BESSEMER TRUST

ACTEC 2018 Summer Meeting Musings (Including "Life Cycle of a Business Entity")

June 2018

The American College of Trust and Estate Counsel is a national organization of approximately 2,500 lawyers elected to membership. One of its central purposes is to study and improve trust, estate and tax laws, procedures and professional responsibility. Learn more about ACTEC and access the roster of ACTEC Fellows at www.actec.org.

This summary reflects the individual observations of Steve Akers from the seminars at the 2018 Summer Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Important Information Regarding This Summary
This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Introduction

Some of my observations from the 2018 ACTEC Summer Meeting Seminars in Chicago, Illinois on June 20-23, 2018 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 presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-34 come from the "Stand Alone" program titled "The Life Cycle of a Business Entity." Items 35-43 come from a seminar titled "Are The Kids Alright? Modern and Practical Challenges of Minors in Estates and Trusts."

Items 1-34 are observations from seminars about "The Life Cycle of a Business Entity."

Items 1-3 are observations from a panel by Steve B. Gorin, Hollis F. Russell, and T. James Lee–Session 1: Getting Started; Choice of Entity; Formation of Entity

1. Ron Aucutt Trachtman Lecture (2011)

One of the panelists strongly recommends Ron Aucutt's Trachtman lecture from 2011, *Creed or Code: The Calling of the Counselor in Advising Families*, available in the ACTEC Law Journal (Spring 2011), as an approach to representing business owner families. He said that he sometimes even gives that to prospective family business owner clients and tells him that the article describes his own personal values-based approach to representing business owner families.

2. Choice of Entity

a. **General Factors**.

Types of Entities. The types of entities are sole proprietorships, general partnerships, limited partnerships, LLCs, S corporations, and C corporations. The first five of those are taxed at the individual owner's level. The C corporation is a separate taxable entity.

Another newer type of entity recognized in some states is the Series LLC, which is a single LLC but with different divisions (or "series") for specific activities; the rights of the owners of each separate series is accounted for by the books and records of the entity. One panelist generally avoids series LLCs because businesses often do not keep excellent records.

Tax Reporting. An advantage of C corporations is that reporting income by the shareholders is easier, with no complicated Schedule K-1 to report all of the flow-through income from the entity. Some venture investors prefer C corporations for this reason, among others.

Fringe Benefits. C corporations also may provide somewhat better fringe benefits in various respects.

Current Income Tax Cost. Under the 2017 Tax Act, C corporations have a maximum rate of 21%, and for corporations that do not distribute a substantial part of their earnings, the current income tax cost may be lower than pass-through entities (as discussed below).

Income that is distributed from the C corporation is generally taxed as a dividend, resulting in double taxation, once at the corporate level, and again at the individual shareholder level. The only way to avoid the eventual second level of tax is if the stock (1) qualifies for the gain exclusion under § 1202 as qualified small business stock, or (2) is sold after the shareholder's death when the basis of the stock is adjusted to its fair market value at the date of death.

Limited Liability. Shareholders of a C or S corporation, members of an LLC, and limited partners of a limited partnership have limited liability (creditors of a limited partner or member of an LLC are generally limited to obtaining a "charging order" against the owner's interest, rather than acquiring the interest directly (though in some states, the creditor will have a foreclosure remedy). The partners of a general partnership or the general partner of a limited partnership typically have joint and several lability for all of the debts of the entity (unless the partner is in a corporate or LLC "wrapper," in which event the liability is limited to the assets of that corporation or LLC (assuming it is adequately capitalized, see Item 4.d below).

Self-Employment Tax. The FICA tax is 7.65% for the employee and 7.65% for the employer, for a total of 15.3%. Taxpayers who do not receive wages but are paid through a partnership pay a self-employment tax of 15.3%. That tax can be reduced to 2.9% for income between $128,000 and $250,000, and to 3.8% for income above $250,000. Shareholders of S corporations and limited partners of limited partnerships do not pay self-employment tax.

