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Family Business Report

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Allocation of Ownership Among Family Members Inside and Outside the Business

Succession Planning with the Founder

One of the most difficult issues confronting the members of a family in a family-owned business is whether and how to allocate ownership to family members who do not participate in running the business. The process of coming up with a plan, as well as the legal tools available to effect the plan, will differ significantly, depending on whether the Founder is still around to participate in the planning process. (For the sake of simplicity, we will refer to the older generation as the "Founder", and in the masculine.)

This article assumes the participation of the Founder and deals with allocation of ownership among family members inside and outside the family business as a part of succession planning. There is, of course, no one approach that is appropriate in all cases. This article seeks to explore the relevant considerations.

If the founder is no longer in the picture, and if there are owners both inside and outside the family, one potential plan is to provide the operating members of the family with greater ownership and control. Such a plan may contain elements similar to that of a "management buyout" in the non-family context. We will examine this possibility in a subsequent article.

Allocation of ownership of a family business is a subject that requires analysis of the family system as well as evaluation of business issues. Indeed, in some cases, the family issues are so powerful that if not addressed, they contain the potential to cause great unhappiness as well as disruption to both the family and the business.

Ownership v. Control

In planning the allocation of business interests among family members, it is important to consider not one but two major questions:

- Should control of the business be concentrated in the family members active in the business?
- Should ownership be similarly concentrated? Outside family members can be allocated

the economic benefits of ownership interests but not the elements of control.

Whether outside family members should have an ownership interest requires analysis both of financial factors, such as allocation of the family property in an equitable manner and the planning for eventual liquidity-perhaps through buy-sell agreements funded by insurance- and non-financial considerations, such as the sentiments of the Founder, the desire of family members to participate in the business in some way, and the possibility that future generations may work in the business.

There are numerous ways in which ownership of a business can be separated from control, including:

- establishment of classes and series of stock (which can provide virtually all rights to certain stockholders, or allocate rights to control significant corporate events)
- voting and other agreements among stockholders (which may provide for election to Board of Directors)
- special charter provisions (allocating authority between the stockholders and the directors)

During the life of the Founder, it is possible to integrate these approaches with estate planning tools. During his lifetime, the Founder has the opportunity to consider structures which give him total or partial control over the business, but he can also have in place the mechanisms to deal with succession issues if he is unable to continue to run the company. Such mechanisms could include:

- a limited partnership or a limited liability company (see following article). By virtue of being the general partner of a limited partnership, the Founder could have virtually unlimited authority in the running of the business. Yet the document dealing with the entity could contain provisions to deal with the selection of his successor.
- a trust to hold ownership interests in the family business. In a situation where the Founder's children are still young, the trust may provide a significant measure of protection and a mechanism for the continuation of the business. A trust is also a useful vehicle for the Founder to express his wishes regarding interests of family members not active in the business. A powerful benefit of a trust is that it can be designed to change (or terminate) over time or at the occurrence of particular events, and therefore can enable the Founder to begin succession planning in an effective, timely manner.

The Founder's Children: Are Some More Equal Than Others?

The path of least resistance frequently adopted by a founder is to provide that ownership of the family business will devolve to each of the Founder's children equally. While in some cases this may indeed be the best solution, it is important that the Founder and his family recognize that this may also breed discontent. One sibling active in the business may consider it inequitable that ownership interests or control lie with siblings who are not active in the business. A sibling outside the business may similarly be disgruntled if he or she received the interest believing that it was a significant portion of the Founder's estate, only to discover over time that without dividends or the prospect of disposition of the business, the interest is of very little value.

There is no standard formula for allocating family business ownership between family members who are active participants and those who are not. It is important to recognize that simple equality of ownership of a closely held business without marketability may not be the right answer. However, in considering the fair or equivalent treatment of children not in the business, it is also important to consider allocation of non-business assets to siblings not in the business and the provision of a liquidity event. This will frequently be the proceeds of insurance on the death of the Founder, but may also be other sources of financing from the business itself or from third parties.

One approach is to have those family members who are not in the business own the real estate which is leased to the business. This has many attractions, since in general it does not require significant management by the owners of the real estate. However, as with many solutions relating to allocation of assets, there will have to be an understanding as to the valuation of such assets and the continuing issue of the fairness of the rental stream, maintenance, and other costs.

