ACTEC 2012 Summer Meeting Musings, Including Special Seminar About Counseling Family Businesses and Business Families

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Items 1-53 come from the "Stand Alone" program titled "All in the Family: How to Counsel Family Businesses and Business Families." (The program included three separate panels addressing issues that arise over the life span of a family business. This program builds on Ron Aucutt's insightful Trachtman Lecture in 2011 regarding the call of the counselor in advising families in light of ethical limitations, and this seminar addresses those issues in the particular context of family businesses. The speakers on the three panels are:
"Toughest Issues," Dennis I. Belcher, Ann B. Burns, Daniel H. Markstein, and Louis A. Mezzullo
"Ethics," Christopher Gadsden, Cynda C. Ottaway, John T. Rogers
"Values and Communications," Ronald D. Aucutt, Dr. Marion M. Hampton, Jon J. Gallo, and Anita J. Siegel
The program is organized around a hypothetical "seven day" fact situation (that really encompasses seven different developments — over decades — in the life cycle of a family business).

Day One — The Beginning of the Family Business (The young business owner's general attorney contacts an experienced business/estate planning attorney to assist with planning to form the owner's new real estate development business. The business owner is married with three children.)

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It's very hard to do the planning for a family and family business without reaching out to peripheral parties. "We need to interpret and apply and maybe even bend or push the rules of professional ethics — to focus on the needs of the family.")

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Important Information Regarding This Summary

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Introduction

Some of my observations from the 2012 ACTEC Summer Meeting Seminars in Colorado Springs, Colorado on June 13-16, 2012 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues. The summary is based on the excellent presentations at the meeting seminars (many times repeated verbatim), but the specific speakers making particular comments typically are not identified.

The "Stand Alone" seminar at the Summer Meeting was titled "All in the Family: How to Counsel Family Businesses and Business Families."

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Day One — The Beginning of the Family Business (The young business owner's general attorney contacts an experienced business/estate planning attorney to assist with planning to form the owner's new real estate development business. The business owner is married with three children.)

1. Selection of Entity Decision

The primary advice is to "keep it simple." Lou Mezzullo describes his three fundamental principles of estate planning: (1) One size does not fit all; (2) Respect the "KISS" principle; and (3) Do not let the tax tail wag the dog. Another panelist warns not to organize a system with 34 boxes on the flowchart, each with a different ownership. The client and professional advisors will regret that complexity.

Use LLCs and partnerships rather than corporations to avoid the double tax. A possible advantage of S corporations is that income can be distributed as dividends in a manner that will not be subject to the Medicare tax. However, beginning in 2013, they will be subject to a 3.8% tax, so that advantage is disappearing as well. Some states tax LLCs or partnerships more favorably than the other. (In California, limited partnerships pay less state franchise tax than LLCs.)

Consider having separate LLCs for separate categories of assets. For example, contribute unimproved real estate, improved real estate, and foreign real estate into separate LLCs. There could be separate LLCs for each project (for liability protection purposes) with a central holding company LLC.

2. Life Insurance

The need for life insurance is driven both by liquidity needs of the business as well as the lifestyle needs of the family following the owner's death. The portion for lifestyle needs will probably be

owned by the spouse or by an irrevocable life insurance trust. The portion for business liquidity needs will probably be owned by the company.

If any of the insurance will be owned in an ILIT, it should be established at the outset. This requires considering where the client will be in the future.

One of the best ways that professional advisors can bring value to young entrepreneurs is to encourage them to consider life insurance. By far the most important factor in family business succession planning is cash flow. That is true when the owner is alive and even truer after the owner dies. Family members who work in and outside the business will be frustrated with each other, and life insurance can provide helpful liquidity to avoid those problems – in addition to paying estate tax and funding lifestyle needs of the surviving spouse.

Estimating the amount of life insurance that will be needed is very difficult. Following the decline of the market in the last five years, it is extremely difficult to estimate principal amounts that will be needed to produce a targeted cash flow. Encourage clients to purchase all the life insurance they can afford. "How many clients do you know who have died who thought they were over insured?"

3. Intra-Family Loans

Intra-family loans may be used to "seed" the business. They may also be used to provide benefits to family members or to provide needed liquidity to non-family members.

Low-interest loans using the incredibly low current AFR interest rate afford a great opportunity for parents to provide assistance to family members. However, keep in mind that repeated loans at these current low rates provide the possibility for long-term distress in being able to repay the notes.

The interest rate does not have to be as low as the AFR. Repeated low-interest loans to one child may generate ill will by other children who feel that they have not received equal financial benefits from the parents.

Because of the absence of a final regulation applying the AFR concepts of §7872 to estate taxes, one may argue that AFR notes may be valued lower for estate tax purposes than for gift tax purposes. For example, some planners are considering filing amended estate tax returns after the estate tax audit is completed valuing an AFR loan significantly below face value (with an appraisal). (However, if the note is valued below face value for estate tax purposes, payments on the note above face value will generate ordinary income.)

Trusts should be wary of making loans to non-family members at the AFR. The trustee has a fiduciary obligation to receive a market rate, and should not make AFR loans to non-beneficiaries without the consent of beneficiaries.

4. Ownership of Business Interests

Be very wary about including younger family members as owners of a new enterprise at the outset the business. Bill Gates and Warren Buffett did not initially put ownership of their companies in trusts. "I think you can be too smart to soon. Be much less concerned about the transfer tax consequences of the entrepreneur's success than that they succeed. You take great risk if you put the stock in the hands of someone unskilled in the business. That may be a great transfer tax plan, but it is not a good business plan."

"A 35% estate tax rate is very different than a 55% rate. Many of us are still thinking in the 55% tax rate mode. We don't know what next year's law will bring, but I worry more about making a

transfer that the client will later regret than keeping the stock and later having to pay estate tax on that stock."

Should the business be owned by the entrepreneur or equally by both spouses? Having the stock owned 50% by each spouse allows a lack-of-control discount for each spouse's interest, and permits estate tax savings without giving any of the stock children. (If stock at the first spouse's death is left to a QTIP trust, that block of stock and the surviving spouse's block of stock are not aggregated for valuation purposes.)

If any of the stock will be owned by others, the others should own non-voting stock with a buy-sell agreement that has significant transfer restrictions giving the business owner the ability to get the stock back with definite procedures for valuing the interests. Be sure to position ownership so that the business owner qualifies for §6166 estate tax deferral.

In buy-sell agreements, address how discounts will be applied. The agreement should specifically address whether the lack of marketability discount, lack-of-control discount, or both should be applicable in determining the purchase price under the buy-sell agreement. There is no right or wrong answer; it depends on what the owners (or more particularly, the founder) wants.

As a practical matter, the business owner and his or her spouse have probably already decided about ownership issues before coming to see the attorney.

Consider transfer planning with new projects. After the new business builds credibility with lenders and vendors, and as new projects are considered, some portion of the new projects could be owned by younger family members (or trusts for their benefit). Use the business owner's skill at that point to build value for new projects that will be owned (in whole or in part) by trusts for the children.

Day Two — The Expansion of the Family Business (The business is generating cash flow, and the owner wants to expand into new locations and service lines. Two employees are key to growing the business. The owner's daughter wants to work in the business upon graduation from college.)

5. Separate Companies For Each Project

For liability purposes, a separate entity should ideally own each separate project. If that creates an unworkable number of entities, consider grouping the projects, putting the most risky projects in one entity, the next most risky group in another entity, etc. Separate bank accounts are recommended for each entity, to keep them as separate as possible from a creditor standpoint, but structure the plan so the entities will file a single income tax return.

6. Employment Agreements for Key Employees

Employment agreements for employees are very important as the business grows. Business planning attorneys often do not focus on that enough. As a company grows, it often continues to operate the same way it did when it was small (such as having loose oral arrangements with employees). Employment agreements, covenants not to compete, and agreements to protect intellectual property should all be considered as the company grows.

Employment agreements are also helpful in setting the expectations and in formalizing systems for communicating with employees. The employee and employer both have formal opportunities to tell each other what is expected. Annual reviews can become formalized and are very effective in facilitating communication. Having employment agreements is also very important when preparing for the sale of a business.

7. Incentivizing Employees

Allowing non-family members to own stock is a bad idea, even for key employees. Even from the employee's perspective, the employee would prefer to have a way of receiving cash value for some portion of the future growth of the company rather than owning a minority stock interest (in an inherently illiquid asset). From the company's perspective, non-family member owners have a right to bring legal action against the company as an owner rather than merely as an employee. Even having a restrictive buy-sell agreement with non-voting stock for non-family members does not necessarily solve problems of having outside owners. Business owners still have the right under state law to sue as an owner, to see records, etc. However, if any stock is transferred to employees, it is very critical to have restrictive buy-sell agreements so that the business owner or the company has the ability to get the stock back when appropriate using a prescribed procedure for valuing the stock.

Phantom equity plans (a type of nonqualified deferred compensation plan) can be an effective way to provide value for key employees. A change in 2004 requires that a change in the payout election cannot be effective for one year, and payout must be postponed over at least five years. Even so, some panelists prefer these types of plans rather than giving stock ownership to employees.

Restricted stock (with buy-sell agreements) can also be helpful if the client is willing to put stock in the hands of employees. Restricted stock and severance pay arrangements in the employment agreement have a powerful effect on the employee. No particular income tax complications arise if the founder gives restricted stock. However, if restricted stock is sold to employees, Regulation §1.83-6(b)(1) says that the transaction is bifurcated -- the employee's payment for the restricted stock is deemed to be a contribution to the Corporation and a distribution back to the individual who sold the stock. That can be very significant if the preferential 15% rate on dividends disappears.

A special technique is available for S corporations. If individuals without much money will be purchasing the business, a possible strategy is to move some restricted stock into their hands, and provide that the restrictions will lapse very early in a calendar year in which the balance of the founder's stock will be redeemed. The pass-through entity is owned for virtually the entire year by individuals acquiring the company and the recognition of income to the individuals who owned the restricted stock under §83 when the restrictions lapse is offset by the compensation deduction available to the corporation that passes through to the individual-owners, and there is a wash. For that to work, the individuals should not have made a §83(b) election when they acquired the restricted stock.

8. Transfer Planning Considerations During Early Expansion Years

For more moderate size families, making a $5 million gift affects the lifestyle of the family. For a $15 million family, whittling the estate down with estate taxes has far more impact on the family's future lifestyle than for a $100 million family. However, the irony is that the client with $15 million is unlikely to be willing to give $5 million currently to avoid future estate taxes.

As discussed in the following item, consider transferring interests in new start up projects of the expanding business when they have low value. Those new projects will probably not produce large cash flow, and the major cash flow from the business can be retained by the founder.

For larger value clients, consider various transfer planning strategies such as--

- Conversion to a Roth IRA for moving value to grandchildren;

- Long term GRATs for assets that produce long-term predictable cash flow (such as real estate used in the business); this can build value that can be used to provide assets for family members who will not be involved in the business; if the GRAT owns assets other than the business interest or if the business produces significant cash flows (including "tax distributions"), the necessity of obtaining annual appraisals of the stock could be avoided (if interests in the business do not have to be distributed in satisfaction of annuity payments); and
- CLATs can be a useful transfer planning strategy in a low-interest-rate environment.

Maintaining control is critical. One panelist has seen two situations in the recent past when the owner transferred ownership to his children and then the children immediately fired him. Less extreme is that if control is transferred to G2, the founder assumes that G2 will not make major changes, but G2 thinks of nothing but changes that he has been wanting to make for years. Communication is important to avoid that blow-up. Until the founder is very comfortable with what will happen, the founder should maintain control.

9. Protecting Owner's Cash Flow

As the business expands, the client may transfer some of the ownership to trusts for children or grandchildren. Even so, cash flow will be important to the business owner. The owner will generally retain interests in the businesses that produce the most cash flow in order to support the owner's lifestyle spending. Some projects start as leveraged projects with low values that would present good opportunities for transfers (and that generate little cash flow).

As the business expands, a management company may be formed that will charge each project a management fee. Cash flow can flow to the business owner from the various trusts for descendants that own some of the expanding new projects. Clients really like this – they can control cash flow by the way they charge management and service fees.

Carefully analyzing cash flow and planning for sufficient cash flow for clients is a way that planners can bring great value to their clients. Work closely with the CPA, who will probably have the best feel for current and future cash flow issues.

Day Three — The Founder's Retirement from the Family Business (The founder wants to start a transition toward retirement, spending more time at his second home. Concerns are having suitable retirement income, maintaining competent management of the companies, and planning to minimize transfer and income taxes.)

10. Triggering Event; Assuring Continued Cash Flow During Retirement

Clients call to have new wills prepared when they're going on vacation. They do that not because people die when they go on vacation, but because the vacation is a triggering event. Retirement is a clear triggering event, and the founder must seriously consider succession planning at that time if it has not been done previously. (Attorneys must impress upon clients throughout the relationship that more subtle triggering events can occur than traveling on vacation.)

If the company is a pass-through entity, the founder's cash flow can be provided by continued distributions from the company (on which income taxes have already been paid).

If the company is not a pass-through entity, a salary continuation plan can provide that payments will continue from the company to the founder (and the founder's spouse) for life. If the company is sold, the plan would be a liability of the company. Purchasers will probably buy assets rather than stock in any event. The company's gain on the sale of assets can be reduced by deductible payments from the salary continuation plan (and salary continuation plans often provide that if the business is sold, there would be a lump sum payout).

Some planners structure the salary continuation plan based on an average compensation over the last several years with an inflation adjustment provision. Some planners believe it is very important to have a compensation consultant advise on the structure of the plan, so that it is not deemed to be unreasonable compensation.

11. Planning Considerations for Second Home

The second home can be any emotional asset both for the founder and the founder's family. Sometimes the vacation home can be even more difficult to deal with than the business itself. The second home may be an asset that could be used in equalizing children who were not involved in the business.

QPRTs are not as favorable with low AFR rates, but they can still be effective with the low depressed values of real estate, particularly if spouses fund separate QPRTs with an undivided 50% interest in the residence, taking fractional-interest discounts.

A GRAT is another alternative for transfer planning with a second home. Fund the GRAT with cash in addition to the home. A graduated GRAT could make the annuity payments for about the first seven years with cash. If the second home appreciates in value significantly, the GRAT ultimately could transfer large value.

Another creative use of a second home for transfer planning is if there are regulatory restrictions on transferring business interests. The second home could be transferred into a grantor trust, and when the restrictions lapse on transferring the business interest, it could be substituted into the trust under the grantor's non-fiduciary substitution power.

Consider putting a second home into an LLC. Provide for member management, and provide procedures for management of the home to avoid later fights among the children.

12. Income Tax Planning

Income tax planning ideas for a mature business include the following:

- Qualified retirement plans to build value for the key employees;
- If the business will be sold, consider selling it when the capital gains rate is low (i.e., in 2012, before a possible increase in the rate in 2013);
- Possible redemption in 2012 when capital gain rates are low;
- Possible big dividend payments in 2012 while capital gain rates are low; and
- If the company is a C corporation, convert to an S Corporation immediately. If the company sells its appreciated assets within the next 10 years, a portion of the built-in gains will be taxed to the company, but get the 10-year period running. (If the assets are sold after two years, a portion of the build-in gains would not be taxed to the company [and therefore would not be double-taxed].)

Day Four — The Transition of Leadership in the Family Business to the Next Generation (The founder has a serious illness and is concerned about the payment of estate tax and transition of leadership. The founder's daughter works in the business and is very successful. She receives the same compensation as the founder's son, who misses work frequently and is not motivated. The son's and daughter's spouses do not get along with each other. A second son has no interest in the business. The founder has the following goals (which are fairly typical at this stage for a business owner): Provide support for the founder's spouse, preserve the company for future generations, provide opportunity for descendants to work in the business, maintain family harmony, support charity and civic interests, minimize transfer and income taxes, fulfill commitments to employees [as well as customers and vendors], and pass the family values to future generations.)

13. Explore Founder’s Priorities; Flexibility With Lifetime Transfers; Powers of Appointment

a. *Explore Founder’s Priorities; Possible Sale of Business.* Explore the founder’s priorities with a number of open-ended questions. Determine whether the founder’s highest priority is long-term continuance of the business within the family or whether the highest priority is unified relationships within the family. Attorneys often never have that conversation with business owners. The founder may come to the conclusion, based on family relationships and based on a realistic assessment of the ability of the business to survive without the founder, that the best approach is to sell the business during the founder's lifetime. The founder often has the primary contact with customers and vendors – not G2. There may be a good likelihood the business will be run into the ground if no one can take control of those relationships. If the founder comes to the conclusion that the best approach for the long-term benefit of the family is to sell the business, the highest price can often be obtained if the business is sold during the founder’s lifetime when the founder can facilitate the transition of the business to the new owner.

b. *Flexibility With Lifetime Transfers.* Whether the founder comes to the conclusion that the business will be retained within the family or sold, the founder may want to make transfers of interests in the business to family members so the future appreciation can be shifted to them outside the estate tax system.

In planning lifetime transfers, keep in mind who will be future leaders of the business. “Ownership determines leadership in a family business.” While the company does not have to be owned entirely by the persons managing the company, ownership *control* should absolutely be left with the leadership.

The key in planning ultimate disposition of assets to family members is fairness. “Fair is not always equal and equal is not always fair.”

Transfers are typically made with non-voting interests, with the founder continuing to own the voting stock.

Most transfers of business interests are to grantor trusts, typically to GST exempt trusts so that the assets are not subject to tax in the children's estates.

If the founder sells stock to a grantor trust, the grantor’s retained non-fiduciary substitution power affords significant flexibility. If the founder changes his or her mind, the business interest can be pulled back out of the trust in return for other assets. The substitution power effectively leaves the founder with a way to control the ultimate disposition of the business interest.

Trusts provide spousal protection, creditor protection, etc. Children may be the trustees, but provide authority to appoint third-party trustees to allow broader distributions than just for health, education, support, and maintenance. Children are typically given broad limited testamentary powers of appointment if the trust lasts for their lifetimes.

c. *Powers of Appointment.* One method of providing a great deal of long-term flexibility is to give testamentary limited powers of appointment to trusted individuals. (The settlor obviously cannot keep a presently exercisable power of appointment and still make a completed gift.) However, explore whether a broad limited power of appointment is appropriate. For example, in this fact scenario, the founder’s wife preferred one child over the others with respect to the business. In that circumstance, is it in the founder’s best

interest to give the spouse a power of appointment that allows her to favor that child over the others? The appointment power could be more limited, such as the power to change ages for distributions. Powers of appointment can be collared — limiting the amount that can be shifted to one descendant over others. A discussion about the implications of powers of appointment may lead to conversations in which the surviving spouse would say that she would never do that. If so, document that discussion with a memo-- and send the memo to the clients.

14. Management Transition

Providing for proper management of the company is absolutely critical. If children who are selected as managers do not have the ability to manage the company, it will fail. (For this reason, the founder should hang onto control, moving the voting stock only as appropriate based upon who will be the appropriate managers in the next generation.)

As an example, the Cargill Company is the largest privately-owned company in the U.S., still owned 85% by the founders' descendants. Their policy is that any Cargill family member who wants a job can have it, but the job will be consistent with that person's individual ability. A nonfamily member was recently named as the chief executive officer of Cargill. (The Cargill family was recently willing to share with one of the panelists the story of how their company has provided for management succession.)

Strong leadership is imperative. However, the first time that the founder (or the founder's attorney) tells someone in the family that they will not be the new leader, that will be very difficult. Earlier conversations about the differences of being a shareholder, director, or employee – with their different responsibilities and compensation – can help the communication process. Similarly, if the attorney advises the founder not choose the child at the founder favors because that child is not capable of running the business, that advice will not be well received (to say the least).

15. Testamentary Planning, Including Testamentary CLAT

a. *Asset by Asset.* As opposed to following the traditional approach of dividing the estate equally on a percentage basis among children, consider making asset distributions when business interests are involved. Children who are not involved in the business can receive specified non-business assets (even including cash), and the business interest can pass for the benefit of children who are actively involved in the business. That may avoid long-term family blowups and ill will among the siblings.

b. *Testamentary CLAT.* The will could provide for a bequest of the business interest to a CLAT, but giving the family member who will ultimately end up owning the business an option to purchase the business interest from the estate before it passes into the CLAT. For example, the will could provide that the business interest could be purchased with a 20-year interest-only note at the AFR rate. In effect, the desired owner can purchase the company entirely on credit with no down payment and can pay interest-only for 20 years. At the end of 20 years, if the CLAT terminates and passes to that individual, the principal effectively is forgiven.

Under this approach, the child who has the ability to run the business exercises the option, and that child owns the business subject to this debt. The payment of the interest is sufficient to allow the CLAT to make the annual charitable annuity payment (meaning

that the interest rate will probably have to be something above the AFR). The charity that receives the payments could be a family foundation.

With this approach, the founder can wait to give away the family business until the founder has determined who would be the appropriate successor owner and manager, and the business interest can then be transferred estate tax-free with this strategy.

Observe that there are no excess business holdings complications, because the CLAT will not own the business interest but only a note from the purchaser. There are self-dealing limitations but there is an estate administration exception in the regulations.

Economics: keep in mind the difference between a 35% and a 55% estate tax rate. With a 35% rate, would the child rather inherit the business and pay a 35% estate tax, deferred over 14 years under §6166? Particularly if the assets in the CLAT pass to all family members rather than just the owner-child, the ultimate payment is just being deferred. If the client is charitably inclined, the CLAT can be quite desirable. But if not, this may not look so attractive under a 35% estate tax rate system.