Preferred Approach for New Businesses. One panelist's preference is to start a new business as an LLC (for its simplicity), with an operating agreement that may have transfer restrictions on transferring a member's interest or that may include a "Russian roulette/shotgun provision" (allowing an owner to offer his interest to other owners, but allowing the owner to purchase the other owners' interests if they choose not to purchase his interest). When the income grows to the point that the self-employment tax is burdensome, the business can be converted to a limited partnership (with an LLC or S corporation as the 1% general partner). A typical structure at that point would have the owners owing 99% of the interest in the limited partnership as limited partners and owning a corporation that is the 1% general partner (for limited liability purposes). The limited partnership, in turn would be the sole owner of separate LLCs for each separate business activity of the partnership.

b. **Comparison of C Corporations and Pass-Through Entities under 2017 Tax Act.** The maximum income tax rate for C corporations was reduced to 21% under the 2017 Tax Act. The current income taxation for shareholders of C corporations, assuming the shareholder is in the top bracket and lives in a state with a 5% state income tax, is summarized as follows. Assume the corporation has income of $100,000. The corporate tax is 26% (21% federal rate and 5% state rate), or $26,000, leaving $74,000 after tax income for the corporation.

If the corporation distributes all of the $74,000, the shareholder pays a 28.8% rate (20% federal tax rate + 3.8% net investment income tax rate + 5% state income tax rate) on the dividend, or $21,312, leaving $52,688. Therefore, the overall current income tax rate is about 47%. For a shareholder in lower personal income tax brackets, the shareholder might receive a net of $59,200, resulting in an overall current income tax rate of about 41%.

On the other hand, if the corporation will accumulate all of its income, the corporation will merely pay the 26% rate currently, thus resulting a lower income tax cost than if the income were earned in a pass-through entity. (Professional firms tend to distribute all of their profits, however, and excess accumulations beyond the reasonable business needs may be subject to the 20% accumulated earnings tax.)

Income from a pass-through entity may be entitled to a deduction under § 199A of 20% of the qualified business income from the entity, which translates to an effective 29.6% federal rate ([1 - .20] x 37%, = 29.6%). In addition, the owner would be subject to a state rate (say 5%) and may be subject to the self-employment tax and the 3.8% tax on net investment income, which could result in a current aggregate tax cost up to about 46%.

c. **Section 199A Deduction for Qualified Business Income**. The 20% deduction for qualified business income under § 199A is subject to a variety of complicated limitations, summarized briefly at Item 2.f.(2) of the Heckerling Musings 2018 and Estate Planning Current Developments Summary found **here** and available at **www.bessemer.com/advisor**.

3. Model LLC Operating Agreement

An outstanding annotated model LLC operating agreement is available on the ACTEC website for the Business Planning Committee.

Items 4-11 are observations from a panel by Lora G. Davis, Kevin Matz, and M. Allicon Taylor–Session 2: Governance, Operation and Management of an Entity. The summary below of best practices is summarized, often verbatim, from excellent materials by M. Allison Taylor (with her permission).

4. Importance of Best Practices

a. **Improves Quality of Business Decisions and Operations.** Documentation resulting from best practices can serve as a basis for communications and as a record for future reference. Formality and structure adds process and emphasis to decisions, thereby increasing focus and consistency.

b. **Increases Appeal and Value of Business**. Prospective purchasers or investors are naturally more interested in well-run businesses. A business that has utilized best practices will face less pitfalls to kill a deal.

c. **Risk Management**. Following best practices measures improves the position of the organization in the face of a variety of threats such as shareholder actions, employee matters, and creditor or other debt-related actions. The business can better respond to external audits (e.g., by tax authorities, labor and employment agencies, and other applicable regulatory authorities). Following best practices can facilitate obtaining insurance coverage, help set the proper tone for the organization thereby reducing the risk of serious operational issues, and can enhance communication and transparency and decrease distraction and misinformation.

d. **Preserves Limited Liability Protection**. The legal requirements for "piercing the corporate veil" to result in the owners having personal liability with respect to claims against the business varies by jurisdiction, but depends on either establishing fraud or on the application of a variety of other factors reflecting that the owners were operating the corporation solely for their personal benefit, such as: Undercapitalization; Failure to comply with corporate formalities and keep records (e.g., failure to maintain minutes, adequate corporate records, confusing records of related entities); Non-payment of dividends while paying sums to the controlling owner(s); Insolvency; Commingling of funds and other assets between the dominant owner(s) and the entity (e.g., lack of separate bank accounts, unauthorized diversion of entity funds to other uses such as paying owners' personal expenses); Lack of participation of other officers or directors; or Use of the corporation as a shell or façade for the business of the dominant owner(s) or other entity (e.g., identical equitable ownership in related entities, use of one business to procure assets or services for another business or personal activities).