The Importance of Starting Early

Because many of these planning approaches have a great deal of flexibility and can be either changed by the Founder over time or provide for changes over time, it is possible for the Founder to begin succession and estate planning reasonably early. It is highly desirable that he do so. First, in general the opportunities for tax planning are much greater in early years, when values for gift tax purposes may be low, and when there may be a significant period of time to implement a periodic gift-giving program. Perhaps even more important, the Founder will have the peace of mind in knowing that if something should happen to him, there is a plan in place to mitigate, to the extent possible, the hardship to his spouse and the other members of the family.

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Family Limited Partnerships And Limited Liability Companies As Estate Planning Vehicles

Limited Partnerships and, more recently, Limited Liability Companies have been widely recognized as useful vehicles for conducting business. However, it is only over the course of the last few years that they have also been recognized as valuable estate planning tools. This article briefly defines both Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs") and summarizes the estate planning advantages that a family can achieve by creating one of these entities.

A limited partnership must have at least two partners, a general partner and a limited partner. The general partner may have complete control over the partnership's affairs (subject to fiduciary responsibilities to the limited partner), while the limited partner may be merely an investor with no control over the daily operations of the partnership. In addition, if appropriately structured, only the general partner is liable for the obligations of the limited partnership, and the limited partner has no liability unless he or she is also a general partner or becomes involved in the partnership's management.

In a FLP most, if not all, of the partners (both general and limited) are members of the same family. In most cases, parents create a FLP naming themselves (or a corporation they control) as both general partners and limited partners. Typically, the general partnership interests are small (e.g., 1%) and the parents hold the remaining interests (e.g., 99%) as limited partners. The parents then transfer assets to the FLP, and subsequently transfer some or all of their limited partnership interests to their children. By retaining the general partnership interests, the parents retain control, while transferring wealth to their descendants.

Limited Liability Companies are "hybrid" entities that combine some of the best characteristics of corporations and partnerships. The equity owners of LLCs are known as "members." Generally, an LLC must have at least two members (although certain states such as Delaware allow one-member LLCs). Management of an LLC vests in its members. However, the duties of managing the LLC may be delegated to one or more of its members, or to a governing body separate from the members, known as the "managers." All members of the LLC, as opposed to only the limited partners of a limited partnership, enjoy the benefit of limited liability.
In most cases parents create an LLC naming themselves as members and managers. The parents then transfer assets to the LLC, and subsequently transfer some or all of their membership interests to their children. By serving as the managers of the LLC, the parents retain control, while transferring wealth to their descendants.

When a limited partnership interest in a FLP or a membership interest in an LLC is transferred from a parent to a descendant during the parent's lifetime, that transfer is subject to gift taxes. However, significant valuation discounts may be available due to the nature of the interest transferred. In appropriate cases, discounts for lack of marketability may be available because there is no market readily available for the relevant interest, and further discounts may be available to reflect minority interest, because the limited partner or member has no control over the operations of the relevant entity. Furthermore, upon the death of a parent, if he or she is no longer a general partner (or in control of a corporate general partner) or is no longer a manager of an LLC, the fair market value of his or her interest in the FLP or the LLC may be lowered for estate tax purposes due to similar discounts for lack of marketability and fractional ownership of an asset. This estate tax savings may be sufficient to allow a family an opportunity to pass a family business from the parents to the children without having to sell it to pay estate taxes.

In addition to the gift and estate tax advantages discussed above, the creation of either a FLP or an LLC provides certain asset preservation advantages for a family. In general, the judgment creditor of a limited partner in a FLP cannot take the limited partner's proportionate share of the assets owned by the FLP to satisfy a judgment against the limited partner. Instead, in most cases, the only recourse available to the judgment creditor is to obtain a "charging order" from a court of law. A charging order entitles the judgment creditor only to the limited partner's share of partnership distributions and the judgment creditor cannot force distributions of income or property to be made from the FLP.