16. Selection of Fiduciaries

Surviving Spouse. The surviving spouse does not have experience with the business and may need a co-trustee. Some planners suggest that having an unqualified spouse as a co-trustee is a disaster waiting to happen, but others think that the spouse should have significant input because the trust is for her benefit in her lifetime.

Child Who Is Likely Next Head of Company. If that child both runs the company and is the trustee, there could be irreconcilable conflicts. That can also create problems for the other co-trustees.

Attorney. Whether an attorney acts as trustee and whether a corporate trustee is used varies throughout the country.

Corporate Trustee. Some planners prefer using a corporate trustee with a committee who can give input to business issues.

Removal Power. It is important to have a removal power, particularly with a corporate trustee.

Co-Trustees. Co-trustees may have different functions, for example there may be an administrative co-trustee, a business interest co-trustee, and a distributions co-trustee who each have primary responsibility for those separate functions.

Family Members Who Serve Free of Charge. When a client says “Aunt Mary knows the children and she will be a perfect successor trustee and she will be happy to serve free of charge,” counsel the client on the role of the trustee, business and investment decisions that will need to be made, the amount of time the process will take, and whether Aunt Mary is an appropriate choice. Be proactive with clients in advising about the implications of their choices rather than merely being a scrivener.

Brief Overview of Ethical Issues for Days One – Four (The theme of these discussions is to anticipate issues that could arise in the future, and manage expectations as much as possible. The goal in counseling the “business family” is to get to “Yes, we can do that” — but to put appropriate structure around the engagement. It’s very hard to do the planning for a family and family business without reaching out to peripheral parties. “We need to interpret and apply and maybe even bend or push the rules of professional ethics — to focus on the needs of the family.”)

17. Ethical Issues in Advising Multiple Family Members and Engagement Letters

The key ethical issue that arises with representing "family businesses and business families" is the potential conflict that can arise with concurrent representation. Rule 1.7 of the Model Rules of Professional Responsibility addresses conflicts of interest with current clients. Rule 1.7 provides that an attorney cannot represent a client if the representation will be directly adverse to another client, or will materially limit the lawyer's responsibilities to another client. However, a very important exception exists, providing that a lawyer may represent concurrent clients if (1) the lawyer reasonably believes the lawyer will be able to provide competent and diligent representation to each affected client, (2) the representation is not illegal, (3) the clients are not in litigation, and (4) the clients give written informed consent.

The ACTEC Commentary on Rule 1.7 observes that the attorney may appropriately represent multiple clients in many family situations, and that such joint representation can be most advantageous for the family:

> "*General No-adversary Character of Estates and Trusts Practice; Representation of Multiple Clients*. It is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate plans, more than one beneficiary with common interests in an estate or trust administration matter, co-fiduciaries of an estate or trust, or more than one of the investors in a closely held business. See ACTEC Commentary on MRPC 1.6 (Confidentiality Information). In some instances the client may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. The fact that the estate planning goals of the clients are not entirely consistent does not necessarily preclude the lawyer from representing them: Advising related clients who have somewhat differing goals may be consistent with their interests and the lawyer's traditional role as the lawyer for the "family." Multiple representation is also generally appropriate because the interests of the clients in cooperation, including obtaining cost effective representation and achieving common objectives, often clearly predominate over their limited inconsistent interests. Recognition should be given to the fact that estate planning is fundamentally nonadversarial in nature and estate administration is usually nonadversarial."

Engagement letters are critical in dealing with many of the ethical issues that arise. "An ounce of prevention is better than a pound of cure." Avoiding problems is much better than fixing them later. The engagement letter is the opportunity to set the stage and frame the representation in a way that it can be managed while the relationship continues and so that the attorney can relatively easily get out of the relationship. Be sure to revise the engagement letter as necessary during the course of representing the client.

A very common joint engagement in the estate planning context is the joint representation of spouses. An example engagement letter includes the following:

> "It is common for a husband and wife to employ the same lawyer or law firm to assist them in planning their estates. You have taken this approach by asking us to represent both of you in your planning. It is important that you understand that, because we will be representing both of you, you are considered our client, collectively. Ethical considerations prohibit us from agreeing with either of you to withhold information from the other. Accordingly, in agreeing to this form of

representation, each of you is authorizing us to disclose to the other any matters related to the representation that one of you might discuss with us or that we might acquire from any other source. In this representation, we will not give legal advice to either of you or make changes in any of your estate planning documents without your mutual knowledge and consent. Of course, anything either of you discuss with us is privileged from disclosure to third parties, except (a) with your consent, (b) for communication with other advisors, or (c) as otherwise required or permitted by law or the rules governing professional conduct.

> If a conflict of interest arises between the two of you during the course of your planning or if the two of you have a difference of opinion concerning the proposed plan for disposition of your property or on any other subject, we can point out the pros and cons of your respective positions or differing opinions. However, ethical considerations prohibit us, as the lawyer for both of you, from advocating one of your positions over the other. Furthermore, we would not be able to advocate one of your positions versus the other if there is a dispute at any time as to your respective property rights or interests or as to other legal issues between you. If actual conflicts of interest do arise between you, of such a nature that in our judgment it is impossible for us to perform our ethical obligations to both of you, it would become necessary for us to cease acting as your joint attorney."

Another possible approach is to have concurrent "separate representation" of estate planning clients. The panelists find that troubling and do not like to do it. A concern with that approach is whether the attorney can represent both and not share confidences. Concurrent separate representation is not typically done.

The materials include an example engagement letter to represent the individual founder when the company is being formed. The letter acknowledges that future potential conflicts could arise in the future:

> "Because the Company may eventually have owners in addition to you, it is important that you understand the interests of the Company may not always be identical to the interests of you and the other owners and managers, and that the interests of any owner may not always be identical to the interests of the others. While this should not necessarily affect our representation of you, the possibility of our representing you and others on a joint-representation basis could conceivably be raised in the future. This would require the execution of a new engagement letter with appropriate conflict waivers, which we will discuss with you if the occasion arises."

18. Ethical Issues in Advising Founder Regarding Employment Agreements Where Employees Are Also Clients

If the attorney represents some of the employees individually, and the founder wishes to engage the attorney to represent the founder in negotiating employment agreements with the employees, there will need to be conflict waiver letters signed by all of the parties. An example letter to the founder includes the following:

> "If you agree to waive any conflict of interest relating to our current representation of you and separate representation of Mr. Jefferson and Mr. Hamilton on different matters, then we will contact Mr. Jefferson and Mr. Hamilton separately to advise them of our prior and ongoing representation of you and your business interest. We will advise them that we will represent your interests and not their own personal

interest in employment matters. If they want their own legal representation, then they will need to retain other counsel.

On a related matter, you should be aware that by including Mr. Jefferson and Mr. Hamilton in our meeting that you will waive the confidentiality privilege that you have under the attorney-client relationship. If there are any confidential matters for which you want to retain the privilege, you should meet with us separately."

Another possible approach is to provide in the engagement letter that there will be an "ethical screen" between firm personnel working on the respective matters. An example memo for firm personnel includes the following:

> "John Adams has engaged the Firm to represent him in connection with his employment of Jefferson and Hamilton, and all parties have consented to the Firm's representation of John Adams on the employment matter while concurrently representing Jefferson and Hamilton on separate unrelated matters. In order to maintain confidences that might be shared from the separate legal matters of these parties, the Firm is constructing an ethical screen between Firm personnel working on the respective matters. The ethical screen applies equally to any attorney who is not listed above but who is now or begins working on either of the described matters.
>
> Whenever this ethical screen affects an attorney, it also affects any non-lawyer personnel assisting the attorney. Please observe the following procedures [specific detail procedures are listed]."

An example waiver letter to the employees includes the following:

> "Mr. Adams has requested that we represent him separately in this employment matter for which we request your consent. While Mr. Adams will be our client in this matter, we will provide you draft copies of the documents to allow you to comment on the terms, suggest changes and generally protect your interests. If you decide to retain your own counsel, then we will provide these documents to your counsel.
>
> Even though you have a good existing relationship with Mr. Adams, situations may arise where Mr. Adams' interests differ from yours. In any such circumstance, we will represent only Mr. Adams' interests."

19. Ethical Issues If Business Expands to Other States

Rule 5.5 governs multijurisdictional practice. It permits an attorney to provide legal services on a "temporary basis" in a jurisdiction where the attorney is not licensed if the representation is undertaken in association with an attorney who is licensed in the state. For example, if the attorney represents the founder to set up a business and satisfy compliance requirements, that appears to be a temporary representation.

An example engagement letter for such representation includes the following:

> "You have advised that you will be expanding your business by building new projects in three new states. We are advising you that our law firm does not presently employ attorneys who are licensed to practice in any of the three other states. We have an obligation to be sure you have competent representation to comply with local laws in these three states. While we are happy to continue to be your lead counsel on these projects, we request your permission to retain the services on your behalf of local counsel in each state who will associate with us on these matters. Each of the local

> counsel will actively participate in the matter, but we will coordinate services so that we may provide uniformity where appropriate for the business plan and avoid duplication to the extent possible."

The ACTEC Commentaries add this gloss:

> "In addition, the associated counsel must "actively participate" in the matter. Active participation is not defined in the Rule or the comments. Lawyers providing estate counseling services in a non-admitted jurisdiction would meet this second requirement by associating local counsel for such matters as the preparation, will execution formalities, and similar services."

20. Attorney Serving As Trustee

A long-time attorney representing the family business owner may be requested to serve as trustee of trusts that own business interests. An example engagement letter addresses responsibilities of a trustee, others who could be nominated as trustee, potential conflicts of interest, compensation to the lawyer as trustee, retention of the law firm to represent the attorney as trustee, use of exculpatory language, and advice that the client may want to consult independent counsel with respect to whether to name the attorney as trustee.

The engagement letter states that the attorney's practice is to charge his or her normal professional billing rates for hours expended as a trustee, and to be reimbursed for out-of-pocket expenses including court costs and fidelity bond premiums. An issue could arise regarding whether the legal billing rate is reasonable compensation as trustee. The Model Rules about compensation relate to legal services. However, even if the attorney is not acting as a lawyer, the Model Rules still apply to the attorney. One way to protect the attorney in this situation is that the trust instrument itself could provide that a trustee would be entitled to receive compensation at the person's normal hourly rate if the trustee is an attorney.

If the attorney hires her own law firm to represent the attorney as trustee of the trust, an interesting issue is who reviews the law firm's billings on behalf of the trust to make sure they are reasonable from the trust's perspective. (Other panelists have pointed out that as a best practice, the fiduciary should not give legal advice to herself as trustee.)

California (and perhaps other jurisdictions) has statutory restrictions on attorneys serving as fiduciaries.

21. Transparency; Listening

Often, no easy bright-line answers exist. Ron Aucutt's 2011 Trachtman lecture and Mary Radford's article about ethical challenges in representing families in family limited partnerships (35 ACTEC J. 2 (2009)) both frequently refer to the situation in representing families as "chaotic."

"Transparency goes a long way in maintaining a good relationship between a lawyer and multiple clients and non-clients (as we have to tell people they are not our client). The concept of the family lawyer can be embraced carefully but if people just work on the assumption of a family counselor without guidance from the attorney, we are apt to have a misunderstanding down the road."

We also must also be transparent with ourselves, recognizing our capabilities and where we need assistance.

Listening skills are incredibly important. In terms of the attorney's ethical obligations to clients as well as the attorney's dealing with non-clients, if the attorney has not listened, the attorney has not received the assignment. The attorney will do it wrong, and that means Rule 1.1 will be violated – the duty to perform competently. That underlying listening theme pervades the entire relationship.

As much as attorneys want to serve families efficiently, ethical rules are important. For example, John Rogers indicates that he sometimes serves as an expert witness in malpractice actions regarding whether a particular action violated a rule of professional conduct. The defense attorney will argue that testimony should not be admissible because it prejudices the jury. However, the judge still allows the testimony.

See Item 31 below for additional discussion about the critical importance of good listening skills.

Communications and Values Issues for Days One – Four (Many if not all of the problems in the case study stem from a lack of communication and unnecessary blaming by the parties involved. Major topics include [i] facilitating communication among family members, [ii] providing family governance structures to achieve the right balance between family and business, and [iii] facilitating an emphasis on values to minimize conflict. Part of the information in Items 22-30 is taken verbatim from materials by Dr. Marion Hampton, who is a professional family business advisor.)

22. Family Business Consultants

Family business consultants have backgrounds in psychology, the law, and advising family businesses. The perspective is from the viewpoint of advising the entire family. A variety of difficult conflict situations that arise in the family can be handled much more comfortably by an outside family business consultant rather than by the attorney. Various Fellows told of stories in which family business consultants (including one of the panelists, Dr. Marion Hampton) have been able to work miracles in seemingly totally irreconcilable family situations.

For example, assume the founder is fixated that his son will be the leader in the next generation, but everyone else in the business understands that the son does not have the necessary skills. Dr. Hampton says that is a recurring problem. The fallback is to have a process and structure that makes sense. If rules and policies governing employment in the business exist, that can help show the founder that the son is not qualified. Build a structure so that different points of view can be expressed. Through that process, a set of criteria will be developed that are expected. Objective criteria are best. As a practical matter, the attorney will not want to dispute the founder about this. That is a case where it can be particularly helpful to bring in a family business advisor. In this situation, the attorney does not want to get between father and son, because that is suicidal. Perhaps an approach would be to raise legitimate objective questions with the son about his ability and fitness and desire for that position. The question is whether any lawyer will do that. The answer is mostly no. That can raise a conflict of interest with the attorney's client, the founder. "That is for someone else to do, not the attorney."

23. When Does "Family Business" Begin?

From the outset, the company is not a family business, it is the founder's dream, his baby, his venture. On the other hand, if the company is successful it will eventually be transferred to his heirs.

Most founders cannot anticipate the changes that the success of their venture will bring, relating to the three central areas of the families and businesses life: family, owners, and business. From the outset, those three areas will almost totally overlap.

At the outset, asking the family to take action or to think about the future in connection with the business is very difficult because they view the business enterprise as being all about the founder himself or herself. In many situations, the founder and family continue to think about the business in this manner for decades.

The founder, the family, and the business advisor often do not think about what will happen in the future with the business if it is successful. The founder cannot anticipate changes that will happen in the family company, and therefore planning or having any conversations other than just implementing necessary transactions just does not make any sense to the founder — and it makes even less sense to the rest of the family.

24. Beginning to Involve the Next Generation

When the college-age daughter expresses some interest in being involved in the business, the line has not been crossed and this has become a family business. However, when the advisor asks the senior generation if it is time to build begin to prepare the next generation, the response is "they are way too young to be burdened by this." (That may still be the founder's response decades later.)

That is a common mentality that is important to recognize and address.

To G1, the founder views the business, owners, and family as being totally uniform, but at this stage of the family and businesses life, there are complex divergent interests. Key nonfamily executives are becoming important, and various family members might join the business.

At that early stage, the issue of the role of the next generation should start to emerge in planning considerations. We have to help the family understand that there are governance structures needed at this early stage, because there are complex interests and concerns that need to be aligned in order to avoid a train wreck later on.

25. Family Governance

The goal of family governance is to get the family to a table to have conversations about what's going to happen next – to make decisions. It's not just getting the family to the table once or having a single-family meeting. That is not family governance. Family governance is having a table, with seats at the table for family members, and the family having *practice* sitting at the table and talking to each other. Families are by nature chaotic and they don't do it without structure. How can they make complex decisions about a family business if they don't have practice and a forum for communication?

There needs to be practice – a sense that siblings can sit at the table and have conversations even when they disagree. That's what builds trust over time and makes family members proud to be a part of a family enterprise that it was to continue as opposed to a family enterprise that will tear apart when it comes to the disposition of the assets.

Of the three spheres involving the family business (business, ownership, and family), we are familiar with the governance structures of the business (company management and board of directors) and ownership (shareholder meetings and perhaps a shareholder councils), but the family business owner typically does not think of any governance structure around the family element. The structure should be a Family Council and Family Assembly.

Family Council. The Family Council is a structured forum for the family to discuss the future of the business and other relationship issues. For example, it might discuss issues involving the vacation house, use of the company plane, etc. If those issues are not discussed here, where else

would they be discussed? Discussing those types of issues at the board meeting or management meeting would not be a good idea. The Family Council is a venue to develop policies to ensure fairness. It provides a seat at the table for spouses and non-involved children for them to find out what is going on in the business, who is holding what positions, etc. They have a place to express a view.

The typical Family Council meets twice a year, with meetings lasting about six hours. It is made up of all adult family members if the family owner group is small (10 members are less). If it is larger, the Family Council is elected based on representation by generation, branch, gender, involvement in the business, etc. The Family Council elects members to serve officer roles (president, secretary, treasurer).

Family Assembly. This may be useful for larger family. It would involve meeting together once a year in a fun setting. It would also involve educational and informational elements about the business.

Facilitation. Facilitation can help at this stage to launch these initiatives. Eventually, it will be self-perpetuating and will have a set of governance rules.

26. Family Employment Policy

One of the most important roles that the Family Council will serve is to develop a family employment policy. The policy will include the credentials that are needed to be hired by the company, standards of performance and compensation, what happens if family employees do not perform their roles, and who is responsible for implementing this policy. The Family Council does not tell the business who to hire, but it has a philosophical view based on values about family employment. If a family is aligned around that policy, there is much less chance of having grave disagreement going forward.

27. Founder's Retirement Coming in View; G2 Vision Matters

Each generation has to make a conscious choice to be owners together. Dad's dream is not his children's dream. At age 45, G2 have their own families' futures to consider. The siblings need to understand the features necessary to create a successful cousin consortium if the family eventually wants the business to pass to the G3 generation. This work can be done in the Family Council or the board of directors, but it is usually best done with facilitation.

Dennis Belcher points out that at this stage, the attorney should have a heart-to-heart discussion with the founder about the incredible difficulty and low odds of a successful cousin consortium at the G3 level. The long-term success of the business may be much more likely if the founder chooses a particular successor to lead the company and does not expect that the leadership will be divided among the siblings, with further division among their descendants at the siblings' deaths.

28. Board of Directors/Advisors

An active board of directors/advisors is very helpful and is critical for a maturing company. As the founder nears retirement, the founder needs neutral, expert advisors to assure continuity. In addition, the board is a good place for founders to "retire to," to keep a connection to the business without daily control. The board could (and should) push the founder on succession planning. Board members can be mentors to G2 and G3 and should evaluate leadership potential.

29. Evolution of Succession Plan

In this case study, and in many situations, there has been no succession planning before the founder is critically ill or even dies. Succession is a process, not an event.

Effective management succession requires a process to assure a smooth management transition to family leadership. The founder must discuss management options with his spouse and children. The inevitable outcome will be an unpleasant surprise for someone, but that issue is better dealt with when the founder is still alive to bring the family together to solve the problems together.

30. Key Lessons Learned

a. *Communication.* Families that have practice coming to the table and discussing these issues that matter do better in succession transitions. Research shows that succession failures occur because of a breakdown in communication between generations. Finances matter, the business matters, but this is key. Family members communicate all the time but not in public forums where all hear and participate.

b. *Structure is Your Friend.* Governance structures provide a forum and rules for decision-making. Governance policies communicate to key stakeholders (family and nonfamily) that everyone will be treated fairly. Clear boundaries around roles and responsibilities help assure the decision-making authority is clear.

c. *Values Matter.* In preparing the next generation for leadership, (i) confidence, education, and training matter, (ii) work ethic matters more, but (iii) values matter the most. Values are discussed, infused, and perpetuated by families being able to get together and talk through the Family Council.

d. *Change*. Family companies change over time.

e. *Each Generation Defines Its Vision.* Each generation must define its own vision and decision-making process.

f. *Ten-Years.* Generational transitions are perilous – plan for a 10-year window.

g. *Don't Wait.* The longer you wait, the higher the probability of conflict.

h. *Structure is Paramount.* Family conflict typically is not about personalities. It is about a lack of structure and preparation for change.

i. *Forced Communication Will Not Work*. How far do you push the client to communicate, even if the attorney knows it will solve problems later? Forced communication will not work; the attorney may have to raise the issue with the founder various times. It may take some time for the founder to understand that it is for the long-term good of the business and the family. But that may not happen until the founder starts to see the problems of not communicating that they see the value of it. Unfortunately, there can be situations when it is already too late when the founder starts to see the problem. The best the attorney can do is to provide encouragement and to discuss possible structures to facilitate communication. The panelists observed that many estate planning attorneys do not pay enough attention to this and do not encourage clients to develop appropriate family communication structures.

31. Listening

Attorneys must be taught how to listen and talk in a nonjudgmental way. One of the problems with lawyers is they are trained to believe that there are solutions and the attorney's job is to tell the client what the solution is.

Another problem that we all have is that the human brain can process information at the rate of about 600 words per minute, but normally people talk at about 250 words per minute. The listener gets bored listening, and starts finding the solution before the other party finishes talking.

Excellent Resources About Listening. Marshall Rosenberg, Nonviolent Communication series of books (which addresses a way for people to talk to one another without making the other person wrong); Gary Friedman, Challenging Conflict: Mediation Through Understanding (published by the American Bar Association).

Listen "between the lines" to what the client is really saying.

32. Curriculum of Information for Trust Beneficiaries of Trusts Owning Family Businessess

The Emerging Adults Subcommittee of the Business Planning Committee has been working on developing a curriculum of information that trust beneficiaries ought to know when a trust owns a family business. The goal is to be able to impart this curriculum to beneficiaries and lessen the likelihood of conflict. Hopefully, that information will be available at the Business Planning Committee at the ACTEC Fall 2012 Meeting.