5. Maintenance of Books and Records

a. **Governance Documents.** Current governance documents should be kept in the official "minute book" for the organization. Copies of previous governance documents should be archived indefinitely.

b. **Ownership.** A register or log of ownership should be maintained on a current basis and should reflect prior transactions impacting ownership. For a business with certificated ownership, copies of all certificates (both outstanding and cancelled) should be on file with the organization while the original issued and outstanding certificates should be held by the owners.

c. **Meeting Minutes and Actions Taken on Behalf of Entity**. Copies of all meeting minutes and formal actions taken by owners, directors, officers, managers, committees, etc. should be maintained in chronological order in the official "minute book" for the organization. See Item 7 below.

d. **Delegations**. Copies of all formal delegations, and revocations thereof, should be on file with the organization.

6. Tax Compliance

a. **Tax Identification Number.** Each entity should have its own tax ID number, which should be accurately associated with all bank accounts, credit arrangements, etc. that relate to the entity. Disregarded entities such as single-member LLCs and sole proprietorships may need to obtain tax identification numbers in certain circumstances such as for employment taxes and excise taxes.

b. **Entity Tax Returns and Reporting Obligations**. The organization should establish clear authority and responsibility for the preparation, execution and filing of all tax returns as well as compliance with all other applicable reporting obligations.

c. **New Partnership Audit Rules.** Any entity taxed as a partnership for federal income tax purposes should review its governance documents, policies and procedures in light of the Bipartisan Budget Act of 2015, as amended by the Tax Technical Corrections Act of 2018, which effectively repealed the prior audit procedures applicable to such entities and replaced them with new procedures beginning with tax year 2018. *See* I.R.C. §§ 6221-6255. (For a discussion of the new partnership audit rules, see Item 12 of the Heckerling Musings 2018 and Estate Planning Current Developments Summary found **here** and available at **www.bessemer.com/advisor**.

7. Documenting Actions and Distributions

a. **Influence of Governance Documents**. An entity's governance documents should set forth the requisite approval for actions to be taken on behalf of the entity, as well as any timing, notice and quorum requirements. The organization should consistently follow the requirements and processes set forth in its governance documents.

b. **Significant Decisions/Actions**. Significant actions that should be properly documented include:

- Election of directors, managers, officers, etc.;
- Declaration of dividends or other distributions;
- Adoption of benefit plans;
- Acquisitions and dispositions of significant assets;
- Credit facilities obtained by the organization;
- Recapitalizations, redemptions, and issuance of additional ownership interests;
- Executive compensation including equity incentive plans; and
- Amendments to governance documents.

c. **How and What to Document**. Both minutes of meetings and other forms of taking action such as written consents should be properly documented and maintained in the organization's records. Be mindful of the appropriate level of detail. Minutes should not be a word-for-word transcript of the events of the meeting. Minutes should generally reflect that matters were discussed and questions raised and resolved, but comments or questions should not be attributed to specific individuals. Minutes should state only facts, not draw conclusions or state the opinions of the author.

Reference documents may either simply be referred to in the minutes and described as having been distributed to the participants previously or may be attached as exhibits if the documents are intended to be incorporated into and become a part of the minutes, depending on the particular circumstances.

Never include legal advice. The minutes may identify the counsel giving the advice, who he or she represents (e.g., the company, the board or the independent directors) and that privileged information was discussed, but should **not** reflect the legal advice given in order to preserve the attorney-client privilege as to the advice. Depending on the subject matter being discussed, the meeting secretary should consider taking separate minutes of the matters covered by attorney-client privilege and keeping that portion of minutes, marked as a privileged document, separate from the minute book. The primary minutes would reflect that privileged information was discussed and is maintained separately.

