

Avoid the pitfalls of trust planning

If you plan to transition family business assets via a trust, be aware of the potential landmines—and know how to sidestep them.

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WHEN STRUCTURING the transition of a family business from one generation to the next, most families use a combination of lifetime and testamentary techniques, usually involving trusts for the benefit of current and future family members. In most cases, the families establishing the trusts spend great amounts of time focusing on the dispositive provisions of the documents. All too often, however, families do not fully consider the fiduciary, tax and administrative provisions of their trusts with the same care. They regard these sections as technical “legalese” and “boilerplate,” but ignoring these provisions can be just as dangerous as disregarding the sections of the trusts directing the distributions to be made to the beneficiaries—if not more so. Here are a few of the potential pitfalls and landmines involved with creating trusts to own interests in a family or closely held business.

Selection of trustees and other fiduciaries

Fiduciary duty is the highest standard of care under the law. A fiduciary, such as a trustee, owes an undivided duty of loyalty to the beneficiary and must put the beneficiary's interests before his or her own. This concept is important in any trust arrangement, but it takes on a special meaning for family businesses. In addition to the qualifications normally sought in a trustee (such as judgment, experience, investment sophistication or familiarity with the family and the beneficiary), a trustee of a trust that will own an interest in

a family business has added responsibility.

The trustee must put the interests of the beneficiaries first. This can be challenging when the trustee is active in the business and one or more of the beneficiaries has a passive role. What is the right decision for the business (and, by implication, the trustee) may not always be right for the beneficiaries. For example, after a thorough business and tax analysis, a business decision by company executives may lead to a conclusion that a division of the company should be sold. As one of the business leaders, the trustee may agree with this decision. However, the beneficiaries might feel differently. The division could have historic significance to the beneficiaries as part of the founder's legacy, among a host of other “non-business” reasons. The business leader/trustee could be in the middle of a conflict or seemingly in a position in which aligning interests to reach a decision is difficult. There is no “correct” resolution to this complex issue, and the trust document will be critical in guiding decision making.

Although striking the right balance of interests is difficult, it is critical to do so when one member of the family must vote stock or make decisions as a fiduciary that affect the entire family. When establishing a trust to own stock in a family business, the grantor of the trust should consider how his or her choice for trustee would react in these situations and whether a more in-depth fiduciary structure—such as multiple trustees, independent and corporate trustees, formalized investment advisers or committee decision making—would be more appropriate for the family and the business separately considered.

In some cases, the person who would be the best choice for a trustee may be reluctant to act because of potential controversy or the possibility of personal liability. For these situations, the terms of the trust document pertaining to trustee liability and decision making—boilerplate sections

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—are critical because they can modify the fiduciary standards that would otherwise apply. Does the trust exonerate an individual trustee if that person acts in good faith? How does the trust handle trustee negligence? What is the scope of the trustee's powers? What happens if people acting as co-trustees do not agree? By paying careful attention to these provisions, families may be able to anticipate problems and insert language into their trusts to reduce the likelihood of future controversy.

Each family is different, but some of the most contentious family business litigation could be avoided if the family had given more considered thought to the selection of a fiduciary and the provisions of the trust governing fiduciary decision making.

Fiduciary investment standards and family businesses

Without special provisions in the documents, an investment by a trust in a closely held or family business is no different from an investment in publicly traded, marketable securities and is subject to the same fiduciary standards applicable to those investments. Many states have adopted a form of the “prudent investor rule,” which provides that the trustee has a duty to “invest and manage trust assets as a prudent investor would considering the purposes, terms, distribution requirements and other circumstances of the trust.” The prudent investor rule adopts modern portfolio theory for trust investments and focuses on the conduct of the fiduciary, rather than the resulting performance of any particular investment.

The application of the prudent investor rule to fiduciary investments may be modified by the specific terms of the trust document. Such a modification is particularly important when a trust will own interests in a family business because, absent modification of the default rule, the trustee is subject to a “duty to diversify” the trust investments. “Diversification” in the context of the prudent investor rule is not what many trustees and beneficiaries think. The duty to diversify means that a trustee must convert a single asset trust or a trust in which there is an over-concentration of a single asset (usually more than 15% of the value) into more than a single investment. For trusts that predominantly hold interests in a family business, the standard duty to diversify, if left unaltered by the language of the trust, could (at worst) create a fiduciary obligation for the trustee to sell the interests in the family business or (at best) create confusion as to the proper authority of the trustee to continue the family business investment.

The existence of the duty to diversify under the prudent

investor rule certainly contributes to fiduciary litigation. Grantors of trusts could avoid much of this controversy, however, by making their intentions with respect to the retention of family business stock explicit in the trusts agreement. Several recent highly publicized fiduciary investment cases have focused on whether the language of the trust was sufficient to overcome the legal duty to diversify. In the cases in which the fiduciaries have avoided liability, they have relied on deliberate and explicit drafting of the trust instrument to modify the application of the prudent investor rule.

Providing an exit strategy: ‘Pruning the family tree’

The transition of a family business between generations is a difficult and uncertain process. Over multiple generations, different family lines and members become more or less involved in the family business. In those cases, when drafting trust agreements to own the business, it is important to consider how family members who desire more liquidity or a different investment strategy should be (or not be) accommodated. For many companies, these issues are addressed in shareholders' agreements or buy-sell agreements. These same concepts also apply to the trusts that own the company stock. The senior generation of family business owners

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should think about whether to include provisions that create a framework for family members to exit the business without financially or emotionally disrupting either the family or the company.

For family business owners especially, taking advantage of current planning opportunities with an appropriate attention to the mundane details of the administrative provisions for trust governance is invaluable. If the trust documents fail to balance family and business interests, an aggrieved beneficiary might ask an aggressive lawyer to help find a more favorable balance. That will be a much more expensive proposition. FB