A classic motivational business approach is known as "Results Oriented Work Environment" (or "ROWE"). It was invented by the Best Buy HR department and has been implemented by various other businesses (including Google, Gap, and Banana Republic). The general approach is that employees can do whatever they want when they want — as long as the work gets done. There are no fixed hours or work times — just look at the results. Jon Gallo, Eileen Gallo, PhD. and James Grubman PhD. have written about a new suggested approach to trust drafting for clients that want incentive-type trusts. They call it "ROTE" — Results Oriented Trust Environment. The approach focuses on the beneficiaries obtaining specific results (financial skills), not on behaviors that do not necessarily correlate with those financial skills. In the business context, the goal is to identify background information and skills that beneficiaries of trusts that own business interests need to know. These include things such as the management of the business, who is on the board of directors, responsibilities of board members and officers, strategic plan of the business, the dividend policy and whether the company can afford to pay dividends to shareholders who are not receiving a salary, etc. With respect to the person's relationship as a trust beneficiary, the information would also include information about the trust, duties of trustees, limits of beneficiaries' rights (such as that the rights of income beneficiaries must take into account the rights of remainder beneficiaries), etc. A family might begin communicating that information and curriculum as beneficiaries reach approximately age 23.

33. Bloodsuckers and Parasites

The conflicts that arise between those family members who are involved and those who are not involved in the business have been characterized by the concept of "bloodsuckers and parasites." Outsiders think of the employee-family members as bloodsuckers drawing off all of the business income as compensation in ridiculous salaries, and the insiders view the outside family members as parasites who get the windfall of large appreciation as a result of the blood, sweat and tears of the insiders.

34. Attorney's Role in Communication Issues

a. *Early Is Not Always Best*. Attorneys must resist the temptation to think that it is a best practice or sometimes even advisable that all estate planning be done at the earliest opportunity. Keep things simple. "You do not run trick plays when you are deep in your own territory."

b. *Role of the Founder's Spouse*. Not every spouse is involved in the business or needs to be involved in the business. Ron Aucutt relates that his wife is not involved in his law practice, but she makes a profound contribution.

c. *Business Family*. "Who would argue that both spouses don't have an equal role with regard to the nurturing and the conveying of values to the family?" For example, the founder's spouse may have had views as to who would be the appropriate next leader. Was her viewpoint solicited? If not, why not? Was there a comfortable environment to draw out the spouse's views? The attorney may be accountable if that communication does not occur. "To have excluded the spouse or not developed an environment in which the spouse was comfortable in participating not only defies biology but all experience, by embracing the notion that a family that does not talk together will long-term be able to walk together. It just doesn't happen."

d. *Founder's Passion*. The attorney should draw out the founder about why the business is his passion? What of his hometown values does he want to pass on to his descendents or protect his descendents from? What are the founder's views on education of the family and importance to the family business? What are the founder's views on philanthropy, which is often the glue that holds the family together because it gives them a focus outside of themselves. That should motivate all of the family members and attorneys.

e. *Attorney Serves Interests of the Client*. The attorney serves the founder as the patriarch of the family, but no patriarch ever wills that the family down the road becomes dysfunctional. The attorney is serving the founder's interest by seeking to cultivate communication in the family.

f. *Trusted Advisor*. An excellent resource about the attorney as a trusted advisor is Solomon (Sonny) Kamm, *How to Attract and Respond to the Needs of the Affluent—The Importance of Being a Trusted Advisor,* 21 ACTEC NOTES 312 (1996).

g. *Communication Within Law Firms*. Estate planning partners should encourage their business transaction partners to understand that every time there is a business transaction, there is the potential for that to impact the individual estate plans of the owners involved in the transaction. That is not only good cross-marketing, but it is the best way to serve the client's needs.

h. *Satisfying Work*. Despite all of the problems and complexities that have been discussed, estate planning for business owners is very satisfying work. Dennis Belcher tells his litigator partner "there'll be a lot more people at my funeral than yours." (The partner responded, "Yes, they just want to make sure you're dead.")

35. Attorney as Trustee

Ron Aucutt, Dennis Belcher and various other panelists expressed the viewpoint that the attorney should serve just as advisor and not as trustee. There are the ethical issues with serving in both roles as discussed above. In addition, there is the very practical concern that both giving and receiving advice at the same time is very difficult. "As involved as the attorney should be, and as

trusted by everyone that the attorney should be, and however that might qualify him to be the ideal trustee, he ought to be just the advisor and not the advisee."

Sometimes the client pushes and implores the attorney to serve as trustee, saying that he can do it better than anybody. Dennis's overriding rule is not to allow the client's problem to become his problem. It is much better for the attorney to serve as an advisor rather than as a fiduciary.

Another factor is that it can be very difficult for the attorney to get into the personal decisions of making distribution decisions as trustee.

Day Five — The Death of the Founder of the Family Business (The founder has died. A Real Estate Company is owned 1/3 by the founder, 1/3 by the founder's spouse, and 1/3 by a dynasty trust. Several services companies are LLCs owned 75% by the founder with the balance owned by key employees, a donor advised fund, and grandchildren. The founder's will gave all of the founder's business interests to a QTIP trust having the spouse, attorney, accountant and trust company as co-trustees. The spouse has a testamentary power of appointment to appoint the QTIP trust assets among any of the founder's descendants. The attorney is a co-executor and co-trustee of the QTIP trust with the spouse, accountant and a trust company. An ILIT holds $5 million of life insurance, and the spouse holds a testamentary power of appointment to appoint the assets among the founder's descendants. The attorney has met separately with the key employees and each of the family members, except that one son refuses to meet with the attorney about the estate and the family business.There are conflicts among the founder's spouse and children as to who should run the business. The key employees threaten not to remain if the son or the founder's spouse runs the business.)

36. Attorney Becoming Embroiled in Family Conflict Situation

The panelists had very different viewpoints about what the attorney should do in light of the family conflict. If you attorney agrees to go forward, he will be attorney, co-executor, co-trustee, and probably on the board of directors.

a. *One Approach--Opportunity*. There is an opportunity for the attorney to provide a huge benefit to the family in this conflict situation. The attorney can give legal advice to the family and can also make important business decisions as a co-executor and co-trustee of the estate and QTIP trust, which owns 2/3 of the stock of the company. If the co-executors and co-trustees failed to take steps in the long-term best interest of the company, they risk catastrophe. The attorney should "step up."

The corporate trustee may be a key factor in this situation. Hopefully, the corporate trustee will provide a voice of objectivity-- if the family does not hang together, the entire company will go down.

This matter goes back to Ron Aucutt's Trachtman lecture-- the attorney's obligation to the family. The attorney has represented the founder for 40 years and has been intimately involved with his family and business. The attorney should not run for the hills in tough times. The attorney has an obligation to serve, particularly since the lawyer agreed to be named as a co-executor and co-trustee. He should serve. As a co-executor and co-trustee, he is not giving advice but making decisions. And who better to do so?

"There's always risk, but are we so risk averse that we cannot do what Ron challenge us to do? We oughta' step up. We should make sure our actions are appropriate, but no executor is a guarantor. It is not impossible to make sound decisions. Fleeing risk at a critical time in the life of a business or family is not what we should be about."

b. *Another Approach--Attorney is at a Tipping Point*. This is a difficult choice to make. The attorney is at a tipping point. If the attorney rides this out, it will get ugly before it gets better. The attorney will be in it for multiple years, will be subject to liability, and at the

end of the day, if it all works out, he will get a pat on the back (maybe). He will probably get fired as lawyer for the company or the company will be sold. That's the best that can happen for the attorney. The worst that can happen is that the attorney can get sued for malpractice, he could lose his law license, he will not get paid, and his life will be miserable.

The attorney will often take a viewpoint that "I can do some good." That is true, but it is not the attorney's money, and the attorney did not create the family mess. This is a difficult decision, but the attorney must be aware he is at a tipping point. This is an awkward situation, because the attorney is a trusted advisor to the family, the attorney becomes embedded with them, and the attorney thinks he can solve their problems.

At the end of the day: "it's only money, and it's somebody else's." The attorney should not approach this with the mindset that he is the savior that can solve this family's problems.

A common fear of the attorney in this type of situation is that if the attorney backs away, it will be worse for himself personally. That obviously is not a good reason to stay in, but that is the inherent human fear-- that if the attorney pulls back, the family will really sue him.

Despite this classic fear, the attorney must step back and remember that "life is nothing except about edges--who has an edge on whom?" At this point, the family may have a slight edge on the attorney, because of the way the documents were drafted. However, that is a relatively minor issue. If the attorney gets involved, there is a big risk of bigger problems arising in the future. "When a client has an edge on you, that is the time to get out." It is extremely difficult to give independent advice without thinking how the advice will impact the attorney. Once that happens, if the attorney gives the right advice it will only be because he is lucky.

If the attorney is inclined to stay involved, the attorney should come forward with a clean slate to the family and say "if you're going to hold all these things against me, I'm out, because I cannot exercise independent judgment. Let's get that off the table right away. If it's a problem, I'll resign and the family can move forward."

An attorney who has agreed to allow himself to be named as fiduciary in a document does have some obligation to step forward, but the attorney must also make a determination whether he will be a part of the solution or whether he will make the problem worse.

In any event, if an attorney serves as fiduciary, the attorney should get independent advice.

c. *There Is a "Deal to be Made."* One factor favoring the attorney's involvement at this early stage where the attorney sees that there can be significant future family conflict is that "there is a deal to be made" before a family blow-up erupts. There are various entities under the business which can be left to different siblings for them to run independently of the others. (That is a nice benefit of having LLCs rather than C or S corporations. Spinning off even an S Corporation is difficult.) There is $5 million of life insurance and that can be a set aside for certain family members.

Ask the family, "where do you want to be five years from now?" The issue is whether the attorney can do that in light of his deep involvement over decades with the founder. Can the attorney take a fresh look at the situation, or will he be intent on following the founder's wishes?

The only way you make a deal is to get the family to start talking about it. The attorney can't force the family to resolve the problems. All the attorney can do is advise the family of what will happen if they don't resolve the problems now.

37. Trend in Modern Law to Shift Toward View of Beneficiaries Rather Than Settlor's Intent

The approach of the Uniform Trust Code is that trust provisions can be changed if there is a change of circumstances, and the Code broadly permits modifications to accommodate the views of the beneficiaries. The old-school approach is that the "dead hand of the testator controls." However, despite this shift under the Uniform Trust Code, many courts still adhere to the "dead hand testator" approach.

Instruments can contain language expressing clearly that the long-term continuance of the trust is a material purpose of the trust, in an attempt to maintain control long-term and to keep the business intact indefinitely. Will that be successful in preventing future modifications? One panelist believes no — the bottom line is that "a lot of lawyers will get paid well to bust that up, and in the end they will be successful."

Another panelist indicates that a lot of his clients are very concerned about the "dead hand" being honored.

Response: The reality is that in situations like this case study, unless the family pulls together, the business will fail; it cannot be kept in the family indefinitely despite the settlor's intent.

In this case study, after the founder died the planners kept looking back to what the founder wanted rather than what the family wanted and what was the best for the family and the business.

Day Six — The Blow-Up in the Founder's Family. (The founder's spouse remarried. The trustees of the QTIP distributed a portion of the business interests to the spouse, so she could make large gifts to her one son who is involved in the business and her stepchildren. [The attorney is getting himself deeper into the family conflict.] The new spouse has requested more trust distributions from the QTIP trust for estate planning purposes. The attorney filed a lawsuit requesting a judicial determination of the authority to make trust distributions for estate planning purposes. A child who is not involved in the business filed an answer objecting to any distributions and counterclaiming against the trustees for breach of fiduciary duty.)

38. What Can the Attorney Do to Manage Familial Conflicts?

Every situation is different, but an important concept is that all family members know what is going on and the rules of the road. The rules of the road are that certain people are in control. Those who are in control must make sure that other family members know what is happening. The more communication, the better.

There are some family situations the attorney will just never be able to fix. But to every extent possible, make sure the communication is perfect with those who are challenging the attorney.

The sad thing about this case study is that panelists have seen everything in the case study, and looming conflicts coming were apparent early on (as they often are in real life situations).

One key fact in this case study that the attorney could have pointed out to the family following the founder's death is that the surviving spouse held a testamentary limited power of appointment with the ability to favor any of her descendants. That gave the surviving spouse a great deal of legal control. Family members who are aware of that may be less inclined to trigger deep family disputes.

39. Yielding to Pressure For Improper Trust Distribution

The trustees of the QTIP trust (one of whom was the attorney) made a distribution of some of the business interest to the surviving spouse, so that she could make a distribution to just one of her children and two stepchildren. Once the attorney sold his soul to the spouse by making the improper distribution to her, "he is in the soup." She now owns him. When the trustees made a distribution to the spouse so that she can make a gift to just one but not all of her children, the trustee should have known that family dispute eventually would erupt.

This goes back to the maxim, "Don't make your client's problem your problem." The attorney may have thought he was doing the right thing, carrying out the founder's intent and helping the surviving spouse. Ultimately the issue comes down to whether the disgruntled child will sue his mother or whether it's easier to sue the lawyer. The attorney fell into the classic trap of making the client's problem his problem. Life is too short for that. We owe an obligation to our clients, but we also owe an: obligation to ourselves, our partners, and our families by not taking undue risk.

Always look at where a particular decision will leave the family five years in the future. Don't just look at whether an action solves an immediate problem.

40. Seeking Court Approval

Prior to the first distribution that was made to the surviving spouse, the trustees should have sought court determination as to the propriety of the distribution. Seeking court approval of a subsequent distribution ultimately resulted in a counterclaim by one of the trust beneficiaries against the fiduciaries.

Whether a large distribution to the spouse from a QTIP trust is permitted, so that the spouse can enter into estate planning transactions, it is not clear where the trust only permits distributions for "health, maintenance and support." One of the panelists was involved in a two-week jury panel involving a situation in which the jury determined that there was not a breach of fiduciary duty for making a distribution for estate planning purposes (approved by the West Virginia Spring Court). (One of the Supreme Court judges in that case told a story that when he was growing up he would go to the drugstore and pay five cents for soda. There were two brothers who would go to the store with only a nickel between them. They would get two straws and one soda, and they would see who could gulp the most. The judge said the beneficiaries of the estate were just like those two brothers – they were just seeing who could suck the most from the estate.)

"Don't go into to court unless you are clean. If you do, you run the risk of giving the beneficiary a venue to come after you. I don't recommend trustees going to court unless they are clean."

41. Attorney's Communication With Client Does Not Assure Communication With Family

An attorney may give good advice to a fiduciary or to a surviving spouse, but there is no assurance that the information is relayed to other family members. The attorney and trustee can encourage that communications happen with all family members. For example, in the case study the fact that one son refused to attend a family meeting was a red flag that should have prompted the attorney to ensure that there was good communication with that individual. (Of course, the attorney must make very clear that the attorney does not represent that other individual.)

Day Seven — The Sale of the Family Business. (While the trust lawsuit was pending, the founder's spouse died. The litigation settled, with a provision requiring the appointment of an independent board of directors and managers who hired new management. The attorney remains as a co-trustee of the QTIP trust and dynasty trust. A

pension fund has submitted an unsolicited offer to buy the assets of the business. Family members involved in the business and key employees will object to the sale because they will lose their jobs.)

42. Sale of Business

a. *Can Be Long Process.* The sale of the business can be a long process (for example, the preparation phase as well as the actual sale process might take two years).

b. *Employee Retention.* Word will get out when lawyers and accountants start showing up at the business. Employees will start worrying that something is happening to the business and will lose their jobs. Employees will start bailing, and suddenly there is nothing to sell. A first step is to meet with key management and discuss that a decision has been made to sell but that the owners want to protect the key employees fairly with employment agreements.

One approach is to provide that the key employees will receive a slice of the sale proceeds once the business is sold. The goal is what strategic planners call "alignment." All of the parties should be aligned. Employees, shareholders, and the board of directors should all be pulling for the sale. The easiest way to get everybody aligned is with cash. One panelist has taken the following approach in several instances. Assume the owners realistically believe, for example, that the business is worth $100. The key employees would understand that if the business sells for $80 they will receive $1. If the business sells for $90, the key employees will get $1.10. If the business sells for $100, the key employees will get $1.15. If the business sells for $150, they will get $3.

These negotiations with employees will not be a simple thirty-day process. The key employees will need independent counsel, and expert consultants will probably be needed to advise the business on appropriate compensation levels.

Everybody must be aligned, including the key employees. Trying to go through the sale process in secret, behind the employees' backs, is a recipe for disaster.

c. *Clean Up Financial Statement.* If there are assets in the business that a buyer will not want, get them out. For example, the second home, life insurance, etc. should be removed out of the business entity. Examine whether there are liabilities that would be a detriment to a prospective purchaser; determine if they can be cleaned up.

d. *Investment Banker Involved?* There is no "one answer fits all" as to whether to hire an investment banker. Advantages include that there is the widest circulation of information among the most appropriate potential buyers, there is a better chance of maintaining confidentiality, and there is professional input regarding appropriate valuations. A critical factor is determining how deeply the investment banker and family members will be involved in negotiations. Investment bankers sometime set unrealistic expectations, and sellers become unwilling to budge off those expectations (over what may be a relatively small amount of money) even though their best interests may be well served by doing so. Do not let the investment bankers stand between the sellers and buyers when negotiations get tough. (On the other hand, family members may get very emotional about aspects of the negotiation, and bankers typically will be objective about issues. Keep the number of people at the negotiating table to a minimum.)

Have a complete understanding of investment banker fees, which are expensive.

Sometimes the better approach is to sell the business to the person who submits an unsolicited offer, without going through the long and laborious sales process (described below). Even after going to the long sale process, there is the risk that the price will be less than the price offered in the unsolicited offer.

Another concern is volatility of the markets. A sale that is delayed for up to two years may be impacted by a changing market environment (which may be a positive or negative, but there is additional uncertainty).

e. *Selection of Investment Banker*. As with choosing an agent to sell a house, do not choose the agent who claims he will be able to sell the business for the highest price. Choose an agent who has a track record of being able to sell within a reasonable period of time at reasonable prices.

f. *Overview Description of Sales Process With Investment Banker*. The sale process is long and detailed, involving many steps. The sale process can take from six months to a year.

- Interview prospective investment bankers.
- The prospective investment bankers will all look at financial statements and put projections in front of the owner (who will get all excited about the projections)
- Set up electronic rooms to locate prospective purchasers.
- Narrow the list of prospective purchasers to serious purchasers.
- Send relevant confidential information to the prospective purchasers.
- Go through rounds of bidding.
- Once a prospective purchaser is determined, there is a period of negotiating the sales contract.

g. *Fiduciary Perspective*. Does a fiduciary have a duty to go through the involved sale process to ensure that appropriate market value is being received for the business? One panelist does not think that is a necessity if the fiduciary has a solid appraisal to support the sale price and if there is a good reason to sell based on a known deal rather than going through the uncertain sale process. A fiduciary is subject to a potential breach of fiduciary duty, which is process oriented. The decision to sell assets of the business will be made by the board of directors, which has a lower standard (the business judgment rule) than fiduciaries. It is interesting that even with an asset sale, the board of directors may avoid a lawsuit, but fiduciaries may be sued for allowing the sale to go forward (because the sale of assets would generally require shareholder consent).

If the fiduciary is not comfortable with the appraisal, the fiduciary will need assistance in determining the appropriate value.

h. *Minority Owners*. A vital function of independent board members is to get objective advice looking out for the best interests of all shareholders. Typically sales of businesses will be asset sales. The sale must be process oriented, with proper meetings, proper notices, proper minutes, and proper advice. Typically there is no difficulty in being able to take appropriate steps to look out for the interests of minority owners.

i. *Get Founder's Advice Regarding Sale Before Founder Dies*. A difficulty with selling the business after the founder's death is that the founder probably had the best sense of the business's true worth and prospective purchasers. While the founder is still alive, the attorney should have discussions with the founder at various stages of the business, about

the founder's ideas on selling the business if it were to be sold. Who would the founder be looking to sell the business to? How could value be maximized? If the founder were not around, who should assist in thinking about thinking through the sales process? Sometimes those persons are competitors. They may not be the potential buyers, but the offender may want them as consultants to the board of directors. Keep notes of those conversations to draw on that information when the time comes.

j. *What if Key Executives Leave?* There are organizations that can provide people to step in and provide transitional management if the business is large enough. The problem is that family members often think they are able to step in and hold the business together. That can be difficult during the sale process because the goal is for the business to look as good as possible during that time frame.

k. *Retaining Real Estate and Selling the Business.* Retaining the real estate while selling the business seems like a good idea, because it provides a stream of cash flow. However, if the business does not continue to use the real estate, it may lose a lot of value. Do not automatically assume that the lease arrangement for the real estate will stay in place indefinitely.

Ethical Issues Regarding Days Five-Seven

43. Ethics — Representing Business Entity or Entity Owners

Following the founder's death, the attorneys need a new engagement letter (because their prior client has now died). Alternatives are (i) to represent the owners jointly and not the entity, or (ii) to represent the business entity and not any of the owners individually.

Under either situation, the attorney will also need to disclose a potential conflict because the attorney also represents the dynasty trust and the estate (which both own interests in the business) and request a waiver of the potential conflict. There are example engagement letters for both situations.