Votes should be recorded. If a vote is not unanimous, the vote can be reflected as having been approved, without any qualification, or the dissent or abstention, as applicable, can be noted. It is not necessary to identify who dissented or abstained and the reason for their doing so unless such party so requests.

d. **Document Conflicts of Interest**. If a participant has a conflict of interest regarding a matter to be discussed at the meeting, the minutes should reflect any special actions taken by the group or the participant in light of the conflict. Minutes are not required to describe the nature of the conflict of interest, but depending on the specific circumstances, the meeting secretary should consider whether it should be disclosed. Applicable state law and the specific transaction or other matters to be approved are key factors in determining how to handle the conflict and whether the interested party should leave the room and abstain from voting.

e. **Describe Other Business Considered**. Include any impromptu matters discussed at the meeting as well as items listed on the meeting agenda.

f. **Necessity of Resolutions**. Not all actions require resolutions. For example, resolutions are not necessary to approve business reports, updates or committee reports that do not involve taking any additional action. However, resolutions are required to appoint directors and officers and may be necessary or desirable in other circumstances such as to establish or delegate authority and responsibilities, to evidence that corporate action was authorized or taken, or if required by state corporate law or the organization's governance documents.

8. Checks and Balances

a. **Governance**. Governance documents should include high level checks and balances such as the relationship between shareholders, directors and officers. Additional checks and balances may be created via committees with a designated area of focus such as finance or executive compensation.

b. **Operational**. Checks and balances should be carried throughout the operations of the business as appropriate.

c. **Authority**. The organization should be mindful of actual versus apparent authority and create an appropriate structure with checks and balances to manage each type of authority.

An agent's apparent authority ends when it is no longer reasonable for a third party to believe that the agent has actual authority from the principal. Terminating actual authority may not be enough, by itself, to end apparent authority held by an agent. The doctrine of "lingering authority" recognizes that third parties may reasonably assume that an agent has ongoing authority until the third party has express notice (from the agent or principal) that the agent no longer has authority or a change of circumstances makes unreasonable the assumption that the agent still has authority.

9. Consistency With Actual Practices

Alignment between governance documents, policies, procedures and actual practices is critical. **It is better to not have them than to have them and not follow them.**

10. Annual Maintenance

a. **Benefits of Annual Maintenance.** Planners should emphasize to their business owner clients the critical importance of annual maintenance. Attorneys should attend the annual meeting if possible. Issues frequently arise for which legal advice can be important. Benefits of consistent annual maintenance include:

- Brings focus to the organization, which is likely to decrease distractions and increase productivity;
- Creates an internal audit system to highlight matters to be addressed and establishes a prioritization system;
- Positions the business to better respond to unforeseen events such as the death of an owner or a person key to management;
- Aids the transition of the business to new ownership and/or management; and
- Assists in preparing for a sale of the business should that opportunity arise.

b. **Annual Maintenance Checklist**. Items that should be addressed at least annually include:

- Governance: Minutes/consent/delegations; Appointment of officers/directors/managers/other authorized representatives, committees, and registered agents;
- Ownership: Records of ownership; Loans/contributions documentation; Buy-sell documents (including the agreement, valuation updates, life insurance maintenance);
- Finance: Bank and investment accounts (signature/access authority);
- Insurance: Policy evaluations (types and term of coverage); Notifications and renewals;
- Primary operations contracts: Leases (real/equipment); Software licenses; Required supply chain contracts; Major customer contracts; Marketing/sales contracts; and
- Other: Employee handbooks, job descriptions and contracts; Non-compete agreements; Intellectual property filings and deadlines; Regulatory filings, deadlines, and internal compliance audits; Information technology review for major operating systems (administrator, access, disaster recovery).

11. Succession Plan; Shareholder Agreements

The business succession plan, particular for family situations involving active and passive owners, should be communicated during the founder's life. "Children can deal with disappointment, but they have difficult dealing with surprise." They will question whether the parent actually understood and intended what the document may legally reflect. Communication during life can make that intent, and the reasons for the plan, clear to all.

