voting rights for key business decisions.

Protective Parents

Passing the wealth that comes from a family business opens up numerous opportunities for the next generation, but it also creates new fears for parents that their children will become idle, or worse. When developing their estate plan, Charles and Eloise felt exactly that concern for their four children. Like many successful entrepreneurs, they started off poor, but worked tirelessly to build a billion-dollar food business. They decided to raise their children modestly, despite the family's wealth. Worried about nepotism, they told their children to find careers elsewhere. Not wanting their children to get a sense of the magnitude of their family fortune, Charles and Eloise told them next to nothing about their business. One of their children told us that the only things she knew about the business had been gleaned from the Internet.

Charles and Eloise set up an estate plan that would ultimately transfer ownership of the business to the children. Non-family managers ran the business, so they hoped the children would learn to become effective board members. Other than a bequest to their foundation, the remaining wealth would be passed to the children on Charles' and Eloise's deaths. They hoped that putting off the day when their children became extremely wealthy as long as possible would minimize the impact of this wealth on their lives.

Unintended consequence. Somewhat ironically, the unintended consequence of their intense concern about wealth is that it made the discussion among the next generation all about the money. The children, understandably, had no positive connection to the business. Instead, they were afraid that they would ruin it and resented that the business was their parents' fifth, and most loved, child. When we asked the children their plans for the business, they universally said that they would sell it as soon as they were given the opportunity. It wasn't that they were ungrateful to their parents, but rather that they believed they could find better things to do with the money than use it to hold onto a business that carried such negative emotions for them.

Remedy. Our approach with this client was to help the pa rents understand that their protective instincts had gone overboard and that the current path would likely lead to an out come they definitely didn't want. If they expected their children to assume a leadership role in the business, even if only from the board, then they needed to educate and prepare them for this responsibility. If they wanted their children to be responsible about wealth, they needed to give them the skills to manage it.

In response to feedback from their children, and after some serious soul searching, Charles and Eloise decided to change course dramatically. In partnership with their attorneys, they accelerated the transfer of business shares as well as their other wealth. They formed a shareholders council that included both generations, where they could talk about their goals for the business and provide a venue for the siblings to learn about it. They developed a training program for all of the siblings, including the opportunity to get to know the company's executives. And, they created a family employment policy to encourage qualified family members to enter the business, realizing that their employees and customers valued the active presence of the owners and that there was no better way for their children to learn how to guide the business than to roll up their sleeves. After all of these efforts, the next generation felt a commitment to carry on the legacy their parents created.

Making Ownership Workable

These three examples illustrate a common them e in our work with family-owned companies. With the best of intentions, family owners often create transfer plan s that make it difficult, sometimes impossible, for their successors to assume effective control over the business. In such situations, the owners and their advisors could have fulfilled the owners' intent and *still* created a more workable platform for succession. What clients ask for may be different from a plan that *will* ultimately best serve the long-term interests of the family and the business.

While clients' wishes absolutely need to be respected, legal advisors should consider the special environment of family companies as a reason to investigate those wishes more thoroughly before creating a plan. To avoid unintended consequences like the ones described in this article, we suggest that attorneys consider the following questions:

- Does the plan support the successor's ability to manage the business effectively?

- Does the plan support the next generation owners' ability to make ownership decisions together effectively?
- Are the successors aligned about what they'll do with the companies they'll ultimately control?
- Is the current generation making efforts, in parallel with estate planning, to set up ownership governance, such as a shareholder agreement and/or a shareholders council?
- *Are* steps being taken to foster communication and build teamwork in the family, such as holding family meetings and/or creating a family council?
- Has the owner given her successors opportunities to learn and practice their skills, such as by auditing board meetings?
- Has the family owner group committed to professional development for the next generation, such as providing opportunities to meet executives, learning about the business and taking courses to bolster their business knowledge?

If you would answer "no" when thinking about one of your clients, consider whether that client would best be served by taking a view of their succession planning that's broader than tax-efficient structures. In our family business advisory practice, we try to help both generations of the owning family, as well as their legal advisors, "roll the tape forward" to anticipate the challenges that the next generation will face as business owners. The time to set up formal rules and structures and to provide opportunities for practice in decision-making is while the current generation family business leaders are alive and active. Advisors who talk with the next generation about their wishes and concerns are more likely to build a workable ownership structure.

An important caveat in those conversations is that legal advisors, while not psychologists, need to consider that many times owners have emotional reasons, sometimes complex and sometimes unspoken, for suggesting or agreeing to certain ownership transfer provisions. For example, in "My Siblings' Keeper;' the fierce competition between Jose and Junior might raise questions about whether the father created hurdles for his successor, in part out of an unconscious desire to see his son fail. In "Three Smart Brothers," an observer could see that formal rules would limit the brothers' ability to work informally to ease the perennial tensions among them. In "Protective Parents," one might consider that the disruption in the parents' lives caused by their wealth colored their concerns for their children who, after all, grew up in relative comfort. When legal advisors suspect that emotions are driving owners' plans and limiting their thinking, we strongly encourage them to bring experienced family business advisors into the discussions.

We understand that estate-planning attorneys are reaching out to collaborate with family business advisors because they see that these clients need a special approach. In June 2012, one of us (Marion) participated in a lively American College of Trust and Estate Counsel panel on family business matters; it's clear to us that our shared clients will greatly benefit from greater alignment between our professions. We recognize that we're all identifying best practices in work with family businesses, and we've offered these thoughts in an effort to further this collaborative effort.

Endnote:

1. Thomas Markus Zellweger, Robert S. Nason and Mattias Nordqvist, "From Longevity of Firms to Transgenerational Entrepreneurship of Families: Introducing Family Entrepreneurial Orientation," *Family Business Review,* Vol. 25(2), at pp. 136-155 (2012).

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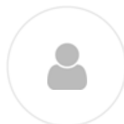

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