If the attorney represents the owners jointly, an example engagement letter describes potential conflicts that could arise between the owners:

> "Because each of your interests could potentially be affected by the interests of the others, it will be necessary for each of you to consent to the form of our representation of all of you.
>
> In a joint representation, we represent all of you collectively and simultaneously, almost as if all of you were a single client. We will not be an advocate for any one of you personally, but will serve only to assist all of you developing a coordinated plan for the structure and organization of the Company and will encourage the resolution of your individual differences in an equitable manner and in the best interests of your ongoing relationship as the owners and managers of the Company. We will normally meet with all of you at the same time, and relevant and material information shared with us by any one of you, although confidential as to all third parties, cannot and will not be kept from any of you; however, we will generally not disclose to the others information any one of you makes known to us outside a joint meeting that we do not think is relevant and material to the organization of the Company. The joint representation of the Company could result in the disclosure of information that one

> of you might prefer to remain confidential, and it could produce dissension if all of you cannot agree on a particular issue relating to the operation of the Company.

An example engagement letter for representing the business entity makes clear that the attorney does not represent the separate shareholders:

> "Our clients will now be Real Estate Services and Cable Services as the Entities. As described below, we will not undertake to represent any of the members individually.
>
> It is important that each of you understands that the interests of the Entities may not always be identical to the interests of each of you as members and that the interests of anyone of you may not always be identical to the interests of the other members. Therefore, each of you should be aware that in your separate capacity you should carefully consider retaining independent counsel to advise and represent you separately from the Entities and from the other members.
>
> …
>
> Nevertheless, because our clients will be the Entities and you will be its governing constituents, we are obligated to disclose to each of you any information any of you discloses to us that is relevant and material to the organization of the Entities. None of you can disclose any information to us and require that such information be withheld from the others if such information is relevant and material to the organization of the Entities.
>
> Each of you may have differing and conflicting interests and objectives, and your interests and objectives may be in conflict with the best interests of the Entities. For example, [several examples are listed]…. These are just general examples. Your own situation and interests are unique. However, because our clients are the Entities and not any of you individually, we could not advise you that a proposal suggested by one of you might be adverse to your own personal interests."

The engagement letter for an entity might also describe who the attorney is authorized to communicate with on behalf of the entity.

The example engagement letter for the entity has provisions for a "noisy withdrawal" if the attorney is required to withdraw at some point because of conflicts:

> "If we are terminated by action of the authorized constituents of the Entities, we would withdrawal from representing the Entities and would communicate to all of you the reason for our withdrawal. In addition, none of you can invoke a duty of confidentiality as between you and the others so as to prevent us from disclosing to the others any information received from you that is relevant and material to the Entities."

44. Ethical Issues — Attorney Meeting With Non-Client Family Members to Get Input

In this case study, the attorney met with various family members in separate meetings to get their input on what should happen with the business, although the attorney does not represent them. Under Rule 4.3 of the Model Rules of Professional Responsibility, if an attorney does not represent a person, but the person might be under the misapprehension that the attorney does represent him or her, the attorney must dispel that misapprehension.

45. Ethical Issues — Attorney As Likely Witness in Legal Proceeding

Rule 3.7 of the Model Rules provides that an attorney cannot be the lawyer in a legal proceeding if the attorney is expected to be a likely witness. There are exceptions if the attorney may be a witness, but none of those exceptions would apply in the case study fact situation.

46. Ethical Issues — Engagement Letter Representing Trustees

If the attorney represents trustees, the attorney should make clear the potential for conflicts among the co-trustees, and make clear whether the attorney is representing the individuals in just their fiduciary or also their individual capacities. An example engagement letter includes:

If an individual is both a trustee and beneficiary of the trust, the typical arrangement is to represent the trustee only in his or her capacity as a fiduciary. A sample engagement letter for the representation of co-trustees includes the following:

> "You should understand that we represent you jointly as trustees. We do not represent the beneficiaries of the trust, even though we will, if requested by you, provide them with information about the administration of the trust. In appropriate circumstances, we may advise beneficiaries to obtain independent counsel as we do not represent them.
>
> Apart from any applicable legal requirement to notify the beneficiaries of the terms of the trust, we consider it good practice to do so and to provide each beneficiary with a copy of the trust instrument. In doing so, we will make it clear that all of you, and not the beneficiary, are our clients.
>
> …
>
> If a conflict does arise among the trustees, and it is impossible in our judgment to perform our obligations to each of you in accordance with the standards we maintain, we will withdraw from all further representation of the trustees and advise all of you to obtain independent counsel.
>
> …
>
> Because three of you as individuals are remainder beneficiaries of the trust, we must advise each of you that we represent you only in your capacity as co-trustee. You are aware that Abby Adams, mother of the three of you, is the sole income beneficiary … to whom you will owe fiduciary duties. We will advise her that we do not represent her in her individual capacity…
>
> [OPTIONAL PROVISION]
>
> As a condition to this representation, we require that you authorize us to notify the beneficiaries of the trust of any actions or omissions on the part of the trustees that have a material effect on the beneficiaries' interests in the trust, including acts or omissions that may constitute negligence, bad faith, or breach of fiduciary duties."

In addition, in the right circumstance, it may be possible to represent an individual both in a fiduciary capacity as well as individually. Often these are routine situations and there is no problem. The engagement letter should provide that the client acknowledges that the attorney must give priority to the person's duties as fiduciary, and acknowledge that the person understands that he or she must also give priority to obligations as fiduciary over any conflicting issues that may involve the person's beneficial interest in the trust.

47. Ethical Issues — Representing Multiple Parties Involved With the Business

Rule 2.1 requires the attorney to exercise independent judgment and to render candid advice to the client. When the attorney represents different people involved with the business, including fiduciaries, situations may arise when the attorney will find it difficult to render independent advice to each of the parties. For example, when there is a proposed sale, some parties may want the sale to proceed and others may not. Even aside from disclosures and informed consent, will the attorney have the obligation to withdraw from representing some of the parties in those situations?

48. Ethical Issues — Termination of Employment

If conflicts arise, the attorney may need to withdraw from representing one or all of the clients. An example letter gives alternatives for either a noisy withdrawal or silent withdrawal:

> [ALTERNATIVE 1: Noisy Withdrawal]
>
> We have become aware that [DESCRIBE NATURE OF THE CONFLICT.] We believe that this represents a conflict that prevents us from representing and advising any of you further in this matter. Accordingly, we are hereby notifying all of you that we are withdrawing immediately from any further representation of any new matter. It will now be necessary for each of you to consider obtaining separate counsel.
>
> [ALTERNATIVE 2: Silent Withdrawal]
>
> We have become aware of circumstances that we believe represent a conflict that prevents us from representing and advising you further in this matter. Accordingly, we are hereby notifying all of you that we are withdrawing immediately from any further representation of any of you in this matter. It will now be necessary to reach you to consider obtaining separate counsel.

A practical difficulty is that whenever an attorney attempts to make a silent withdrawal, all of the parties inevitably will ask what conflict has arisen. For that purpose, some of the panelists prefer that the clients allow a noisy withdrawal. (The "girlfriend of the husband" is the classic difficult situation. One panelist makes a big deal in the initial conference with clients that they not call the attorney to discuss a boyfriend/girlfriend, because the attorney will have to disclose that to the spouse. Hopefully, the clients get the message and will never have a conversation with the attorney.)

49. Ethical Issues — Summary of Potentially Applicable Model Rules

Potentially applicable Model Rules that may apply in the context of representing family businesses and business families are the following:

> Rule 1.1, the duty of competence
>
> Rule 1.2, scope of representation (defining it and the allocation of authority between attorney and client)
>
> Rule 1.3, duty to act diligently on behalf of the client
>
> Rule 1.4, communications (including the issue of dormant representation of clients)
>
> Rule 1.6, duty of confidentiality in the attorney-client relationship (and in some cases the exceptions under the Rule)

Rule 1.7, dealing with conflicts between current clients (concurrent conflicts of interest)

Rule 1.8, conflicts of interest (involving the lawyer and the lawyer's personal interest)

Rule 1.13, representation of an organization as a client

Rule 1.14, dealing with the client with diminished capacity

Rule 1.16, declining or terminating representation

Rule 3.7, the lawyer as a witness or prospective witness

Rule 4.3, dealing with unrepresented persons

Rule 5.5, unauthorized practice of law and multijurisdictional practice.

Communications and Values Issues for Days One – Seven (Including discussions of structuring Family Meetings, the attorney's role in fostering good communication within families, and Letters of Guidance.)

50. Family Meetings

The materials address issues that should be considered in structuring family meetings, and issues that might be discussed at family meetings.

a. *Who Is the Client*?

b. *Who Should Attend*? Determine what family members should be at the meeting (usually adults only) and whether or not spouses and descendants should be included. Consider what professional advisors and key business management persons should attend. (The chief financial officer may be helpful in providing reasonable expectations for the business.) Do not overwhelm the family with too many people at the meeting. A family business consultant may be appropriate, but often not at the initial meeting unless the consultant is organizing and facilitating the meeting.

c. *Where to Meet.* Typically do not meet at the business office. Employees may be uncomfortable with what is going on or may overhear information. A meeting at the attorney's office may set a formal tone, and a meeting at the founder's residence may be too informal with too many distractions. Having the meeting outside the business and outside the home is typically best.

d. *Topics to Cover.*

- Estate plan of the senior generation
- Plan for continuation of the family business
- Business succession planning within the family, valued employees, or partner
- Equalization (or not) of children who are not involved in the business
- Differences in treatment of family members
- Terms of trust arrangements to make sure family members understand the concept of trusts
- Various nontax issues should be covered as well including classic non-tax estate planning issues (creditor protection, divorce issues, dealing with spendthrift issues, dealing with irresponsible children, etc.)

e. *Information to be Provided in Advance of Meeting.* Agendas and appropriate background information might be sent in advance of the meeting.

f. *Length of Meeting*. Typically the meeting should not last longer than about three hours. A weekend retreat may be appropriate for meetings on more than one day. Consider the attention span of attendees.

g. *Frequency of Meetings*. Annual or biannual short meetings are appropriate if there is a family business. Longer retreats are less frequent. There should be meetings to address updates as the business succession plan develops and is implemented.

51. Importance of Discussions About Family Values; Powers of Appointment

If persons have broad powers of appointment, it is very important that those individuals understand values of the decedent. In the case study, the surviving wife has a limited power appointment that, together with the business interest she owns directly, allows her to control the disposition of 2/3 of the business interest. Does the spouse understand the founder's values? Did the founder and the spouse ever discuss joint values? Are there joint values of the founder and the spouse?

In this case study, the founder's spouse was not involved in discussions at the beginning about the business. As it worked out, the spouse controlled the disposition of 2/3 of the business following the founder's death. The spouse's over-exclusion at the beginning and over-empowerment at the end may both have been accidents. The latter may be an accident from failing to consider the overall situation in preparing the documents.

52. Attorney's Role in Communication

a. *Engagement Letters*. The discussion above includes comments about a number of engagement letters. Keep in mind that this really has occurred over decades of the business, and the attorney must keep in mind the potential benefits of engagement letters for both the attorney and client. However, there may be some concern of overdoing formal engagement letters. In any event, do not think that the engagement letter is all that the attorney needs to communicate the scope of the relationship. "Being engaged is one thing, but getting engaged in the issues that matter to the family is something entirely different."

Rather than having the founder's children at some point sign formal engagement letters acknowledging the attorney's representation of the business for the family, the preference is to build the relationship as a family tradition or culture. Create the understanding that the children are attending a family meeting with their parents' attorney who their parents trust, and who, as the children get to know the attorney, the children also trust.

b. *Tone of Relationship*. The lawyer sets the tone of communication in the relationship. "We lawyers need more reminders, perhaps the most, that each of us has two ears and only one mouth, and the mouth comes with the ability to close it. The attorney should certainly ask appropriate questions and not expect the family to develop all solutions on their own, but should ask questions and listen carefully and meaningfully. We do not have to appear bumbling as if we know nothing. But we can learn from Lieutenant Columbo's humility and questioning. 'I may have this wrong but….' Indeed, the book Trusted Advisor has an entire chapter on Lieutenant Columbo."

c. *All the Attorney Can Do is Facilitate Discussion*. The attorney can look for opportunities to help the family make the decisions, identify the values, identify their objectives, and affirm their relationships. Attorneys cannot do that for the family, but can certainly

facilitate that communication. The attorney will then see the family talking about itself, and evolving into issues about family governance.

"To be realistic, if all of this works perfectly, it will not obliterate greed, suspicion and self-absorption. It will not guarantee that there is no dissension. But all the attorney can do is to create a climate in which the dignity and value of each family member is affirmed, and a venue is provided for offering views, bearing concerns and even disagreements and then minimizing conflicts, or if necessary resolving conflicts. If all else fails, the attorney will know the attorney has done all that he or she can."

d. *"Heir-Conditioning."* Issues to discuss with the family include the business, the home, the second home, etc. In some appropriate way, discussions should be had with the next generation that prepares them to receive the family wealth. "Call it, if you will, a kind of 'heir-conditioning.'"

e. *Distinctions of Family and Business; Employment of Family Members*. The attorney must stress with the founder the distinction between family and business. For example, it is important to develop protocols for the employment of family members in the business. Outsiders who have a role in shaping the business should have a role in developing this policy. The protocol should address compensation and accountability. Some family businesses enforce a requirement with satisfactory results that a family member should not come into the family business as a full-time employee until the individual has had some minimum amount of time working outside the business.

Pilot/Owner Analogy. "Owning the plane does not make someone fit to fly the plane. Similarly, the pilot who does fly the plane does not have the right to choose the destination. The owner chooses the destination, and the pilot flies the plane. These kinds of distinctions are extremely important."

f. *Billable Hours*. What are the impediments to the attorney becoming involved not only in the construct of the legal documents but also the construct of the family culture and how that relates to the long-term success of the business? There are many possible impediments, including awareness, education, resolve, just raw courage. One other thing is critical-- the billable hour.

Ron Aucutt reiterated his view expressed in the 2011 Trachtman lecture: "It doesn''t always happen, but it happens often enough to be no accident, that we can bill a lot of hours as long as we don't bill all of them. Some time off the clock might be necessary to make all these things work."

There is something about the attorney's business that doesn't always accommodate facilitating appropriately the family business or the business family that is represented by our clients.

Dennis Belcher agreed with Ron Aucutt on this point. "The biggest barrier we have in helping clients resolve problems is the billable hour. … Clients don't call us until it's too late. Or they call and you can hear in the background: tick tick tick tick." When the attorney asks the client about his children, the client must think -- why she is paying $X a minute for the attorney to hear about the children. But the attorney cannot do the job without that information.

A much better approach, for selected clients, would be able to bill clients on an annual retainer basis, based on the approximate level of work for the client in the past. The medical profession has been successful in developing concierge practices.

One Fellow described that at her firm (a large New York firm) for some clients the firm has carefully reviewed prior years of billings to determine what portion of the work was routine and what was not, in order to come up with an annual flat fee. There is an agreement with the client about the flat fee, but an understanding that if the actual charges incurred during the year are more than 15% higher or 15% lower than the fixed fee, adjustments will be made. Therefore there is incentive on both sides for reasonableness. It has worked well with selected clients.

g. *Ask Questions*. What are the founder's goals and desires for his or her spouse? For each of the children? What about grandchildren who have expressed an interest in the business? If the founder hears from a particular child he or she has no interest in being involved in the business, that may change the approach. Lack of communication infuses problems that occur long-term.

53. Letter of Wishes; Mission Statement.

a. *Overview*. Legal documents do not address personal issues of importance to the client. More and more clients are willing to put together a letter of instructions, a letter of wishes and desires, and mission statement for the family, where the parents give guidance to the family. Some of these things may have been discussed orally with family members over the years, but the parents want the family to read it, reread it and then reread it again after the death of the person who wrote it. That is especially important in the context of the family business.

The letter must be in the client's words, not the attorney's words. If the letter sounds like a lawyer wrote it, the family will give it less weight.

There may be some concern that the letter of guidance or mission statement may be used in a legal action against someone who improperly relied on the letter or by someone who feels that the fiduciary did not act in accordance with the letter. The letter of guidance or mission statement is not legally binding, it is just a mission statement. In the speaker's experience, it has been unifying for the family rather than divisive. One panelist has researched the issue and concludes that the fiduciary cannot rely on the letter to absolve the trustee for doing something that is later questioned. However, if a legal action is filed to seek court approval of a proposed transaction, the letter of guidance is admissible as evidence and may be quite helpful to the court in providing guidance.

b. *When to Give the Letter to Family?* Some clients give the letter of directions to their family and fiduciaries during their lifetimes. The client can see how others react. There may be the ability to impact behavior while the client is still alive. Others want this letter to be delivered only after the individual's death. Sometimes there are different letters delivered at different ages. (For example, for the 16-year-old, the client's hope is that the individual goes to college, etc.)

c. *Instructions to Executor and Trustees*. There may be guidance as to various issues, such as how active the executor should be in the conduct of the business, whether to sell the business, etc. There may be more detail for the trustees as to investment issues, and how to handle differences among family members and their respective involvements in the business.

d. *Guidance not Requirements*. The letter of guidance should merely provide guidance and not legal requirements. Situations and circumstances (and children) can change.

e. *Guidance Regarding Powers of Appointment or Delaying Distributions.* The letter could give guidance as to whether the discretionary distribution power should be interpreted strictly or broadly and give input as to factors that might be considered in how powers of appointment are exercised.

f. *Sample Letter to Adult Children.* The following is a sample letter offered by Anita Siegel:

> "To our children, ___ and ___, with a copy to our financial advisors and the trustees about various family trusts:
>
> This letter expresses our wishes and desires for the administration of our estates and the various trusts and entities we have established for the benefit of our family and loved ones.
>
> We have been very fortunate to earn an accumulated substantial estate. We want our descendents to benefit from our estate within certain parameters.
>
> The management and investments of our funds should be continued in a relatively conservative manner, as we have done during our lives. It is our wish and desire that the investments be managed for preservation of principal and comfortable cash flow, with modest or little growth. It is our wish and desire that essentially all investments be high-quality securities to accomplish the goals. The funds for each of our descendants are substantial and will generate a nice cash flow for your benefit.
>
> As each of our descendants attains age __, the descendant will be receiving all the income from his or her trust share. We are also providing for additional distributions in the discretion of the trustee for certain needs and purposes. With respect to the discretionary distribution of our funds, it is our wish and desire that these distributions be available to maintain a nice lifestyle and to be there for emergencies, such as medical expenses resulting from a major illness or accident. We do not wish these funds to be used for unnecessary super luxuries. In other words, these distributions are to be limited to 'heat, light and rent but no stupidity.'
>
> I want the family to consider which of the properties it wants to and should keep after our deaths. We have enjoyed our properties at___ and ___ as a family but that may not be suitable for our descendants going forward. Consider the costs of maintenance of each property and who would take the responsibility of maintenance and allocating time for each of the members of the family to use the properties. As you continue to grow and start families of your own, you may choose to spend summers and/or vacation somewhere other than ___.
>
> We have designated ___ Trust Company to serve as trustee. ____ will serve together with each of you (and our further descendants) for your respective trust shares. ___ will manage the funds and make distributions to and for you and your descendants in accordance with our wishes and the terms of the trust agreements. We have confidence in the judgment of the trust officers and investment managers at___ that they will take good care of our family and financial matters."

g. *HEMS Standard.* John Gallo wrote a 2008 article for the Heckling Institute on Estate Planning titled *Dear Mr. Trustee – Please Send Money* that provides details about ways to further explain the health, education, support, and maintenance standard in a separate letter of guidance or the trust instrument itself.

The discussion in Item 54 is not from the ACTEC 2012 Summer meeting but is from a Workshop at the 2012 Heckerling Institute on Estate Planning by Ann Burns, John Bergner, and David Handler about planning for large estates that happen to own significant closely held business interests. The discussion is outstanding, and is included with these materials (with the permission of those speakers) as a complement to the outstanding seminar at the ACTEC meeting about planning for family businesses.

54. Estate Planning For Large Estates With Closely Held Business Interests

An outstanding panel discussion by Ann Burns (Minneapolis, Minnesota), John Bergner (Dallas, Texas) and David Handler (Chicago, Illinois) addressed planning approaches and alternatives for hypothetical clients with $30 million and $100 million estates. The discussion addressed not only technical tax issues and best practices tips for various planning alternatives but an analysis of deciding which types of strategies are most appropriate for various different types of assets and family situations.

a. *Beginning the Process*. First, explore the client's personal and financial situation. Next, focus on the client's goals — aside from taxes. That lays the groundwork for the overall planning recommendations, including tax effects of implementing the client's goals.

b. *Communicating With Client; Complexity*. It is imperative to be able to communicate the significance of planning issues that the client understands. "Providing a solution that is not implemented is not a solution."

- Point out to the client that the IRS is a 35% silent partner with the client as to all future appreciation.
- Also, point out to clients that we now have a $5.12 million gift, estate and GST exemption but there is no guarantee that will continue past 2012. That has motivated a number of clients to move forward now.
- Complexity is at the top of the list of things that keep clients from moving forward and pulling the trigger on advantageous tax planning strategies.

c. *Determine Client's Comfort Level With Transfers*. Explore with the client whether the client is comfortable giving away $5 million (or $10 million for a couple). Get a feel for the long term future cash flows needed for the client to maintain his or her lifestyle.

Carefully consider what amounts clients would want to pass to children. In the past, we have often focused on the estate tax exemption amount, but with the dramatic increase in the exemption amount over the last several years we should not assume the clients want the full exemption amount to pass to descendants.