The foundation document for business succession planning is the shareholder agreement/buy-sell agreement (which can be in the organizational documents or in a separate agreement). The buy-sell agreement can address various triggers requiring an ownership change, such as death, divorce, disability (which must be carefully defined), retirement, withdrawal or termination of employment (with or without cause), bankruptcy, or a voluntary transfer. The manner of purchase for each trigger can also be addressed–whether mandatory, optional, or with a mere right of first refusal. The agreement may also provide the method for funding purchases.

Transfer restrictions are almost always included to limit who might become future owners (at least allowing a right of first refusal for existing owners). Transfers may be allowed to "permitted transferees" (e.g., family members or trusts for their benefit), with the transferee becoming a full-fledged partner or member of a partnership or LLC. The agreement might also determine the selling price of an interest in the entity and how the purchase price will be funded (e.g., cash or a note, with specified terms of any such notes).

Super-majority vote requirements may be included for certain major decisions, such as certain financing decisions and loan guarantees, the sale of substantially all of the assets, or the decision to liquidate in whole or in part.

To deal with the possibility of minority members effectively having a veto power over sales, or being left out of enjoying the benefits of sales by majority owners, the agreement may provide for "drag along rights" (requiring minority owners to join in sales by majority owners if so requested by majority owners) or "tag along rights" (allowing minority owners to join a sale by majority owners on the same terms).

The price that is set in a buy-sell agreement will not automatically be respected as the date of death value for estate tax purposes. Court have established that the following requirements for the agreement price to be binding for estate tax purposes (which may be remembered with the acronym POLE):

Price-the agreement must set a determinable price;

Obligated-the estate must be obligated to sell at that price if so requested to sell by the entity or other owners;

Lifetime-lifetime transfers are prohibited at a higher price than the agreement price; and

Esoteric-the arrangement is a bona fide business arrangement and not a device to transfer the ownership interest to natural objects of the decedent's bounty at less than fair consideration.

The "Esoteric" requirement has been codified in § 2703(b), which provides an exception to the general rule of § 2703(a) disregarding agreements permitting someone to purchase an interest for less than fair value or restricting the sale or use of an assets, if the arrangement is (i) a bona fide business arrangement, (ii) not a device to transfer to "natural objects of the transferor's bounty" (in the regulations) for less than full and adequate consideration, and (iii) comparable to similar arrangements entered into by persons in an arm's length transaction. Cases have been pretty restrictive in applying these requirements, as illustrated in the *Holman* (130 T.C. 170), *Fisher* (106 AFTR 2d 2010-6144), and *Smith* (94 AFTR 2d 2004-5283) cases.

Items 12-14 are observations from a panel by Nancy Schmidt Roush, Kurt A. Sommer, Andrea C. Chomakos, and Joshua E. Husbands–Session 3: Special Topics in Family Businesses, Part One

12. Related Entities

a. **Typical Structure**. Specific types of assets are often held in separate related entities for many businesses (not just family businesses). For example, a typical structure may have an operating entity that would own operating cash, inventory, and accounts receivable and that would hire employees. Separate entities, which could each be owned by different persons than the operating entity, would own particular assets to be leased to the operating entity, such as a Real Estate LLC, an Equipment LLC, and an I.P. LLC (which would own intellectual property, logos, trademarks, tradenames, patents, etc.). The LLCs would each lease their respective property interests to the operating entity under lease/licensing agreements with reasonable terms. The rental agreements will clarify which entity is responsible for maintenance, taxes, insurance, and replacement.

   One advantage of separating assets into separate entities is the asset protection of the real estate, equipment and intellectual property from labilities of the other related entities or of the operating company.

   For pass-through entities, questions will exist as to whether the income from each entity constitutes "qualified business income" to qualify for the 20% deduction under § 199A. The lease agreements may need to require the landlord to perform active service on the real estate or other assets in order for the LLC to qualify as a trade or business (for example, a triple net lease may not be advisable for leasing real estate used by the operating entity).

Each separate entity would have separate bank accounts, operating agreements, and separate tax reporting by each. Guarantees might be required. Insurance costs may increase as compared to insuring all of the assets under a single unified policy.