Creating either a FLP or an LLC also has a number of non-tax advantages such as: 1) lowering out-of state probate costs by avoiding ancillary administration, 2) the simplification of annual giving, 3) the ability to transfer capital to younger family members without undermining their productivity and initiative, and 4) the consolidation of family assets.

The creation of either a FLP or an LLC can serve a variety of tax and non-tax purposes. Parents who wish to retain control over assets, while transferring wealth to their descendants should consider the creation of such an entity.

Susan Valente Marandett

A Look Inside Family Foundations

Family foundations provide an exciting opportunity for families to work together, sharing their values and visions, as they give back to the community through family philanthropy. Family foundations can also provide an expanded arena for playing out ancient feuds, sibling rivalries, and parental conflict.

What makes the difference? Why are some family foundations models of orderly, carefully considered, responsible social institutions, while others collapse into disorderly, conflictual "free-for-alls" with a vaguely articulated mission and little ability to manage responsible philanthropy because family members have a hard time agreeing on anything?

An example: The E. H. Jones Foundation has an endowment of approximately $20 million administered by three siblings. Their widowed father established the organization more than thirty years ago, clearly articulating goals of family philanthropy in support of education and social welfare projects. Mr. Jones brought his three children into the administration of the Foundation early in its inception. He listened to their interests and took them seriously. He hired outside advisors to guide the children as they studied the fields of education and social welfare. Outside advisors also guided them in learning to review grant applications, keeping in mind the overall goals of the Foundation.

But most importantly, the relationship between the siblings and their father, until his death two years ago, was open and energetic. Each child had a spouse and family, they lived independent personal and professional lives, but they came to Foundation Board meetings with enthusiasm and focus. Dissent was not discouraged. If one family member disagreed with another about a particular grant, they talked through their differences one-on-one and in the larger family meetings. If they couldn't agree, then that proposal was put aside and they moved on in their discussions. They had a sense of balance in the way they participated in the meetings, always managing to fit in a couple of good meals and lots of vigorous conversation around the tasks of the Board.

In contrast, consider the Marvin Brown Foundation: The Brown Foundation was founded by entrepreneur and inventor, Marvin Brown and his wife Suzanne, in the early 1970s. The mission of the Foundation was clearly established at its inception. All grants were to be in support of medical research, the field in which Marvin had made his money. But Suzanne resented Marvin's greater knowledge of the field and his attempts to dominate decision-making. Philanthropy became a battleground for Marvin, Suzanne, and their two young adult sons. Because Marvin and Suzanne's marriage was highly conflictual and they rarely agreed, each of them regularly tried to enlist the support of at least one son against the other. As a non-family Board member told me, this foundation "has always been a mess. December rolls around each year and no grants have been decided on. It's always a last minute, impulsive, disagreeable process." The two sons want little to do with the Foundation and both have taken jobs in distant states, only very reluctantly coming to Board meetings. Two non-family Board members resigned from the Board in the past year.

The Jones Foundation and the Brown Foundation are not actual family foundations, but are composite descriptions created to dramatize many of the themes that I encounter in my work with family foundations.

What is the difference between them? Both have similar assets and are technically and legally well established. Both have clear mission statements and grant-giving schedules. The difference lies in the way the two families manage their relationships in the context of a family foundation. Families and advisors who work with family foundations have an opportunity to create energetic effective organizations when they:

- Promote curiosity about the family history and the relationship patterns, such as triangles, that precede the establishment of the foundation.
- Develop ways to maintain the boundary between the work of the foundation and more long-standing family relationship issues.
- Include experienced non-family members on the foundation board in order to provide calmness and objectivity in grant-making decisions.
- Strive for agreement on a common set of principles, goals, and objectives for the foundation.
- Consider hiring professional staff to assume the administrative responsibilities and tasks of the foundation.
- Plan a yearly family retreat to build positive family relationships.
- Create a vision of family philanthropy intelligently and responsibly.

A family foundation can be a unique institution in which family members learn to work together effectively and generously, while expressing and respecting their differences. Families with a multigenerational history of energy, productiveness, mutual respect and good humor will be most naturally effective in this arena, but all of us can benefit from becoming less reactive to important family relationships while enjoying the shared satisfactions of making a difference in the world through philanthropy.

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