Case Study 1: Client With $30 Million Estate. ("The Middle Class of the Super-Wealthy.") The couple's estate includes:

- Closely held business - $15 million
- Investment assets - $5 million
- Residence - $4 million
- IRA - $6 million
- Life Insurance - $200,000 cash value in $10 million policy, premiums of $50,000/year

d. *Straightforward Gifts Preferred If Client Comfortable With That*. If the client is comfortable with making $5 million gifts, straight gifts are the simplest and most efficient. All appreciation is out of the estate and can be GST exempt. Perhaps the transfer would be made to trusts (most preferably long-term grantor trusts). If the client prefers outright gifts

to children but likes the other advantages of trusts, the beneficiary can be given a great deal of control over the trusts.

e. *Equalize Gifts Among Children or Grandchildren.* If unequal gifts have been made to children and/or grandchildren in the past, clients are typically very concerned about wanting to equalize them at some point. Equalizing trusts for all children and equalizing trusts for all grandchildren is one of the first places the clients will want to make use of their $5 million gift exemption amount.

f. *If Client Concerned About Possibly Needing Access to Transferred Funds.* If the client is concerned about possibly needing access to the transferred funds, consider making a $5 million gift to a trust for the donor's spouse. Possibly give the spouse a limited power of appointment that could be broad enough to appoint the assets back into a trust for the original donor spouse. There is some potential risk of having §2036 or §2038 apply at the original donor's subsequent death. But if the facts do not suggest an implied agreement that the assets would be appointed back to the donor spouse, §§2036 and 2038 should not apply. There is also a possible argument that after appointment of the assets back into a trust for the original donor, the trust might be considered a self-settled trust as to the original donor for state law purposes. Some states (e.g., Arizona) have legislation saying that it would not be considered a self-settled trust, and other states have legislation saying that creditors cannot access trust assets merely because the grantor is a permissible discretionary beneficiary of the trust.

The next issue for consideration is whether both spouses should create trusts for each other. If that is done, various differences must be structured into the trusts to avoid the reciprocal trust doctrine.

g. *Consider Liquidity.* This client has a $5 million investment portfolio and will probably be uncomfortable transferring the bulk of the liquidity in gifts. Look at what other assets are possible assets for transfer planning.

h. *Life Insurance.* The $10 million life insurance policy has a $200,000 cash value. The policy could be given to an irrevocable life insurance trust (ILIT) so that the $10 million of death proceeds would be excluded from the insured's gross estate.

(1) *Not Needed During Life.* A particular advantage of giving a life insurance policy is that it is an asset that is not used by the couple during lifetime.

(2) *Communicating Advantage of Using ILIT.* If clients balk at the expense of creating an ILIT to hold the policy, explain to the client that the IRS will otherwise receive 35% of the policy in estate taxes, so the client really only has a $6.5 million policy. So the client could reduce the policy to $6.5 million, place the $6.5 million policy into the ILIT, and the reduction in premiums the first year alone would more than pay for the cost of setting up the ILIT. "That helps clients move forward. That is a way of communicating to a client solutions and empowering them to move forward with those solutions."

(3) *Obtain Independent Objective Financial Analysis of Policy.* Obtain an independent financial analysis of the policy. Get a comfort level that the premiums will not have to increase above $50,000 per year at some point in the future in order to maintain the policy.

(4) *Determining Value of Policy.* Knowing the value of the policy is important to know the amount of gift if the policy is given, or the appropriate purchase price if

the policy is sold. The life insurance company will typically issue a Form 712 listing the value of the policy.

The value is generally the interpolated terminal reserve value. However there can be surprises. For whole life policies, the interpolated terminal reserve value is generally about the same as the cash surrender value. However, for a term policy this can be quite different. We generally think of the value of a term policy as being the amount of unexpired unearned premiums. However, the life insurance company may value the policy at many multiples of that. For example, in one case in which the annual premium for a $3 million policy was $3,000, with $30,000 having been paid in premiums over the first 10 years, the life insurance company valued the policy at $60,000. (Some companies take the view that the policy should be valued at the amount of reserves that the company must set aside to cover the particular policy.)

Even once we know how the life insurance company will value the policy, there is some uncertainty as to whether the IRS will respect that value.

(5) *Paying Premiums Going Forward*. In this case, the premiums are $50,000 per year which the couple can cover with $26,000 annual exclusion gifts to the ILIT, giving Crummey withdrawal rights to the three children.

If the non-insured spouse dies first, the surviving spouse's $13,000 annual exclusion gifts for three children will not be sufficient to cover the premiums. There must be a plan to be able to pay the premiums in that event. Possibilities include:

- Transfer the full $78,000 of annual exclusion gifts available each year for the three children to the trust and build up some excess to pay premiums.
- Have the policy owned by a trust with other assets as well that can be used to pay insurance premiums. For example, if the client makes a gift of some investment assets to a trust for children, the policy could be transferred to that same trust.
- Loans.
- Split dollar arrangements, including possibilities of a split dollar arrangement with the business or a private split dollar plan. (Split dollar arrangements need to have a plan for "rollout" to be able to repay the premium advances at some point. The $5 million gift exclusion is a way of providing funds for being able to rollout of existing split dollar plans.)
- This issue is more significant for second to die policies. After the first spouse dies, the second spouse must continue to be able to pay premiums.

(6) *Avoiding Three Year Rule*. If the insured transfers an existing policy, the proceeds will still be included in the insured's estate if death occurs within three years. Alternatives to avoid this include:

- Insured gives policy to spouse (covered by gift tax marital deduction) and the spouse then later gives the policy to an ILIT.
- Insured funds the trust, and the trust purchases the policy from the outset.
- Fund an ILIT that is a grantor trust, and the ILIT will purchase the existing policy from the insured. (If the sale approach is used, it is very important to

know the value of the policy. If the purchase price is insufficient and there is a gift element, the three-year rule will still apply.)

- The trust should say that if any policy is included in the insured's estate, it should pass in a manner that would qualify for the estate tax marital deduction so that estate taxes are not accelerated at the first spouse's death.
- The three-year problem is more significant for a client in his 80s rather than in his 70s or younger.

(7) *Structuring ILIT as Grantor Trust.* There will be more flexibility if the ILIT is a grantor trust. For example, the grantor trust could purchase a policy from the insured without violating the "transfer for value rule." Rev. Rul. 2011-28 says that a substitution power will not cause inclusion of life insurance proceeds in the insured's estate under §2042. A substitution power is an easy and now safe way to cause the trust to be a grantor trust as to both income and principal.

i. *Residence.* This is not the first asset to focus on for transfer planning. It may not be the most highly appreciating asset. Children may not want the home and the obligation of paying upkeep expenses. However, if the residence is the only asset that the client is willing to consider giving, it can be a good use of the gift exemption.

- *Outright Gift.* The residence could be transferred outright to children or to a trust for children (preferably a grantor trust), but the client must understand that the client would have to rent the house if the client uses it. (If a grantor trust is used, the rent payments would not be taxable income to the trust.)
- *Gift to Trust for Spouse and Children.* With this arrangement, the client would not need to rent the house. The spouse is a beneficiary of the trust, and the donor can continue to live in the house with the spouse-beneficiary without triggering §2036.
- *QPRT.* For example, the client could be able to live in the house for a 10-year term of the QPRT, and the rental arrangement would not need to begin until after that time. However, this can be problematic for a 70-year-old, because the client would need to outlive the initial term or else the residence would be in the client's estate.
- *Due on Sale Clause.* If there is an outstanding mortgage on the resident, there is likely a due on sale clause that must be addressed with the lender before making any transfers.
- *Favorite Approach.* Of those alternatives, the outright gift to a grantor trust for children is the simplest and preferred approach if the client is not otherwise going to make use of the $5 million gift exemption amount.

j. *Closely-Held Business.* The first step is to determine the client's expectations for the business. Examples: Are children expected to work in the business? Is there an anticipated future liquidity event?

- *Favored Assets for Transfer Planning.* Closely held business interests are typically favored assets for transfer planning.
  - They may have the highest appreciation potential.
  - They may produce cash flow that can assist in making the payments if the business interests are sold rather than given.
  - Substantial valuation discounts may be available for closely held business interests that would not be available for other assets.

- Pass-through entities may produce substantial cash flow that is merely used for paying income taxes. However, the cash flow can be "counted" for purposes of paying off loans to acquire the business interest (which the client-grantor would then use to pay the income taxes on the pass-through income attributable to the trust).

- *Outright Gifts*. Many clients with this size of estate will not feel comfortable giving away $5 million of value to children
- *Trust Transfers*. However, they will feel comfortable transferring a significant portion of the business interest to a trust with the donor's spouse as a potential beneficiary. A valuation discount of about 40% would likely be available. All of the assets are still available for the spouses.
- *Single Trust With Multiple Duties*. The same trust will probably hold a life insurance policy as well. So cash flow from the business can be used to pay premiums.
- *Continued Cash Flow With Salaries*. Even after transferring the business interest, the client (and possibly the spouse) could continue drawing salaries for continued cash flow as long as they continue to work.
- *Cash Flow For Surviving Spouse*. After the client who is actively involved in the business dies, there may be no further cash flow if the spouse is not working in the business. Factor in where necessary cash flow will come from in that circumstance for the surviving spouse. A salary continuation plan could be adopted to provide continuing cash flow benefits even after the client retires or dies.
- *Buy-Sell Agreement*. Include appropriate transfer restrictions. For example: provide that the business interest cannot be transferred outside the family without consent; give a right of first refusal to the entity or owners to purchase business interests that someone wants to transfer; address whom the stock can be transferred to and under what conditions without getting consent; discuss whether the stock can pass to family members or trusts for their benefit or for their spouses. Do any family members have the right to buy back stock that is transferred? For example, if some children are involved in the business, can they purchase stock that is transferred to other family members? How will the stock be valued for any such transfer?

  After the client decides what restrictions are desired aside from tax considerations, the planner must then determine whether §2703 would apply to disregard those restrictions in valuing the stock for gift and estate tax purposes.
- *Ethical Issues*. It is very important for the planner to consider ethical issues if the planner is in the role of creating a plan for the closely held business for all family members. The planner will want to very carefully clarify who the planner is representing and who the planner is not representing.

k. *Education Issues*.

- *529 Plans*. The primary advantage of a 529 plan is that the assets grow tax-free and can be withdrawn for education purposes without paying income tax. The downside is that if the grandparents are still alive when the grandchildren reach college age, the grandparents could pay the college tuition directly. More value could be transferred free of gift or estate tax in that case if the annual exclusion gifts that were contributed to the 529 plans had instead been in a trust that the grandchildren would receive at some appropriate time.

- *Section 2642(c) Trusts*. A more favored approach is to make annual exclusion gifts to §2642(c) trusts for grandchildren that would be exempt from the gift and GST tax. (Section 2642(c) provides that special provisions must be included in order that annual exclusion gifts in trust for grandchildren qualify for the GST annual exclusion exemption — there must be "vested" separate trusts for each grandchild.) If the grandparent is not alive when the grandchildren go to college, education expenses could be paid from the trust funds. If the grandparents are alive, they could pay the tuition expenses directly, leaving the trust assets for the grandchildren.

l. *Assisting Children to Acquire Residences*.

- *Pay Off Prior Loans*. Clients may have previously loaned funds to the children to acquire houses. The $5 million gift exemption amount could be used to forgive those loans. Clients love the simplicity of this.
- *Loans to Acquire Houses*. The mid-term AFR in January 2012 is 1.17% (in July 2012 it is under 1%). That is far lower than is available from any third party mortgage lender. Issues can arise with equalizing the benefits of these low-interest loans among children if one child wants a more expensive house than the other children, or if one child lives in a more expensive city than others.
- *Security Required*. For the children to be able to deduct the mortgage interest as qualified residence interest, the loan must be secured by the residence. Be sure to properly document the loan with a mortgage.

m. *IRA*. Gifts of IRAs are generally not available, because they will be treated as withdrawals requiring current income taxation on the retirement account. The client might consider using the IRA for living expenses during retirement to facilitate gifts of other assets. The planner will need to balance that approach against the advantages of "stretch-out" IRAs to delay as long as possible the time of withdrawal and payment of income taxes on the funds accumulated in the IRA.

n. *Favored Approaches*.

- Give $5 million from one spouse to a trust for other spouse, and allocate GST exemption to it.
- Ideally, that $5 million gift would be of an interest in the closely held business. There are valuation discounts, and it leaves the client with all the liquidity intact.
- If a closely held business interest is used, consider using a defined value clause in the transfer to the trust.
- Sell the insurance policy to that trust.
- Make annual exclusion gifts to §2642(c) trusts for the grandchildren.
- Make annual exclusion gifts outright to children if they need to consume the assets or to grantor trusts for children to provide creditor protection for them.
- Consider what alternatives are available for the other spouse (the donee-spouse) to make use of his or her $5.12 million gift exemption at some point. The donee-spouse could very safely make a gift to a trust for children (realizing that the spouse has access to the original $5.12 million of value transferred into the trust for the benefit of the donee-spouse). Another possibility would be to make a gift into a trust with the other spouse (the original donor-spouse) as a potential beneficiary, but the reciprocal trust doctrine creates a potential audit risk.

- Traditional basic planning. The testamentary planning will address how remaining assets will eventually pass to children and grandchildren or to charity. Take appropriate steps for disability planning. Coordinate IRA and life insurance beneficiary designations as appropriate. Make sure both spouses have enough assets in their names to make full use of the exemption amounts. By transferring one-half of the closely held business interest to the non-owning spouse and using QTIP trusts, lack of control discounts become available even without transfers to children. (Even better, transfer 1% to the children, so that each spouse ends up with 49.5%, yielding even greater discounts.)

Case Study 2: Client With $100 Million Estate. (The exact amount doesn't matter. The key is that the estate is large enough that the clients can afford to make transfers.) The couple's estate includes:

- Closely held business - $50 million
- Real estate used by business - $10 million
- Investment assets - $25 million
- Three homes (one owned jointly with a child) - $4 million
- IRA - $2 million
- Life Insurance – None
- Auto collection - $3 million

The clients both have previously used their $1 million gift exemptions. ($1 million was used in acquiring the house held jointly with the child. No GST exemption has been used.)

o. *Equalize Prior Gifts.* The client made a $1 million gift for one child in acquiring the home held jointly with that child. The client may want to consider equalizing the other two children.

p. *Closely Held Business.* With a $50 million business, this is clearly the preferred asset for transfer planning. Take into account the financial situation of the business, anticipated economics and cash flows, anticipated liquidity events, etc. That will have a considerable impact on the decision of whether to use direct gifts, gifts and installment sale, or a GRAT. All of those options must be explored with the client.

q. *Business Interest -- Gift and Sale to Grantor Trust.*

- A starting point is to create voting and non-voting units. One planner typically creates 999 non-voting shares for every 1 voting share. Non-voting shares can be transferred without fear of the client losing control of the business.
- Gift of 10% and sale of 90%, leaving 1/9 ratio of equity to debt.
- The installment sale allows tremendous leverage. For example, the client could make a gift of $5 million and then sell $45 million worth of closely held business interests.
- Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.) Make the gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days, or even the prior taxable year). John Porter suggests transferring an initial gift of cash to the trust — something other than the illiquid asset that will be sold to the trust — so that the cash is available to help fund note payments.
- The key of using the installment sale is to get an asset into the trust that has cash flow. For example, if the business does not have cash flow, the real estate could be

transferred to the trust because it does have cash flow. (See the following subparagraph.)

- Cash flow from the business may be sufficient to assist making payments on the promissory note.
- Model anticipated cash flow from the business in structuring the note.
- For pass-through entities, cash distributed from the entity to owners so they can pay income taxes on the pass-through income will be distributed partly to the grantor trust as the owner of its interest in the entity; that cash can be used by the trust to make note payments; the grantor could use that cash to pay the income tax. This "tax distribution cash flow" may be enough to fund a substantial part of the note payments.
- The goal is to be able to pay off a note during lifetime.
- Lack of control and lack of marketability discounts would apply.
- Best practices for avoiding §2036, 2038 argument: Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments)(John Porter suggestion). Be as certain as possible that consideration paid in the sale transaction is "adequate and full consideration" so that the full consideration exception to §§2036 and 2038 applies.
- Use a defined value clause to protect against gift consequents of the gift and sale of hard-to-value assets to the trust. (If a charitable entity is used for the "excess value," typically a donor advised fund from a Communities Foundation is used. It should act independently in evaluating the values. It should hire an appraiser to review the appraisal secured by the family. The donor advised fund will want to know an exit strategy for being able to sell any business interest that it acquires. An advantage of using a donor advised fund as compared to a private foundation is that it is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.)
- The interest rate is very low. For example, in January 2012 a nine-year note would have an interest rate of 1.17%. If there is a 30% discount, effectively the interest rate as compared to the underlying asset value is 0.8%, so if the business has earnings/growth above that, there is a wealth shift each year.
- This approach takes advantage of opportunities available today that could be eliminated in the future – discounts, $5 million gift and GST exemptions, and extremely low interest rates.

r. *Real Estate Used In Business.*

- If the business does not produce excess cash flow, consider first transferring (by gift and sale if appropriate) the real estate to the trust. The lease of the real estate from the business will produce consistent cash flow. The trust can use some or all of the lease payments to pay down the note. After nine years when the note has been paid, the continued cash flow from the lease payments could be used to purchase some of the closely held business interests.
- Reverse planning strategy (depending on client's objectives): transfer the closely held business interest into the trust, and have the client retain the real estate. The client may want to retain the cash flow coming from the real estate.

- If the client is considering selling the business at some point, inquire whether the real estate would also likely be sold. If not, the real estate could provide continuing cash flow. (The third-party buyer of the business may or may not allow that.)
- When the ownership of the business and real estate are not the same, determining and structuring appropriate fair market rental rates becomes very important.
- Document the lease with commercially reasonable terms.

s. *Timing of Gift and Sale Transactions*. Do not make the gift and sale on the same day. The *Pierre* case aggregated assets that were given and sold on the same day for valuation purposes, to reduce the lack of control discount of the respective blocks that were given and sold. In addition, if the gift and sale is made the same day, that would open up a potential argument from the IRS that §2036 applies to the sale transaction, because the aggregate transfer is a transfer that does not come within the bona fide sale for full consideration exception in §2036 (i.e., it involves a gift element).

t. *GRATs*.

(1) *Target Client*. "I see GRATs as really fitting two types of clients-wealthy and very wealthy." The "wealthy" client who is not comfortable giving away $5 million can still freeze his or her estate with a GRAT. The GRAT is also helpful for the "very wealthy" client who has done lots of planning and is in the mode of "what else can we do"? For example, the GRAT can be used to freeze the investment portfolio.

(2) *Flexible With Caps and Floors on Remainder*. One of the unique and most intriguing aspects of the GRAT is the ability to customize the amount passing to children in relation to the amount that will be returned to the grantor at the end of the GRAT term. The GRAT can customize how much the client is willing for children to receive at the end of the GRAT term. If the remainder has grown to a value that is more than the client wants the children to receive, the GRAT can by formula when it is drafted specify how much will be returned to the client. (The calculation of the annuity amount in order to "zero out" the GRAT does not change. If the assets appreciate over the cap amount, the client could have left more to children without gift tax cost, but chooses not to do so.)

(3) *Increasing Annuity Payments*. The GRAT may be structured so that the annuity payments will increase as much as 20% each year over the prior year. If the client anticipates that the assets in the GRAT will appreciate substantially and the annuity payments will have to be funded in kind, or if there will be additional liquidity in the future, having increasing annuity payments is beneficial.

(4) *Decreasing Annuity Payments*. Using decreasing annuity payments may essentially turn the GRAT into a one-year GRAT. For example, the annuity payment due at the end of the first year may be about 90% of the value that was contributed to the GRAT initially. At the end of the first year, if the assets have declined by 10% or more, all of the assets will be returned to the client, which can be contributed to a new GRAT so that all of the appreciation from that time forward could be shifted. (The Obama Administration proposes a prohibition on decreasing annuity payments, but that restriction does not apply currently.)

(5) *Multiple GRATs*. Use multiple GRATs so that the appreciation of assets in one GRAT is not offset by depreciation in another. Use different GRATs for each different category of investments. One speaker went through a gift tax audit of the client that had done dozens of GRATs with a clean bill of health.

This approach is "heads I win tails you lose" for the children. They receive the appreciation from the appreciating GRATs but do not have to bear any losses from the depreciating GRATs.

In order to assist clients with administering multiple GRATs, one firm uses a tickler system to keep track of all GRAT annuity payments that will be due each month. The firm sends out letters each month to every client with an annuity payment due that month, describing the due date and the amount of the payment.

Judge your client's willingness to stomach the complexity of multiple GRATs. One planner says that for some clients, he just does not even mention the possibility of multiple GRATs because he knows of their anxiety in dealing with just one GRAT.

(6) *Place to Hold Investment Portfolio For Mega-Wealthy Client*. For the mega-wealthy client, with hundreds or billions of dollars in investment assets, keeping the bulk of the investment assets in GRATs makes sense to shift all future appreciation out of the estate at no transfer tax cost.

(7) *Typically Do Not Use Short-Term GRATs With Illiquid Assets*. Short- term (2-year) GRATs are typically not used for illiquid hard-to-value assets. (The asset must be valued at the end of each year to determine how many units to distribute in satisfaction of the pecuniary annuity payments.) However, if a liquidity event is anticipated within the very near future, short-term GRATs could still make sense for illiquid assets.

(8) *Fund GRAT with Illiquid Business Interest and Cash to Make Annuity Payment in First Several Years*. If a client anticipates a liquidity event within 3-4 years, fund the GRAT (say a 4-year GRAT) with the business interest and a marketable securities portfolio that can be used to make the annuity payments in the first several years before the liquidity event is likely to occur. (The increasing annuity structure is also helpful in that scenario.)

(9) *Qualified Disclaimer*. The client may contribute stock to a general power of appointment marital trust for his spouse, and also create a GRAT at the same time. The marital trust provides that any assets disclaimed will pass to the GRAT. At the end of nine months, if the asset has appreciated substantially, the spouse will disclaim, and the disclaimer is effective as if the asset had passed into the GRAT when the trusts were originally created. If the asset has depreciated, the spouse will not disclaim, and it is a marital gift.