Establishing the separate related entities when the business is being formed is preferable. Splitting an entity into separate components can be practically difficult to implement (for example, shifting cash and providing for payments of expenses out of multiple separate bank accounts, addressing creditor issues if assets have been pledged as collateral, addressing potential fraudulent transfer issues with existing or potential creditors, etc.) and can have adverse tax consequences (although the segregation of assets may be simpler if the initial entity is organized as a limited lability company taxed as a partnership).

b. **Advantages for Family Businesses.** A special advantage of using separate related entities in family businesses is that the separate entities can be owned by different family members. A classic problem for family businesses is how to equalize family wealth among those family members who are active in the operating business and those who are not. For example, the operating entity could be owned by family members who are active in the businesses, and the related asset LLCs could be owned by other family members, as a way of equalizing the family wealth and providing cash flow to family members who are not active in the business. A key to that type of planning is structuring fair rental and licensing agreements to avoid family disputes, and structuring fair distribution provisions from the related entities that own the real estate, intellectual property, and equipment.

13. Corporate Opportunities

a. **General Duties Regarding Corporate Opportunities**. The corporate opportunity doctrine provides that an officer, director, or perhaps a controlling shareholder cannot take advantage of a business opportunity that belongs to the corporation, unless the corporation decides not to take advantage of the opportunity. The doctrine also applies to LLCs or partnerships to the extent the members or partners owe fiduciary duties.

b. **New Business Opportunity**. The corporate opportunities doctrine can come into play in family estate planning situations. For example, when a parent becomes aware of a new business opportunity, the parent might tell the children about the idea and allow them to organize a separate business to take advantage of that opportunity. Is that a gift? It is if the existing business had a legal right to that opportunity and the parent who owned the existing business chose not to pursue the opportunity in order to transfer value to the children. Alternatively, the parent might have individually owned rights to that opportunity and made a gift by transferring the opportunity to children.

c. ***Bross* and *Adell* Cases**. *Bross Trucking Inc. v. Commissioner* (T.C. Memo. 2014-7) and *Adell v. Commissioner* (T.C. Memo. 2014-155) both involved gift issues in these contexts. Both cases concluded that no gifts were made when children created companies that grew in value with respect to some opportunity similar to an existing family entity's business. Both cases depended in part on the family members not having non-compete agreements with the existing business so any goodwill attributable to the new line did not belong to the existing business. A summary and analysis of the *Bross Trucking* and *Adell* cases is found **here** and is available at **www.bessemer.com/advisor**.

d. **Non-Compete Agreements**. When setting up a new business should non-compete agreements be in place for family members? If they do not exist, specific family members may be able to compete with the business and grow their own business to the detriment of other family members. That can be good or bad.

The absence of non-compete agreements may lessen the value of the existing business. (*Adell v. Commissioner* acknowledged that fact.) It may also facilitate allowing younger family members to take advantage of new opportunities. If restrictions exist but the existing business does not enforce them, that failure to enforce might constitute a gift by owners of the existing business. Therefore, the absence of non-compete agreements may facilitate future direct or indirect transfers of value to younger generations, but it may also allow some family members to take advantage of others or may reduce the value of the main family business.

14. Trusts as S Corporation Shareholders

a. **Eligible Trust S Corporation Shareholders**. The only trusts that are eligible S corporation shareholders are (i) grantor trusts if the deemed owner is a U.S. citizen or resident, (ii) testamentary trusts for two years after the date of death, (iii) a revocable trust that become irrevocable only upon the settlor's death, for up to two years following the date of death, (iv) a qualified subchapter S trust ("QSST"), and (v) an electing small business trust ("ESBT").

b. **QSSTs and ESBTs**. A QSST can only have one beneficiary who must actually receive all of the trust accounting income each year, and the income interest must terminate at the beneficiary's death. An ESBT is much more flexible–it can have multiple mandatory or discretionary beneficiaries (as long as each is an eligible shareholder, with one exception allowed by the 2017 Tax Act), and all income does not have to be distributed each year. Accordingly, an ESBT can accumulate substantial assets over time.

