Family Businesses Need Legal Documents that Go Beyond Estate Plans

By: Craig Aronoff and Otis Baskin, The Family Business Consulting Group

Recently an attorney friend with vast experience in helping business-owning families plan for the continuity of their businesses and wealth asked us: "What are the most frequent problems caused by inappropriate legal advice to family business owners?" Actually, the most common problem isn't inappropriate advice – it's that the family and business have outgrown the last legal advice they requested. Too often business owners are operating a successful business with legal advice and documentation more than a generation old.

Success in subsequent generations requires review and revision of many operating assumptions to assure that they fit current needs and intent of both the business and its owners. It is easy when things are going well to leave important documents in a safe place without questioning their ability to safeguard the enterprise as it exists today. But, we do encounter clients who have put themselves or their heirs at risk while following legal advice that doesn't consider all relevant objectives.

When Good Advice Goes Wrong

With respect for our legal colleagues, we find that sometimes their immediate focus is on the details of what they do rather than the client's overarching needs. So, questions like: "Who should be your successor trustee?" or "How will your assets be disposed of if everyone in your family were to die?" (as important as those questions may be) get more attention than: "What are the goals you hope to accomplish through the planning process that allow us to produce the documents to guide your family in the future?" or "What are the principles that will guide your decisions as we work through this process?"

Here are some recommendations from our experience that can guide both attorneys and their clients in creating legal solutions that will work now without impeding the future of the family or the business they own.

Don't just tell clients that they need to make certain decisions and have certain documents drawn for them or assume that you know their needs and goals. Take the time to interact and help them understand that these processes and agreements should be parts of comprehensive plans which facilitate client goals consistent with their values. That, in turn, requires that clients be able to thoughtfully understand and articulate their own values and goals, something they perhaps have never done before. Clients often need help understanding that passing an operating business or mutually owned investments along to subsequent generations isn't like creating an estate plan for stocks and bonds.

When passing shares of an operating business to successor generations, more needs to be considered than just the cash value or how to divide the profits. Sometimes, the most important challenge is keeping control of the business within the family. This usually requires expertise beyond the scope of most estate planning attorneys because technical issues of corporate law are involved. Critical areas to consider are:

- Shareholder agreements or buy-sell agreements need to allow owners liquidity without harming the enterprise or other owners. Provisions to retain ownership within a given family must also consider ways to nurture ownership commitment to the enterprise, particularly when only a minority of the ownership is held by those operating the business. Forced sales of shares for those who choose not to work in the business may result in the business becoming top heavy with uninvolved and unproductive management and/or fractures in family relationships that may never be healed. Restrictions on leverage in the business appropriate for one stage of operations can hamper the ability of the business to grow and compete in the future.

- The proper role of owners should be defined for shareholders not involved in daily management who need confidence about how their capital is being deployed for the best interest of all. Good corporate governance processes need to be created to protect rights and provide a voice for all owners. Owners must understand the difference between their input and the roles of management.
- Clients should understand that when they put their shares into trust for the benefit of their heirs, they may be giving voting power to professionals outside of the family. We have worked with families in multi-generational businesses to make necessary changes to by-laws or other legal documents who were shocked to learn that the majority voting control for ownership was in the hands of outside trustees. Trusts are important tools to provide for heirs in a tax efficient way. But before they are "set in stone," the often-unintended impact on ownership decision-making needs to be clearly understood.

Not Just a Legal Exercise

Understanding and articulating goals and values takes time and thought, and is facilitated by probing, sensitive, informed questioning. This is particularly important, difficult and time consuming when dealing with a family business rather than an individual. Successful ownership transition in a family business often requires that consensus be achieved concerning goals and values to provide a foundation for gaining answers for all the other questions that emerge in the course of generational transition. Family businesses rarely approach generational transition ready to articulate goals and values without going through a process of intensive communication, planning and joint decision making, often with the guidance of a facilitator experienced in helping families through such processes.

One of our recent clients illustrated how complex it can be to reach consensus even when there is agreement on the goal. A sixth-generation family of more than 40 owners had operated two businesses for more than 100 years. As most of the ownership transitioned to G5, the ownership percentages became smaller and there was a need to increase revenue. Because the family had accumulated large and valuable land holdings over generations that were owned mutually through partnerships, they needed to agree on a way to monetize their assets that would respect the needs and interests of all owners.

While everyone agreed that maximizing the value of more than 10,000 acres of high-demand real estate required outside expertise and sound business planning, creating the structures and processes to achieve the desired outcome required careful preparation. The ownership group selected a working group of family members with the responsibility to represent the interests of all branches and keep them informed. Working with a facilitator, this group reviewed what other families had done in such circumstances and drafted a document of more than 30 pages describing values and objectives that the entire family could embrace. As the document was being prepared, the group members circulated drafts within the family for comment and two family meetings were held to have open discussions of drafts. At each stage, comments were addressed and drafts were revised.

When the working group and the larger ownership group agreed on a document that represented their mutual interests, they began to interview law firms to create the documents necessary for business operations and governance. They soon realized that greater expertise in corporate law, real estate law and estate planning was needed and narrowed their search to only firms with those capabilities. The law firm selected understood that this would not be a matter of changing names in a document already residing in their computer system. The resulting document defined the roles of owners, managers, and the board of directors along with providing mechanisms for ownership to be passed down and bought and sold within the family.

Finally, the document was adopted by all owners as the official governance system for all their enterprises present and future.

What Can Go Wrong?

Under the best of circumstances, blockages that slow down or stop the process are not uncommon and patience is required. Obstacles include:

- Conflicts among family members (often related to perceived past injustices)
- Fear of death
- Inability to make objective decisions (for example, who can perform more responsibly in various roles)
- Inexperience with the kinds of issues that arise in the process
- Inability to communicate effectively

These blockages typically need to be addressed with empathy and understanding if they are be overcome. The best response is often a team effort among involved family members, lawyers representing different perspectives, financial advisors, and experts in family ownership dynamics.

Conclusion

The best legal advice for any family business owner is always specific to the needs of the individuals and their business. Taking into consideration how the actions of any owner will impact the others. Planning for the continuity of family wealth and an operating business that can continue to generate wealth for generations to come requires more than tax efficiency. The financial welfare of current owners and those whom they wish to be future owners must be balanced with the need to make ownership decisions. A team approach that includes legal advice, financial planning, business governance, and family dynamics is the best approach.

Craig Aronoff, Ph.D. is a co-founder and principal consultant of The Family Business Consulting Group. He can be reached at aronoff@thefbcg.com.

Otis Baskin, Ph.D. is a consultant with The Family Business Consulting Group. He can be reached at baskin@thefbcg.com.

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