(10) *Use Stand Alone Separate Single Trust to Receive GRAT Remainders*.

- *Simplicity*. If "rolling" GRATs are used, with the client contributing the assets received in each year's annuity payment into a new GRAT, provide that the remainder in all of these various GRATs will pass to a single trust for simplicity. The trust would be structured as a grantor trust, and the client might be the trustee of that trust. The trust receiving the remainders should be established under a separate trust agreement, and not under the same agreement creating a GRAT.
- *Fewer Boxes on Flowcharts*. One planner puts it well: "My clients like fewer boxes on their flowcharts."
- *Sale of Remainder Interest to Existing Trust*. Having a separate legal entity own the remainder interest of a GRAT affords the opportunity to enter into transactions regarding the remainder interest. For example, the trust that owns

the remainder interest might sell the GRAT remainder interest to a GST exempt trust before the assets appreciate significantly, while the remainder interest still has a low value. (Determining that value may be somewhat difficult, because the value changes each day after the GRAT is created.) In order to leave open the flexibility of using this planning, ***there must not be a spendthrift provision*** in the GRAT instrument.

u. *Investment Portfolio.*

(1) *Family Limited Partnership*. FLPs are not appropriate for all situations.

- If the client is looking for discounts, ask the client whether he or she anticipates holding onto most of the limited partnership interest for life. If so, what is the likelihood that valuation discounts will be available at death? Also factor in the §2036 risk at death.
- If there is not a legitimate and significant nontax reason for the FLP, §2036 will apply at death, removing any discounts.
- If creditor concerns are one of the nontax issues, focus on whether existing liability insurance coverage is likely to cover that risk, and whether the FLP is reasonably needed for that purpose. (The client will recognize that the cost of umbrella liability coverage is very low – suggesting that the likelihood of liability concerns is also very low.)
- If creditor concerns justify using an FLP, organize the FLP or LLC in a jurisdiction with strong protective laws. Some state laws provide more protection than others, especially where a charging order is the sole remedy. The law of the client's residence may not be the best choice. Also, intentionally going out-of-state for more asset protection bolsters creditor protection as a genuine non-tax purpose.
- The planner gains credibility with the client and other advisors by not drafting partnership agreements that are not really useful.
- The client must factor in the administrative inconvenience of administering the FLP in future years.
- The FLP can set up many headaches for clients with administrative issues.
- For this client, $60 million of their net worth is tied up in the closely held business and real estate connected with it – in discountable entities. Don't get greedy and try to get everything into discount entities.

(2) *GRATs*. A GRAT might be a realistic possibility for the investment portfolio. See the preceding subparagraph. If the client does an installment sale with the business interest, that merely freezes the value, and indeed the estate continues to grow at the 1% rate of the interest on the note. The planner needs to chisel away at the estate using other planning alternatives as well. This could include GRAT planning with the investment portfolio.

v. *Automobile Collection.* A collection of "collectibles" is not generally a desirable vehicle for transfer planning.

- Accumulating the collection is a hobby to the client, and the client often does not want to part with the collection.

- From a tax standpoint, it may be preferable for the client to retain the collection to receive a stepped-up basis at death. Collectibles are subject to a 28% income tax rate when sold.

w. *Remainder Purchase Marital Trust*. David Handler developed the concept of the Remainder Purchase Marital Trust (or "RPM Trust")as a type of freezing transaction. *See* Handler & Dunn, "GRATs and RPM Annuity Trusts: A Comparison," 20 TAX MNGMNT EST., GIFTS & TR. J. (July 8, 2004); Handler & Dunn, "RPM Trusts: Turning the Tables on Chapter 14," TR. & EST. 31 (July 2000).

(1) *Basic Description*. The RPM Trust involves a transfer of assets to a trust in which the donor's spouse has an income or annuity interest for a specified term or life of some individual. (It is important that the spouse is not a beneficiary under an ascertainable or discretionary standard, because that interest would be hard to value; straight income or annuity interests can be valued easily under the IRS's actuarial tables.) The transfer to the trust is gift-tax free because it qualifies for the gift tax marital deduction, even though it is not a general power of appointment trust or a QTIP trust. (See the discussion below about why this is not a "nondeductible terminable interest.") A grantor trust (perhaps a GST exempt trust) for descendants (referred to below as the "Descendants Trust") that was funded by someone other than the spouse pays the donor the actuarial value of the remainder interest when the RPM Trust is created in order to be named as the remainder beneficiary of the RPM Trust. The RPM Trust assets are not included in either the donor's estate (because the donor has no retained interest in the trust) or the spouse's estate (because the spouse does not have a general power of appointment and there was no QTIP election) at their subsequent deaths.

(2) *Overall Result*. No gift or estate tax is paid with respect to the trust assets. The Descendants Trust pays an amount equal to the actuarial value of the remainder interest when the trust is created (i.e., the full value of property transferred to the trust less the actuarial value of the spouse's income or annuity interest). The value of the remainder interest may be relatively low compared to the value that the Descendants Trust will ultimately receive. (As with QPRTs, the discount is greater for an RPM Income Trust at higher § 7520 rates. However, as with GRATs, the discount is greater for an RPM Annuity Trust at lower § 7520 rates.) Thus, the Descendants Trust can acquire assets at significant discounts. The many restrictions that apply to GRATs or QPRTs would not be applicable.

(3) *Marital Deduction Terminable Interest Rule*. A transfer to a donor's spouse qualifies for the gift tax marital deduction unless it is a nondeductible terminable interest. Section 2523(b)(1) provides that no gift tax marital deduction is allowed if the spouse receives a life estate or other interest that will terminate at some time *and* if the donor provides that the assets will then pass to someone else "for less than an adequate and full consideration in money or money's worth." As long as the amount passing to the third party is passing for full consideration, the marital deduction is allowed even though the spouse's interest terminates at some point.

(4) *Advantages of RPM Annuity Trust*. The RPM Annuity Trust functions much like a GRAT. The spouse receives set pecuniary annuity payments each year of the trust. The annuity payments are structured so that the spouse's present value of the annuity payments is equal to almost the full value transferred to the trust. The

separate trust purchases the remainder interest from the client. Thus, almost all appreciation above the initial value will inure to the benefit of the remainder trust, analogous to a GRAT.

- In effect, this allows a GST exempt GRAT. (The issue is whether the distribution of RPM Trust assets to the Descendants Trust at the end of the RPM Trust term is a contribution to the Descendants Trust requiring that it change its inclusion ratio. Cf. Letter Rul. 200107015 (sale of remainder interest).)
- There is no mortality risk of inclusion in the donor's or the spouse's estate for estate tax purposes.
- Because there is no mortality risk, the trust can be structured for a longer term (so that the anticipated cash flow from a business interest contributed to the trust, for example, would be sufficient to fund the annuity payments).
- The trust does not necessarily need to be for a fixed term but could be for the shorter of a term of years or life (of the donor or donor's spouse).

Backloaded annuity payments are possible. Using backloaded annuity payments solves the problem of transferring business interests, real estate, or other assets that do not produce significant cash flow but have large appreciation potential. (For GRATs, the annuity is given value under § 2702 only to the extent that it has annual increases of no more than 20%.) In effect, this is a "shark-fin GRAT" substitute.

(5) *Disadvantages; Specific Requirements for RPM Trusts.*

- *Spouse Beneficiary.* The donor's spouse must be the beneficiary of the term interest (so that the transfer to the trust is covered by the gift tax marital deduction). (In the typical QPRT or GRAT, the donor retains the term interest rather than the donor's spouse. The client must be married and be willing to benefit his or her spouse in an RPM Trust transaction.)
- *No "Divorce Clause."* The spouse's term interest cannot terminate in the event of a divorce. Divorce would make the term interest very difficult to value, which would make the remainder interest very difficult to value.
- *Easy to Value or "Proportional" Assets.* Generally, cash or marketable securities that are easy to value should be contributed to the RPM Trust so that full consideration could be paid for the remainder interest. The RPM Trust at a later time could purchase other assets (such as business interests or real estate) in an independent purchase transaction. If hard-to-value assets are contributed to the RPM Trust, there is the possibility that the Descendants Trust will not pay full and adequate consideration for the remainder interest, which would mean the disallowance of the gift tax marital deduction (whether this would cause disallowance of all or just part of the marital deduction is not clear).
- *Same Entity.* An alternative is for the donor and the Descendants Trust each to use interests in the same entity.

(6) *"Old and Cold" Descendants Trust.* The Descendants Trust should have been funded previously in a separate independent transaction. If the donor makes a gift to a new Descendants Trust and the Descendants Trust uses those funds the next

day to purchase the remainder interest in an RPM Trust from the donor, can the IRS argue that there was not full consideration paid for the remainder interest but that it was, in effect, a gift from the donor? If so, the gift tax marital deduction may not be allowed for the contribution to the RPM Trust because the exception to the nondeductible terminable interest rule would not apply.

(7) *Not a "Garden Variety" Recognized Transaction*. There are no cases or rulings specifically addressing the RPM Trust transaction, and it is not a widely used strategy. However, the concepts underlying the use of the strategy seem sound. David Handler reports that he has created a number of these trusts. He has had at least one of these RPM Trusts go through an estate tax audit without question. The basic economics of the transaction are not abusive of the transfer tax system.

x. *Life Insurance*. The estate has $60 million of illiquid assets, and the estate tax will exceed the liquid assets of the estate. Address with the client whether the goal is to get $100 million of value to the family, or $100 million less estate taxes. The planning steps described above largely just freeze the value of the estate, and do not reduce the amount subject to estate tax. Therefore, it is appropriate to consider having the trust described above that is created to acquire business or other assets also acquire life insurance to assist in funding the estate tax.

y. *Testamentary CLATs*. Testamentary charitable lead annuity trusts (CLATs) involve paying a fixed amount to charity over a set period, with any remaining value passing to family members at the end of the trust term. The annuity payments payable to charity can be structured so that no estate tax is paid on the value of assets passing into the CLAT. With discounted assets, cash flow from the business may be sufficient to fund the annuity payments. Testamentary CLATs involve considerable complexity, but can be powerful for transferring business interests with minimal estate taxes.

Items 55-65 are observations from a seminar by Scot W. Boulton and Dana Fitzsimons: The Dead Hand, the Black Robes, and the Modernists: A Review of How State Courts Have Grappled with, and Occasionally Fumbled, the Uniform Trust Code. The seminar addresses recent cases involving the Uniform Trust Code.

55. Trend Toward Attorneys Becoming Fact Witnesses in Trust Construction Cases (§412)

Section 412 of the Uniform Trust Code provides that even if a trust agreement is not ambiguous, extrinsic evidence is admissible to evidence a manifestation of the settlor's intent. There is a trend toward attorneys becoming fact witnesses more and more in trust construction cases.

56. Broadened Authority of Court Regarding Attorneys Fees (§1004)

One of the changes made by the Uniform Trust Code is that §1004 gives the court broad authority under its equitable powers to award attorneys fees. That is much broader than the prior American rule.

57. Refusal to Treat Gift to Charity as a Trust to Provide Settlor With Standing to Enforce Gift (§405(c))

Section 405(c) of the Uniform Trust Code departs from the common law and provides that the settlor of a charitable trust has standing to enforce the trust. *Hardt v. Vitae Foundation,* 302 S.W.3d 133 (Mo. App. W.D. 2009), in sophisticated reasoning, refused to treat a charitable gift subject to a gift agreement as a trust in order to provide the settlor with standing to enforce the

trust. A similar result was reached in *Dodge v. Trustees of Randolph Macon Woman's College*, 661 S.E.2d 805 (Va. 2008). Both cases suggest that when making large charitable gifts for clients, if the clients want to retain control to be able to enforce gift agreements, one possibility is to choose a charitable trust. Another is to draft the donor agreement specifically with the donor or retaining standing to enforce the charitable gift.

58. Effective Date of Uniform Trust Code (§1106)

In *McCabe v. Duran,* 180 P.3d 1098 (Kan. 2008), the court addressed §1106 of the Uniform Trust Code, which says that the Code applies broadly to trusts but with limitations intended to avoid constitutional due process problems so that the Code does not change vested property rights retroactively. The Kansas Uniform Trust Code includes double damages provisions. A jury verdict found that a former trustee breached its duty and awarded double damages. The double damage award was reversed, because at the time of the breach, double damages were not part of the law and applying it would be unconstitutional.

59. Consensual Trust Termination (§411)

Section 411 provides that a non-charitable irrevocable trust may be terminated upon consent of all beneficiaries if the court concludes that the continuance of the trust is not necessary to achieve *any material purpose* of the trust. The cases tend to turn on the material purpose issued.

In *Vaughn v. Huntington National Bank Trust Division,* 2009 WL 342697 (Ohio Ct. App. 2009), the trust provided that distributions of $250 per month would be made to all of the grandchildren. There were no termination provisions and no perpetuities provision. The beneficiaries sought to terminate the trust by consent under §411. The comments to §411 say that the material purpose is not to be inferred but there must be a specific purpose stated or established by extrinsic evidence. However, sometimes the very design of the trust suggests a protected purpose. The court determined that the design of this trust is that no beneficiary should ever receive the property and that beneficiaries should only receive $250 per month. The court refused to allow the termination of the trust, but reformed it to add a perpetuities provision.

A similar conclusion was reached in In re *Estate of Somers*, 89 P.3d 898 (Kan. 2004). A trust established in 1956 had grown to $3 million. The trust provided $100 per month in annuities to be paid to named grandchildren for their lives, with the remainder passing to a charity. The parties sought to terminate the trust under §411, against the corporate trustees' wishes. The court refused for several reasons. (1) This trust had a spendthrift clause, and Kansas (unlike all other states) provides that a spendthrift clause itself represents a material purpose. (2) The remainder passes to charity and §411 applies to non-charitable trusts. Even though the court refused to allow the complete termination of the trust under §411, it terminated the trust in part because $3 million was far in excess of the amount needed to make the payments to the grandchildren for their lives. The court left $500,000 in trust to pay the small annuities.

60. Non-Consensual Trust Modification and Termination; Recent Cases Have Used Burden of Proof to Avoiding Setting Aside Settlor's Intent (§§412, 415, 416)

The Uniform Trust Code provides relaxed standards for modifying and terminating trusts as compared to common law. Sections 412, 415 and 416 address the power of the court to modify otherwise clear provisions of the trust instrument.

Section 412(a) provides that the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, because of circumstances not anticipated by the settlor, the

change will further the purposes of the trust. "To the extent practicable, the modification must be made in accordance with the settlor's probable intention." (The "to the extent practicable" exception provides "a huge door through which trucks may be driven.")

Section 415 permits a court to "reform the terms of the trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by mistake of fact or law, whether in expression or inducement."

Section 416 allows modification of the trust to achieve the settlor's tax objectives if the modification is not contrary to the settlor's "probable intent" (whatever that is).

Recent court decisions evidence that courts are sometimes uncomfortable with the substantially increased authority for modifying irrevocable trusts under the Uniform Trust Code. If a court wants to put brakes on the ability to modify or terminate trusts under the Code, a tool that judges have is the burden of proof. The court can simply find that the burden of proof has not been met to satisfy the standard required for modification or termination under the Code. Three relatively recent cases adopted such an approach.

In *Reid v. Estate of Sonder*, 63 So.3d 7 (Fla. Dist. Ct. App. 2011), a trust beneficiary brought a reformation suit to abate charitable gifts under the trust agreement. The court threw out the suit and the appellate court agreed, on the basis of failure to meet the burden of proof. (The case had a good discussion of the meaning of the burden of proof.)

In *Ladysmith Rescue Squad, Inc., v. Newlin,* 694 S.E.2d 604 (Va. 2010), the trust remainder was to pass equally to the charities. After years of fighting with beneficiaries about other issues, an agreement was reached. One charity wanted the trust continued and the other charity wanted its portion outright. The party sought to divide the trust and commute only the trust for the charity that wanted its assets immediately. The trial court thought that was a good way to end years of fighting. At a hearing to prove up and approve the settlement agreement, there were no witnesses or proof offered. On appeal, the Virginia Supreme Court reversed the division and commutation because of the lack of proof at trial.

In the Matter of Trust D Created Under Last Will and Testament of Darby, 234 P.3d 793 (Kan. 2010) involved a special Kansas law allowing parties to appeal an uncontested judgment to the Kansas Supreme Court in order to get around the limitation under *Bosch* of giving effect to state court judgments for tax purposes. The parties expected a rubber stamp by the Kansas Supreme Court, but the court concluded that the reformation violated a material purpose of the trust and that there was no proof offered in an uncontested hearing of the changed circumstances that necessitated modification.

61. Creditors Claims, Spendthrift and Discretionary Trusts (§§502, 506)

Section 502 validates spendthrift provisions, §503 creates an exception for child support and spousal maintenance, and §506 provides that a creditor may reach a terminating distribution or other mandatory payment that is unreasonably delayed.

In re *Mercato*, 2009 WL 1856578 (Bkrtcy. M.D. Ala. 2009) involved a QPRT that was divided into separate shares for each of four children following the settlor's 10-year retained use of the residence. There were no clear provisions as to when the separate trusts would terminate. Subsequent to the division, a child filed bankruptcy. The court rejected the bankruptcy trustee's motion to require the child to turn over her interest in the trust. The court determined that the termination of the trust was within the discretion of the trustee and did not occur. That is an

unusual case. In contrast, In re *Hilgers*, 371 B.R. 3465 (10th Cir. Bank. App. 2007) *aff'd*, 279 Fed.Appx. 662 (10th Cir. 2008), allowed a creditor to reach a beneficiary's interest in a terminating trust, based upon §506, which provides that the terminating distribution cannot be unreasonably delayed for creditor purposes.

In re *Tait*, 2008 WL 4183341 (Bkrtcy. S.D. Ala. 2008) dealt with a situation in which a beneficiary-trustee embezzled $4 million from his employer and spent the $4 million in renovating a house and plantation owned by the trust. In settling an action brought against the trustee by the employer, the trustee borrowed money to pay off the employer, with the loan being secured by the house. A successor trustee sued to rescind the mortgage, and the court held that the mortgage was invalid because the prior trustee breached its duty of loyalty. Spendthrift protection applied as to assets that were contributed from the original grantor, but the court held that to the extent of the beneficiary's contribution to the trust, there was an equitable lien on the beneficiary's 1/3 interest in that portion of the trust.

62. Trustee's Duty Is Only to Settlor of Revocable Trust (§603)

Section 603 provides that while a settlor of a revocable trust is alive and competent, the trustee owes duties only to the settlor. This was not clear in many states prior to the enactment of the Uniform Trust Code, and has been addressed in several recent cases. The underlying policy is that future beneficiaries, whose interests are subject to divestment, should not be able to disrupt the trust.

For example, in *Gunther v. Gunther*, 350 S.W.3d 44 (Mo. App. 2011), the settlor created a revocable trust. After the settler died, his surviving spouse sued for an accounting of the revocable trust administration during the settlor's lifetime. The court dismissed the action because the trustee owed duties only to the settlor during the time for which the accounting was sought.

While the policy underlying §603 is understandable, the implication is that if a trustee breached its duty to the settlor and if the settlor did not sue the trustee during his lifetime, the remainder beneficiaries are left without any remedy. They have no ability to receive information or to seek redress of damage to their interest. It is not clear that the settlor's estate would have standing to sue. All of the damage fell on the remainder beneficiaries of the revocable trust and not on the estate. There could be a breach with no accountability, and that is a troubling result.

63. Trustee Resignation Must Comply With Trust Agreement or Satisfy Local Law to be Effective (§705)

Section 705 specifies how a trustee resigns, the consequence of resignation, and the duties of a trustee after resignation. *Wortman v. Hutaff*, 2012 WL 379752 (N.C. Super. Ct. 2012) is a good lesson that a trustee must comply with legal resignation requirements before the trustee is absolved of responsibilities as trustee. In that case, the trustees filed a resignation with the court that had jurisdiction over a will. No successor trustee was appointed for two years. In the intervening time, there was a foreclosure against trust assets. The trustees brought a lawsuit, claiming that the purportedly resigned trustees were still trustees. The court held that the resignation was not effective because the Uniform Trust Code required giving notice to qualified beneficiaries or getting court approval, and the trustee did neither.

64. Trustee Induced by Beneficiaries to Maintain Overconcentration in Trustee's Stock (§802)

Section 802 codifies the duty of loyalty a trustee owes to the beneficiaries of a trust. Various cases have previously addressed a corporate trustee's investing in stock of the corporate trustee. In *W.A.K. ex rel. Karo v. Wachovia Bank, N.A.,* 712 F. Supp.2d 476 (E.D. Va. 2010), the trust was

originally funded primarily with bank stock of the same bank that served as co-trustee (with the settlor's husband — who was the primary beneficiary — as the other co-trustee). The corporate trustee was concerned about the concentration in its bank stock, and repeatedly recommended selling the stock, but the beneficiaries (including the settlor's husband-primary beneficiary/co-trustee) refused and signed consents. After the stock declined in value, the husband alleged that the bank should have sold the stock on its own and should have treated him as an "unavailable" co-trustee. He disclaimed his interest in the trust, so that his adult son became the beneficiary. The adult son also had signed the consent letter to retain the stock, so the adult son also disclaimed and his minor child became the beneficiary. The minor child had not signed the consent letter. Under the Uniform Trust Code, the grandparent and parent could bind the minor child under virtual representation, but the federal court was not willing to rule on that as the first case in Virginia to address the doctrine. Instead, the court relied upon the boilerplate in the document allowing the retention of assets contributed to the trust. Planners should not rely upon the holding in the case relying on the retention clause. It is more likely that this is a case of beneficiaries inducing a breach of trust.

65. Duty to Inform Beneficiaries; Secret Trusts (§813)

Section 813, which codifies the trustee's duty to keep trust beneficiaries reasonably informed, is a controversial section of the Code, and it has been extensively modified by adopting states. Furthermore, §105(b)(8) prevents a settlor from overriding the provisions of §813 by terms of the trust. (Section 105(b)(8) is now an optional provision in the Code and has either been eliminated or heavily modified in many adopting states.)

Several recent cases emphasize that a core legal concept for a trust is the ability of the beneficiary to enforce the trust, and thus there is a necessity for the trustee keep trust beneficiaries informed of trust activities at some level.

Wilson v. Wilson, 690 S.E.2d 710 (N.C. Ct. App. 2010) addressed the North Carolina version of the Uniform Trust Code, which allows secret trusts and deletes all mandatory requirements for giving information to beneficiaries. Even so, the court determined that the trustee must manage the trust in good faith and in the interests of the beneficiaries. A conclusion that the beneficiaries were not entitled to information would render the trust unenforceable by those who it was intended to benefit. Therefore, under North Carolina law, if there is a secret trust and the beneficiary requests information regarding the trust, the trustee must refuse to give the information (or else it would breach the terms of the trust) but should tell the beneficiary that court could enter an order for the beneficiary to obtain the requested information.

Items 66-75 are observations from a seminar by Bryan Howard and Christy Reid, Trust Me — Your Irrevocable Trust Can Be Modified Without Going to Court.

66. Overview of Tools Available

There are four tools available for nonjudicial modification of trusts: (1) nonjudicial settlement agreements: (2) nonjudicial consent modifications; (3) decanting; and (4) dividing trusts. Tools 1, 2, and 4 are addressed in the Uniform Trust Code. Decanting is not a Uniform Trust Code provision, but has been adopted by statute in some states. Many states have statutes regarding trust divisions separate from the Uniform Trust Code, and many instruments permit trust divisions as well.

67. Identification of Governing Law

The governing law of a trust determines which tools are available and who are necessary parties to the modification. Changing the place of administration might be possible to change the governing law to a state that allows a tool that is particularly favorable in a given situation.

68. Identification of Necessary Parties

The necessary parties to implement a modification under each of the tools vary depending on the tool, but consist of some combination of (1) the settlor, (2) the trustee, and (3) beneficiaries (or under the Uniform Trust Code, qualified beneficiaries).

a. *Settlor*. The settlor includes a testator, the person named in a trust instrument as creating the trust, and persons who contribute property to trust.

b. *Beneficiary*. A beneficiary is a person who has a present or future beneficial interest in the trust, whether vested or contingent, and also includes someone who, in a capacity other than as trustee, holds a power of appointment over the trust.

   Some states have added an explicit exception, providing that *permissible appointees* under a power of appointment are not beneficiaries for this purpose. That is probably clear in any event, but questions conceivably could arise in a state that does not add that specifically. This could be very troubling if the permissible appointees include a very broad range of people (such as everybody in the world other than the power holder's estate or creditors of the power holder's estate).

c. *Qualified Beneficiaries*. Under the Uniform Trust Code, a qualified beneficiary is someone who is (1) a permissible distributee of trust income or principal, (2) someone who would be a permissible distributee if the interests of the distributees described in clause (1) terminated without causing the trust to terminate, or (3) would be a permissible distributee if the trust terminated on that date. Generally, this means that first-tier remaindermen are included, but second and third tier remaindermen (for example, under a "wipeout" clause) are excluded as qualified beneficiaries.

69. Representation of Parties

For purposes of delivering required notices and obtaining necessary consents for any of the modification tools, there are rules governing who represents minors, unborns, incapacitated beneficiaries, beneficiaries whose identity and/or location are unknown, permissible appointees under a power of appointment (in the unlikely event that they are qualified beneficiaries), and takers in default under powers of appointment.

The representative can be either an actual or virtual representative. An actual representative is determined based on the individual's relationship with the represented party. A virtual representative is based on an individual's holding substantially identical interests in the trust as the represented beneficiary.

The theory of virtual representation is that if an individual has a substantially identical interest, the person will represent his own interests and in doing so will adequately represent others with identical interests.

a. *General Limitations*. The representative must not have a conflict of interest with respect to the particular question at issue in the modification. In addition, a settlor may never represent a beneficiary in a nonjudicial consent modification (Tool 2).

b. *Actual Representative – Based on Relationship*.

Family Members. A parent (if there is no conflict of interest) can represent his or her own minor or unborn child (unless a conservator or guardian has been appointed for the minor child, in which event that fiduciary is the actual representative).

Some states allow actual representatives for more remote relationships, such as allowing an individual to represent his unborn issue and even minor issue.

Some states provide priority between parents who both want to represent a minor child. Of those states that do, the general approach is to provide that the parent who is also a beneficiary of the trust or whose ancestors created the trust has priority. (Wyoming takes a different approach, giving the parent with primary custody priority.)

Some states (such as New Hampshire) allow a parent or grandparent to represent an adult child who is incapacitated and for whom no conservator or guardian has been appointed. (Using that authority is problematic if the statute does not define "incapacity" for this purpose.)

Fiduciaries. In addition to family members, certain fiduciaries can be actual representatives, including a conservator, a guardian of the person if there is no conservator, an agent under a power of attorney, a trustee with respect to trust beneficiaries (even if the beneficiary is adult and competent), and a personal representative with respect to persons interested in the decedent's estate. Some states provide that the trustee's actual representative authority does not apply to internal affairs but only to external matters.

Powerholders. In addition, certain powerholders can serve as actual representatives. The holder of a general testamentary power of appointment can represent permissible beneficiaries and takers in default if there is no conflict of interest. The holder of an inter vivos general power of appointment is treated as the functional equivalent of the settlor of a revocable trust, meaning that the inter vivos powerholder can act directly without the necessity of representing anybody else. Some states also permit the holders of a *special* power of appointment to represent permissible appointees.

c. *Virtual Representative-- Based on Having Substantially Identical Interests*. A beneficiary can be represented by a person with a substantially identical interest with respect to the particular question if there is no conflict. This can be either horizontal (the person represented is in the same class or has the same level of beneficial interest as the representative) or vertical (the person represented has a beneficial interest that is successive to the representative's interest-- meaning that first tier remaindermen can represent second or third tier remaindermen).

d. *Bootstrapping Representation*. The extent to which representation can be "bootstrapped" is not clear. For example, may an individual representing a beneficiary under actual representation also represent another beneficiary that the represented beneficiary would be permitted to represent by virtual representation? Speakers indicate it is not clear, but they are aware that attorneys are doing it.

e. *Priority Among Representatives*. May a permissible virtual representative leapfrog a permissible actual representative to represent a particular individual? An uncertainty arises because §304 of the Uniform Trust Code recognizes virtual representation for a person "unless otherwise represented." The speakers believe those words mean "unless there is a court appointed representative," and do not refer to other people who could be actual representatives of the person.

70. Tool 1 — Nonjudicial Settlement Agreement (UTC §111)

a. *General Requirements*. Under §111 of the Uniform Trust Code, nonjudicial settlement agreements require (1) the consent of all "interested persons" whose consent would be required in order to achieve a binding settlement were a court to approve it, (2) the change "does not violate a material purpose of the trust," and (3) can only include terms and conditions that could be properly approved by court. Item (3) is not particularly important because a court would likely approve anything that does not violate a material purpose of the trust.

b. *Necessary Parties*. "Interested persons" must be parties to the agreement. The Uniform Trust Code is intentionally vague about who are "interested persons." The determination depends upon the nature of the modification. For almost any changes, the consents of beneficiaries will be required. (For some things a trustee's consent is needed, and for some things the consent of a settlor if living is required.)

Observe that the consent of the settlor is not always required. This is an important distinction from the requirements of Tool 2.

c. *Permissible Scope of Modification.* The Uniform Trust Code has a nonexclusive list of six matters. The common thread of this list is that, except for the first one, the others do not deal with dispositive provisions. The six items are matters relating to (1) interpreting or construing the terms of the trust, (2) approving a trustee's report/accounting, (3) directing the trustee to refrain from performing a particular act or granting the trustee a necessary or desirable power, (4) resignation/appointment of trustee and determination of trustee compensation, (5) transfer of the trust's principal place of administration, and (6) liability of the trustee for an action taken relating to the trust.

Some states have an exclusive list of permitted modifications (primarily administrative matters) because of a perceived potential for abuse.

d. *Living Settlor Not Required*. This tool is particularly helpful in situations in which there is not a living settlor.

71. Tool 2 — Nonjudicial Consent Modifications (UTC §411(a))

a. *Distinguishing Characteristics*. Nonjudicial consent modifications require the consent of the settlor and all beneficiaries. Trustee consent is generally not required (and that can be very helpful where it is not possible to get trustee consent). All types of modifications are allowed.

b. *Broad Scope Permitted.* All modifications are allowed, even if inconsistent with the material purpose of the trust (under the theory that the settlor's consent is required).

c. *Section 2036/2038 Concerns*. Some planners have questioned whether the trust is really revocable if the settlor and beneficiaries can modify it. Does that give the settlor the power "in conjunction with others" to modify the trust, thus triggering the application of

§§2036(a)(2) and 2038? In reaction to this concern, §411(a) of the Uniform Trust Code was revised to stipulate that the consent of all beneficiaries is required and that the settlor could not represent them. Some states alternatively have provided that the settlor has a mere veto power, feeling more comfortable that the settlor's mere passive involvement does not trigger §§2036(a)(2) and 2038. See Item 74 for a further discussion of the tax considerations.

72. Tool 3 — Decanting

a. *General Description.* At least 15 states have adopted decanting statutes, permitting a trustee to distribute trust assets from the original trust to a second trust for some or all of the beneficiaries, without court involvement or beneficiary consent. The Uniform Trust Code does not address decanting. In addition, it may exist by common law in some states (there is a 60-year-old Florida case recognizing a trustee's decanting authority).

b. *Distinguishing Characteristics; When to Use.* There are various situations in which decanting would work but one of the other tools would not, including (1) the settlor is dead so Tool 2 is not available, (2) some states do not have the Uniform Trust Code (and even some states that do have not passed Rule 111 recognizing nonjudicial settlement agreements), (3) the desired modification may be beyond the scope of a settlement agreement allowed under Tool 1 (which does not allow changes beyond the original material purpose of the trust), or (4) obtaining beneficiary consents is impractical, impossible, or undesirable.

c. *Necessary Parties.* The trustee is the only necessary party. In some states, a beneficiary-trustee cannot decant. Some states require notice to qualified beneficiaries.

d. *Beneficiary Consent.* The trustee may ask for beneficiary consent, but for tax reasons beneficiaries should rarely if ever consent to decanting transactions, especially if dispositive changes are made. The paradox is that when a trustee will be most concerned about getting beneficiary consent (if dispositive provisions are changed) is when there is the most risk of the beneficiary making a taxable gift if the beneficiary consents.

e. *General Requirements.*

No Uniformity. The state statutes vary as to the requirements and permitted transfers under their respective decanting statutes. The following is a very general summary of requirements and provisions in many of the state statutes.

Discretionary Distribution Authority. In all states, the trustee must have discretionary authority to make distributions to beneficiaries. (Some states say that the trustee must have absolute discretion.)

Beneficiaries. The beneficiaries of the second trust must be beneficiaries of the original trust – there can be no power to add beneficiaries. An exception is that it may be possible to add permissible appointees under a power of appointment. However, all of the beneficiaries of the original trust do not necessarily have to be beneficiaries of the recipient trust. The trustee has the power to remove beneficiaries, subject to certain protected interests. (Not surprisingly, trustees are reluctant to do this without a release by those beneficiaries who are being removed.)

Preservation of Certain Fixed Interests. Generally states do not allow (1) acceleration of future interests, (2) reduction of a fixed income, annuity or unitrust interest, (3)

elimination of powers of withdrawal (i.e., Crummey powers), or (4) elimination of ascertainable standards.

Preservation of Tax Attributes. States generally impose the requirements that the recipient trust must contain terms qualifying for the marital or charitable deduction if the original trust so qualified, and cannot cause a loss of qualification for the gift tax annual exclusion.

Rule Against Perpetuities. In states with a rule against perpetuities or restraint on alienation, exercise of the decanting authority may not extend the trust term or suspend the power of alienation beyond the term permitted under the original trust.

73. Tool 4 — Dividing a Trust (UTC §417)

Most states have had statutes permitting trust divisions before the adoption of the Uniform Trust Code, and many instruments allow dividing a single trust into multiple trusts.

a. *Scope of Modification.* Under §417 of the Uniform Trust Code, the divided trusts do not have to be identical, but the division cannot "impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust." For example, a trust requiring equal distributions of income to two separate beneficiaries for life could be separated into two equal trusts with one trust payable solely to beneficiary A and the other trust payable solely to beneficiary B.

b. *Trustee is Only Necessary Party.* The trustee is the only necessary party, which can be very helpful if there are any concerns with obtaining consents from others.

c. *Example of Use.* Assume that a trust allows discretionary distributions to two grandchildren, one of whom is much more needy than the other, and at some point terminates and is distributed equally to the two grandchildren. Assume further that the parent of the grandchildren has a power of appointment, to appoint the assets between the grandchildren. The trust can be divided into two equal trusts, and distributions to the needy grandchild could be made solely out of one trust. At the termination of the trusts, the parent could exercise the power of appointment to appoint the remaining assets in the trust from which distributions have been made to the needy grandchild to that grandchild, and appoint the assets remaining in the other trust to the other grandchild. A division in that circumstance can also be helpful if the grandchildren wanted "their trusts" to follow different investment strategies.

d. *Procedure.* Under §417, qualified beneficiaries must receive advance notice of the division but do not have a veto power.

74. Tax Considerations

Trust modifications can have potential income, gift, estate, or GST tax effects. For example, the modification could have an impact on whether the trust qualifies as an S corporation shareholder or as a grantor trust. Potential gift tax concerns are raised if a beneficiary consents to the modification that results in some of his beneficial interest passing to another person.

There are potential estate tax concerns under §§2036 and 2038. Section 2036(a) should not apply because the power to consent is bestowed by statute, and is not *retained* by the settlor. *See* PLR 200919010. Furthermore, §2038 does not apply if the decedent's power can be exercised only with the consent of all persons having an interest (vested or contingent) in the transferred property. Treas. Reg. §20.2038-1(a). PLR 201233008 (August 17, 2012) concluded that a settlor's consent to a trust modification pursuant to a state statute did not cause the trust assets to

be included in the gross estate of the settlor under §§2036 or 2038. The ruling reasoned that the settlor's right to participate in the modification "arises solely from rights granted under State Statute 1 and may be exercised only with the consent of all of the parties having an interest (vested or contingent) in the transferred property." The ruling cited the §2038 regulation but ruled that neither §§2036 nor 2038 applied, without observing that there is not a similar regulation under §2036. While the ruling interestingly did not cite *Helvering v. Helmholz*, the ruling is consistent with the U.S. Supreme Court's holding in *Helvering v. Helmholz*, 296 U.S. 93 (1935), which held that the power under a trust instrument allowing termination of a trust by a written instrument signed by all beneficiaries (which included the settlor) did not cause inclusion in the gross estate under the predecessor to §2038 because

> "[t]he clause in question added nothing to the rights which the law conferred. [Citation to Restatement of the Law of Trusts §§337-338.] Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust."

A settlor's consent on behalf of another trust beneficiary arguably could trigger §2038; therefore the Uniform Trust Code was revised to provide that a settlor may not represent a beneficiary in a nonjudicial consent modification.

The IRS is currently examining the tax effects of decanting transactions.

To avoid GST concerns with modifications, most conservative planners follow the regulations that address changes that can be made to "grandfathered" trusts without causing the GST tax to apply. That typically requires that there be no shift of a beneficial interest to a lower generation and no extension of the time for vesting beyond the perpetuities period that applied to the original trust.

75. Example — Trusteee Succession

Assume that a bank is currently serving as trustee of a trust established by a settlor (now deceased) for the benefit of the settlor's child (Suzie) for life, and upon termination the trust will be distributed to the settlor's then living issue, or if none to the Red Cross. Suzie has one son, and he has two surviving children, ages 18 and 11 (his ex-wife has primary custody of the minor child). The trust instrument requires that the trustee be a bank, and Suzie wants to change that so her son becomes the trustee. She wants to do that without going to court or discussing the change with the Red Cross.

a. *Tool 1*. This is the best alternative. The settlor's consent is not necessary if he or she is deceased (which she is in this case). The Red Cross is not a first tier remainderman and therefore is not a qualified beneficiary whose consent is required.

b. *Tool 2*. This alternative is not available because the settlor is deceased (and obviously cannot consent).

c *Decanting*. This is a possible alternative if the trustee is willing to decant to a trust that effectively removes the existing trustee. The trustee may be unwilling to do that.

d. *Representative of Minor Grandchild*. Possible representatives of the minor grandchild include (1) Suzie (the grandparent of the minor grandchild), (2) the minor grandchild's adult sibling by virtual representation, or (3) the minor grandchild's mother (who is the ex-wife of Suzie's son, who Suzie does not want to involve in this matter).

Some, but not all, states allow a grandparent to represent a grandchild by actual representation. If state law does not allow Suzie to be the actual representative, the issue is whether the adult grandchild can serve as virtual representative rather than having to use the minor grandchild's mother as the actual representative. The speakers believe that the Uniform Trust Code does not prohibit using a virtual representative rather than an actual representative (i.e., an actual representative does not have priority over a virtual representative).

Items 76-82 are observations from a seminar by Peter S. Gordon and Margaret E.W. Sager, Trust Adventures in Wonderland — From the Meadow and Through the Looking Glass; Situs and Governing Law.

76. Primary Factors in Determining Trust Situs and Types of Trust Situs

a. *Primary Factors.* The primary factors that may come into play in determining the situs of the trust are the trust terms, the domicile of the settlor, the location of trust assets, the place of administration, and the location of the trustees.

b. *Types of Trust Situs.* Every trust has an administrative situs, locational situs, tax situs, and jurisdictional situs. They may be related to each other but are not necessarily the same.

Administrative Situs. This is the place where administration primarily occurs, also known as the "principal place of administration" in the Uniform Probate Code (§7-203) and Uniform Trust Code (§108).

Locational Situs. This is where the assets are physically located. In particular, the location of real estate is taken into account. For intangibles, the administrative situs is determinative. For real and tangible property, the location of the property controls with respect to this factor. There can be administrative situs of the trust in one state and real estate located in another state. For certain issues, the laws of the state where the real estate is located are determinative – such as zoning laws.

Tax Situs. This is where the trust is taxable for state fiduciary income tax purposes on retained income and capital gains. This is generally characterized as whether the trust is a resident or nonresident of the state for state income tax purposes. A trust can be a resident trust for income tax purposes in more than one state. However, a trust can also be a resident trust for income tax purposes in *no* state (that obviously is the most desirable result).

Jurisdictional Situs. This determines what state's courts will hear matters concerning the trust. Provisions in the trust document about jurisdictional situs may or may not be determinative. The other types of situs can all play a role in determining jurisdictional situs. Jurisdictional situs can be nonexclusive – multiple states may be able to exercise jurisdiction. In that case, a court having jurisdiction may decline to hear a case if another court is in a better position to exercise jurisdiction.

77. Why Change Trust Situs?

a. *State Income Taxes.* For a state that taxes the trust solely on the basis of where trust conducts its business, an alternative is to move that trust to another state. Indeed, all of the beneficiaries may have even moved out of the original state.

b. *Directed Trusts*. For nontraditional assets, directed trusts may be preferable so that family members or other designated persons could control investment decisions with respect to those assets. For this purpose, the trust could be moved to a state with directed trust legislation. Many corporate trustees are creating affiliates in states that have directed trust legislation.

Uniform Trust Code States. The Uniform Trust Code allows the trustee to follow directions from an advisor if the directions are not "manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty." (§808(b)).

Restatement (Third) of Trusts. The Restatement has similar language. The trustee can rely upon directions "unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries." (§75).

Specific States. Some states allow greater protection. For example, in Delaware the trustee can rely on directions "except in cases of willful misconduct on the part of the fiduciary so directed."

c. *Trust Remodeling*. There may be various reasons for modifying the trust based on a clear change of circumstances. States have differing standards as to the ability to make trust modifications. Methods for modifying trusts include nonjudicial settlement agreements, nonjudicial modifications, decanting, trust divisions, and judicial modifications.

d. *Asset Protection*. There are 14 states with self-settled trust asset protection statutes.

e. *Total Return/Power to Adjust*. The states vary with respect to their power to adjust provisions. For example, some require a straight 4% unitrust while others are more flexible, allowing a 3-5% payout approach.

f. *Tax Savings/Disabling Statute*. If the trust has a distribution power that is so large that it will result in a beneficiary having a general power of appointment under §2041, the planner may consider moving the trust to a jurisdiction that disables that power.

g. *Premortem Validation/In Terrorem Clauses*. Delaware has a statute that allows delivering a copy of the trust to an individual and giving that individual only 120 days to contest the trust. The contest will then take place when the settlor is alive to deal with any disputes.

h. *Silent Trusts*. This settlor may not want a 25-year-old beneficiary to know that there is $30 million in a trust. In some states, notice to a beneficiary can be deferred until what the parties believe is a more appropriate age.

78. Duty to Change Situs

a. *Statutory Provisions*.

Uniform Trust Code. Section 108(b) states that a trustee "is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries."

Uniform Probate Code. Section 7-305 is similar. It also adds that "[i]f the principal place of administration becomes inappropriate for any reason, the Court may enter any order furthering efficient administration and the interests of beneficiaries, including, if appropriate, release of registration, removal of the trustee and appointment of a trustee in another state."

Restatement (Third) of Trusts. Comment b(2) to §76 provides that "[u]nder some circumstances the trustee may have a duty to change or to permit (e.g., by resignation) a change in the place of administration. Changes in the place of administration by a trustee, or even the relocation of beneficiaries or other developments, may result in costs or geographic inconvenience serious enough to justify removal of the trustee." The factors discussed in that comment that would justify changing the place of administration of a trust "include the nature and location (and particularly changes in the location) of assets under the trustee's management, relocation of beneficiaries or significant changes in their needs and circumstances, and opportunities to obtain more favorable tax or other treatment in another state or country."

Twenty-six jurisdictions have the UTC or UPC language. The Pennsylvania statute omitted that language, for fear that it would cause trustees to have a duty to consider "all conceivable jurisdictions," which theoretically might require knowing laws of the entire world.

b. *Case Law*. Only a handful of cases have addressed the trustee's duty to change situs. Those cases have involved reducing trust administrative costs, such as avoiding state income tax. One speaker described a situation in which a trust company pointed out that state income tax could be avoided if the trust moved to Delaware. A beneficiary inquired why the trustee did not raise this issue 10 years earlier.

d. *Trustee and Attorney Potential Liability*. If a trust has no contacts with the state other than the location of the trustee, and if the trustee fights being removed in order to change the trust situs to save administrative expenses, potential liability could be alleged. With respect to potential attorney liability, problematic situations could arise, such as the failure to advise a trustee-client or beneficiary-client to consider moving the trust situs. There have been no cases on attorney liability yet.

79. How to Move Situs

The situs of the trust can be changed pursuant to provisions in the trust instrument (most modern trusts allow a change of situs), by court action (there may be a court proceeding in both jurisdictions; in the receiving jurisdiction, the action would typically make the desired modification in the same proceeding in which the court acknowledged the change of situs), or pursuant to state law. (The written materials include a 50-state survey that covers Uniform Trust Code states and other states about moving trust situs.)

As an example, the parties could agree to move the trust in a nonjudicial settlement agreement. To be crystal clear that the trust situs has moved, file the nonjudicial settlement agreement with the court and ask the court to bless it. The standard for the court's review is lower than if the court were simply asked to modify the trust in the first place. The parties then have a court decree approving the situs move.

80. Impact of Moving Trust Situs on Validity, Construction and Administration of Trust

a. *Overview*. The Restatement (Second) of Conflict of Laws (in §§268-272, 277-279) addresses governing law regarding a trust's validity, construction and administration based upon whether the trust is testamentary or inter vivos, and based on whether the trust holds real estate or movables (personal property). The Uniform Trust Code applies a uniform approach in §§403 (regarding validity) and 107 (regarding "meaning and

effect”), rather than having separate rules for testamentary and inter vivos trusts or for real and personal property held in a trust.

b. *Validity.* Validity is straight-forward, and includes things such as complying with required formalities for creation of the trust, whether the trust violates the rule against perpetuities, and competency or capacity of the person creating trust.

Under the Restatement, validity of a will is based upon the law of the testator’s domicile. Validity of trust provisions are governed by the law of the state designated in the trust instrument, provided the state has a substantial relation to the trust, unless (i) for testamentary trust, the trust provision violates a strong public policy of the decedent’s domicile, and (ii) for inter vivos trusts, the designated law violates a strong public policy of the state with which the trust has its most significant relationship. If there is no governing law designation in the instrument, the validity of a trust provision is based on (i) for testamentary trusts, the law of the state of the testator’s domicile at death, except that the law of the state where the trust is administered applies if necessary to sustain the validity of the trust unless the trust provision involved violates a strong public policy of the decedent’s domicile, and (ii) for inter vivos trusts, the law of the state to which the trust has its most significant relationship. The validity of a trust for real property is generally determined by the law where the real property is located.

Under the Uniform Trust Code, the validity of an inter vivos trust can be determined under the law (i) where the settlor was domiciled, (ii) where the trustee was domiciled or had a place of business, OR (iii) where any trust property was located. The settlor presumably could designate in the trust instrument any of those states to govern the trust’s validity. The validity of a testamentary trust is ordinarily determined by the law of the decedent’s domicile.

c. *Construction.* Construction issues include things such as when heirs are determined, whether a spouse of the beneficiary is included among the beneficiary’s next of kin, the effect of class gifts, the meaning of *per capita* or *per stirpes* transfers, whether a disposition is vested or contingent, the effect if a beneficiary dies without issue, the effect on spousal election rights, and the rules governing powers of appointment. Construction also involves the effect of adult adoptions, and civil unions or same-sex marriages.

Under the Restatement, the governing provision in the instrument controls, whether the trust is testamentary or inter vivos and whether it is an interest in movables or land. If there is no governing law designation, the governing law regarding construction with respect to movables will be in accordance with the state the settlor likely would have desired to apply, and with respect to land will be based on where the land is located.

Under the Uniform Trust Code, the “meaning and effect” of the trust is governed by the law designated in the trust unless that law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue. If no governing law is designated in the trust, the law of the jurisdiction having the most significant relationship to the matter at issue will govern “meaning and effect” of the trust.

d. *Administration.* Administration includes matters relating to the management of the trust, duties owed by the trustee to beneficiaries, principal-income determinations, powers of the trustee, liability of the trustee, removal of trustees, appointment of successor trustees, trustee compensation, termination or modification of trusts, creditors’ rights, notice requirements, and decanting provisions.

Relatively recent statutes regarding various administration issues (such as a power to adjust or decanting provisions) provide specifically that the provision is a law governing the administration of a trust--so that trusts that move situs to the state can take advantage of that provision. Some question whether it is really appropriate for a state to legislate what is construction vs. administration in an attempt to persuade trusts to move to that state. For example, is a decanting authority really administration or is that a construction issue? The power to adjust provisions could be viewed as raising construction rather than administration issues. Notice provisions could be viewed as more than just administrative matters.

Under the Restatement, there is a distinction for movables and immovables. For movables, administration issues are governed by the law designated in the trust instrument except for matters based on public policy grounds. As to other matters, the state designated to govern administration does not have to have any other relation to the trust. If no governing law is designated for the administration of movables, the law where the trust is administered generally controls for testamentary trusts, and for inter vivos trust the law of the state to which administration is most substantially related controls. For immovables, administration is governed by the law where the land is located.

Under the Uniform Trust Code, the governing law as to "meaning and effect" includes administration, and the UTC provisions described in subparagraph c above regarding construction apply.

e. *Impact of Transfer of Situs—Changes Law as to Matters of Administration.* The law governing the validity and construction of a trust should not change as a result of changing the trust situs. However, the law governing administration of trusts generally is controlled by the law of the new situs.

Under the Restatement (§§271-72), the law governing administration will be the local law of the new jurisdiction if this is in accordance with the intention of the testator, express or implied. For inter vivos trusts, the law of the new jurisdiction governs administration provided the change in the place of administration is authorized by the terms of the trust, either express or implied. The mere authority to appoint a new trustee in a different state can constitute such implied authorization. However, if the trust terms reflect the settlor's intention that the trust is always to be administered under the local law of the original state, the law of administration would not change.

Under the Uniform Trust Code (§107), changing the "principal place of administration" will change the law governing the administration of the trust.

81. Principal Place of Administration

The Uniform Trust Code (§108) and Uniform Probate Code (§7-203) both refer to the "principal place of administration" rather than situs. The "principal place of administration" concept is central to many situs related issues under the UTC and UPC. The comment to §108 of the Uniform Trust Code, which addresses the designation of the principal place of administration) provides that locating a trust's principal place of administration ordinarily determines which court has jurisdiction over a trust. "It may also be important for other matters, such as payment of state income tax or determining the jurisdiction whose laws will govern the trust."

The Uniform Trust Code does not define the "principal place of administration," but the comment to §109 states that a "trust's principal place of administration ordinarily will be the place where the trustee is located.

In the famous U.S. Supreme Court case of *Hanson v. Denckla,* 357 U.S. 235, *reh'g denied* 258 U.S. 858 (1958), a Pennsylvania resident (who later moved to Florida) created a Delaware trust with a Delaware corporate fiduciary. The trust was revocable and the settlor retained the power to control distribution decisions. Investment authority was directed by a trust adviser who was also in Florida. The U.S. Supreme court affirmed the decision of the Delaware Supreme court that the trust was administered in the state of Delaware (not Florida) *where the trustee was located*.

Factors that could be relevant in determining whether a trust is principally administered could include the location of the trust's assets and documents evidencing ownership of property, where trust records are maintained, the location of the trustee's office that is responsible for the administration of the trust, where the trust officers responsible for the administration of the trust are located, where trust officer meetings concerning the trust are held, where trust committee meetings and trust reviews occur, whether trust account administrative transactions occur, where trust accountings and reports are prepared and reviewed, where documents relating to the trust are executed on behalf of the trust, where trust income and contributions are received and where distributions are authorized and disbursed, where tax reports are prepared and reviewed, where tax compliance audits are preformed and reviewed, where the trust instrument is executed by the trustee, and where decisions are made concerning the timing and amounts of discretionary distributions.

If there are trust advisors of directed trusts with a corporate trustee, the advisors are typically individuals who are not regulated in any respect. Therefore, the principal place of administration would appear to be the place where the trustee is located and subject to regulatory authority.

82. Jurisdiction

Various states may have jurisdiction over a trust because of multiple contacts with the trust from various states. The Uniform Trust Code (§108) and Uniform Probate Code (§7-203) both refer to the principal place of business. The comment to §108 of the Uniform Trust Code provides that "[l]ocating a trust's principal place of administration will ordinarily determine which court has primary if not exclusive jurisdiction over the trust."

The Uniform Probate Code also references the *forum non conveniens* concept. The Comment to §7-203 recognizes that while a trust may be subject to the jurisdiction of many states, §7-203 "employs the concept of *forum non conveniens* to center litigation involving the trustee and beneficiaries at the principal place of administration of the trust…." The Comment to §108 of the Uniform Trust Code also adds that the principal place of administration "may also be considered by a court in another jurisdiction in determining whether it has jurisdiction, and if so, whether it is a convenient forum." The issue of convenience of the beneficiaries often comes up in the cases that have addressed jurisdiction issues.

An example of a case that addressed which state should have jurisdiction is *Perry v. Agnew*, 903 So.2d 376 (Fla. Dist. Ct. App. 2005). In that case, the instrument stated that Florida law applied, and a beneficiary sought to remove the trustee, who was an individual residing in Massachusetts. The trust had a jurisdictional situs in both Florida and Massachusetts, and the court ultimately determined that because the principal place of administration was in Massachusetts, the trial court should determine whether all interested parties could be bound by litigation in Massachusetts.

The importance of the trustee's place of administration in determining jurisdiction matters is illustrated by an actual matter handled by one of the speaker's law firms. In that case, a trust owned a residence (the deceased settlor's former home) in California, the settlor died as a resident of California, the trust agreement provided that California had jurisdiction, and there were California beneficiaries. However, the trustee was in Pennsylvania. The beneficiaries filed a petition in California asking the court to direct the sale of the residence, to surcharge the trustee, and to terminate the trust. The trustee responded that the California court did not have jurisdiction because the trustee resided in Pennsylvania and the trust administration was located in Pennsylvania. The California court agreed and dismissed the petition. The beneficiaries were then forced to litigate the matter in Pennsylvania.

A planning tip to help maintain court jurisdiction in a particular state is to have some court proceeding in that state (perhaps even a very minor innocuous proceeding). If there are later arguments that the court of another state should exercise jurisdiction, one of the possible arguments would be that the prior state has already exercised jurisdiction over the trust and should continue as the court to manage the administration of the trust.

Item 83 is a compilation of various interesting quotations, words of wisdom, and comments from the various seminars.

83. Interesting Quotations and Golden Gems of Wisdom

a. *You're All Right.* "On most issues, I had 6 opinions from four panelists. Danny [Markstein] and Lou [Mezzullo] had several opinions each." –Dennis Belcher

b. *Fundamental Principles.* Lou Mezzullo's three fundamental principles of estate planning: (1) One size does not fit all; (2) Respect the "KISS" principle; and (3) Do not let the tax tail wag the dog.

c. *35% vs. 55%.* "A 35% estate tax rate is very different than a 55% rate. Many of us are still thinking in the 55% tax rate mode. We don't know what next year's law will bring, but I worry more about making a transfer that the client will later regret than keeping the stock and later having to pay estate tax on that stock." –Dennis Belcher

d. *Too Smart Too Soon.* "I think you can be too smart too soon. Be much less concerned about the transfer tax consequences of the entrepreneur's success than that they succeed. You take great risk if you put the stock in the hands of someone unskilled in the business. That may be a great transfer tax plan, but it is not a good business plan." --Danny Markstein

e. *Bifurcation.* In discussing a regulation that requires bifurcating a certain transaction for tax purposes, Danny Markstein notes that "Generally bifurcation is illegal in Alabama."

f. *Importance of Control.* "Ownership equals leadership." –Dennis Belcher

g. *Fairness.* "Fair is not always equal, and equal is not always fair." –Dennis Belcher

h. *What Comes Around… .* "How a client has been treated often impacts how the client treats his or her children." –Dennis Belcher

i. *Family Employment.* "Any Cargill family member who wants a job in company can have it, but the job is consistent with the individual's ability." --Danny Markstein

j. *Bloodsuckers and Parasites*. The conflicts that arise between those family members who are involved and those who are not involved in the business have been characterized by the concept of "bloodsuckers and parasites." "Outsiders think of the employee-family members as bloodsuckers drawing off all of the business income as compensation in ridiculous salaries, and the insiders view the outside family members as parasites who get the windfall of large appreciation as a result of the blood, sweat and tears of the insiders." –Jon Gallo

k. *Timing*. "You don't run trick plays when you are deep in your own territory." –Ron Aucutt

l. *Spouses' Contributions*. Ron Aucutt relates that his wife is not involved in his law practice, but she makes a profound contribution.

m. *Values Matter the Most*. "In preparing the next generation for leadership, (i) confidence, education, and training matter, (ii) work ethic matters more, but (iii) values matter the most. Values are discussed, infused, and perpetuated by families being able to get together and talk …" – Dr. Marion Hampton

n. *Talking and Walking*. "The family that doesn't talk together will not walk together." –Ron Aucutt

o. *Whose Problem?* "Do not allow your client's problem to become your problem." –Dennis Belcher

p. *Staking Out Your Turf*. Shakey's Pizza stores used to have a sign on the wall saying "Shakey's made a deal with the bank…Shakey's won't cash checks, and the bank won't make pizza." –John Rogers

q. *An Optimist*. "There are two kinds of lawyers. Those who have been sued for malpractice and those who will be sued for malpractice some day." –John Rogers

r. *God's Waiting Room*. Florida is God's Waiting Room—where many are adjusting to room temperature. –Dana Fitzsimons

s. *Tradition*. Despair.com calendar has picture of the running of the bulls with the caption: "Just because you've always done it that way doesn't mean it's not incredibly stupid." –Dennis Belcher

t. *Retirement*. Despair.com calendar has a picture of a nub of a pencil with the caption: "Because you've given so much of yourself to the company that you don't have anything left we can use." –Dennis Belcher

u. *Procrastination*. A Despair.com calendar has the caption: "Hard work pays off after time, but laziness always pays off now." –Dennis Belcher

v. *Transparency*. "Transparency goes a long way in maintaining a good relationship between a lawyer and multiple clients and non-clients (as we have to tell people they are not our client). The concept of the family lawyer can be embraced carefully but if people just work on the assumption of a family counselor without guidance from the attorney, we are apt to have a misunderstanding down the road." –Chris Gadsden

w. *Ethics and Shaving Square Pegs*. From an ethical standpoint (as well as for other reasons) a good deal of what we end up facing is how to make a square peg fit into the round hole. By shaving the square peg a little bit we may be able to achieve that, but we may not end up with the perfect product. –John Rogers

x. *Selling May be Best*. Stacy Eastland points out that "selling your business does not mean you have been a failure. Many times that's the right answer." The senior generation often has the primary contacts with customers and vendors – not G2. There may be a good likelihood the business will be run into the ground if it is not sold when the founder is still around to structure the sale and facilitate the transition of the business to the new owner. –Stacy Eastland

y. *Who Will Feed the Elephant*? A client told Dennis Belcher: "Everyone likes to have an elephant that he can pull out and ride around on occasion. But I've got to feed the elephant." -Dennis Belcher

z. *Listening*. Seek first to understand—then to be understood. –Steve Covey, Seven Habits of Highly Successful People.

aa. *Listening and Anatomy*. "We lawyers need more reminders, perhaps the most, that each of us has two ears and only one mouth, and the mouth comes with the ability to close it." –Ron Aucutt

bb. *My Brother's Keeper*. "Are we their legal advisor or are we their keeper? Try to stay in the role of legal advisor, not keeper." –Dennis Belcher

cc. *Communicate From the Outset*. "If you wait to communicate until the documents are signed, you are doomed to fail." –Anita Siegel.

dd. *The Lawyer's Keenest Eye*. "The client has died, and you now look at the document with the keenest eye possible. You immediately spot a typographical error, and you hope it is not significant. There is no lawyer with a keener eye than a lawyer looking at a document he drafted for a client who just died." –Dennis Belcher

ee. *Two Straws, One Soda*. In a case involving beneficiaries fighting over a trust, a state supreme court judge told the story that when he was growing up he would go to the drugstore and pay five cents for soda. There were two brothers who would go to the store with only a nickel between them. They would get two straws and one soda, and they would see who could gulp the most. The judge said the beneficiaries of the estate were just like those two brothers – they were just seeing who could suck the most from the estate. –Dennis Belcher

ff. *Pessimistic Lawyers*. "The worst thing about being a lawyer is that you always have to think of the worst things that may happen, because many times the worst things do happen and we need it point it out to our clients." –Dennis Belcher

gg. *Small Town Excitement*. In the small town of this case study, "the town excitement on Saturday night was to go watch the Safeway truck unload." –Ron Aucutt

hh. *Triggering Events*. "Why do clients call attorneys saying they are going on vacation in two weeks and need a will? It is not because people die on vacations, but the vacation is a triggering event." –Dennis Belcher

ii. *Satisfying Work*. Despite all of the problems and complexities that have been discussed, estate planning and estate planning for business owners is very satisfying work. Dennis Belcher tells his litigator partner "there'll be a lot more people at my funeral than yours." (The partner responded, "Yes, they just want to make sure you're dead.)"

jj. *Five Year Rule*. Always look at where a particular decision will leave the family five years in the future. Don't just look at whether an action solves an immediate problem. –Dennis Belcher

kk. *Real Engagement*. "Being formally engaged is one thing, but getting engaged in the issues that matter to the family is something entirely different." Ron Aucutt

ll. *The Columbo Approach*. "The attorney should certainly ask appropriate questions and not expect the family to develop all solutions on their own, but should ask questions and listen carefully and meaningfully. We do not have to appear bumbling as if we know nothing. But we can learn from Lieutenant Columbo's humility and questioning. 'I may have this wrong but….' Indeed, the book *Trusted Advisor* has an entire chapter on Lieutenant Columbo." –Ron Aucutt

mm. "*Heir-Conditioning*." Issues to discuss with the family include the business, the home, the second home, etc. In some appropriate way, discussions should be had with the next generation that prepare them to receive the family wealth. "Call it, if you will, a kind of 'heir-conditioning.'" –Ron Aucutt

nn. *Know Your Role; Pilot/Owner Analogy*. "Owning the plane does not make someone fit to fly the plane. Similarly, the pilot who does fly the plane does not have the right to choose the destination. The owner chooses the destination, and the pilot flies the plane. These kinds of distinctions are extremely important." –Ron Aucutt

oo. *That's All We Can Do*. "To be realistic, if all of this works perfectly, it will not obliterate greed, suspicion and self-absorption. It will not guarantee that there is no dissension. But all the attorney can do is to create a climate in which the dignity and value of each family member is affirmed, and a venue is provided for offering views, bearing concerns and even disagreements and then minimizing conflicts, or if necessary resolving conflicts. If all else fails, the attorney will know the attorney has done all that he or she can." –Ron Aucutt

pp. *Edges*. "Life is nothing except about edges--who has an edge on whom? … When a client has an edge on you, that is the time to get out." –Dennis Belcher

qq. *When the Going Gets Tough, Step Up*. "There's always risk, but are we so risk averse that we cannot do what Ron challenge us to do? We oughta' step up. We should make sure our actions are appropriate…. It is not impossible to make sound decisions. Fleeing risk at a critical time in the life of a business or family is not what we should be about." –Danny Markstein

rr. *Getting Intertwined in Ugly Family Imbroglios (the comment refers to a fact scenario in which the attorney drafted documents naming himself as co-executor and co-trustee and the attorney could predict that he would be confronted with difficult contentious business decisions and distribution decisions)*. "The attorney will often take a viewpoint that 'I can do some good.' That is true, but it is not the attorney's money, and the attorney did not create the family mess. This is a difficult decision, but the attorney must be aware he is at a tipping point. This is an awkward situation, because the attorney is a trusted advisor to the family, the attorney becomes embedded with them, and the attorney thinks he can solve their problems.

At the end of the day: "it's only money, and it's somebody else's." The attorney should not approach this with the mindset that he is the savior that can solve this family's problems." –Dennis Belcher