Because of the added flexibility, ESBTs are typically preferred over QSSTs, unless (i) the trust is a QTIP trust that satisfies all of the requirements for a QSST in any event as long as the spouse is alive, or (ii) unless the beneficiary is in a lower tax bracket. (The portion of the ESBT represented by the S corporation stock is taxed entirely at the highest marginal income tax rate.)

Items 15-22 are observations from a panel by Brian C. Sparks, Carrie E. Byrnes (Michael Best & Friedrich LLP), Thomas W. Abendroth, and Michael D. Whitty–Session 4: Special Topics in Family Businesses, Part Two

15. Structuring Compensation and Fringe Benefits

a. **Health Insurance**. Family business owners often want to include family members who are not employees or may want to continue coverage for ex-employees under the company health insurance plan. Review the terms of the policy closely because typically only full-time employees may be covered under the company health insurance plan. If a catastrophic claim occurs, the insurance company may take the position that the patient is not a full-time employee and therefore is not covered under the policy.

Health insurance policies also typically allow coverage for the employee's dependents, and the definition of dependents was expanded in the Affordable Care Act.

Discriminating provisions are typically not allowed to provide better benefits for family members than for other employees.

When employees leave employment (other than for gross misconduct), COBRA or state law may require that employees be allowed to make payments to continue coverage under the health plan. The business should have practices in place so that an employee is automatically notified whenever an opportunity to continue COBRA coverage occurs.

b. **401(k) Plans**. The company cannot simply buy a "canned" 401k Plan and forget it. Significant attention must be devoted to the administration and investment of the 401(k) Plan assets. The Department of Labor indicates that the best practice is to have a committee that meets quarterly regarding investment decisions. Outside providers may be used to provide appropriate oversight.

   ERISA plans involve significant fiduciary responsibility. The company will typically want to secure a fidelity bond with respect to the company's responsibilities under the plan.

c. **ERISA Documents**. If someone requests documents relevant to an ERISA plan, the employer must respond within 30 days or a $110 per day penalty may be incurred.

d. **Claims for Benefits**. If a claim for benefits is filed under an ERISA plan, the claimant is entitled to a written response within a certain period of time. Treat claims for benefits very seriously.

e. **Cafeteria Plans**. Cafeteria plan documentation cannot be adopted retroactively.

f. **Controlled Groups**. If family members own interests in various businesses, they may all be part of the same controlled group for ERISA purposes. If so, benefits under the various plans must be coordinated, and the planner must ensure that no discrimination in benefits exists among the various businesses that are part of the same controlled group.

g. **Government Filings**. The Plan Administrator must file Form 5500 for qualified retirement plans and health and welfare plans covering more than 100 participants. The Form is typically prepared by the plan's third-party administrator. Information regarding the number of participants, financial information about assets in the plan, and service providers must be included on the Form. For certain types of plans, the Form must also include an actuarial report and an audited financial report on the plan assets (e.g., if 100 or more participants are covered).

h. **Tax Treatment of Fringe Benefits and Perks**. Be thoughtful about whether fringe benefits and perks are taxed to employees. Just because they have not been taxed in the past does not mean that is appropriate.

i. **Deferred Compensation and Section 409A**. Section 409A was adopted in 2005 to regulate the time and form of payments that are made in a year after the year in which they were earned. These rules are very strict and onerous and must be taken seriously. The IRS has not released promised guidance specifically addressing partnerships or LLCs, but most of the § 409A rules apply by analogy to partnerships and LLCs. Section 409A provides that payment schedules that have been established under a deferred compensation plan typically cannot be changed.

Rabbi trusts are sometimes used to fund deferred compensation plans. They provide some security to employees that money will be available when payments are due, but the plans are subject to the claims of general creditors of the company in order to avoid immediate taxation to the employee.

Split dollar life insurance plan arrangements are typically not popular fringe benefits. Secular trusts are not typically used because of the adverse tax consequences to the employee.

Deferred compensation arrangements may be very useful tools in providing for continued cash flow to the owner and owner's spouses for their respective lifetimes. See Item 29 below.

j. **Severance Agreements**. Employees typically cannot be left on compensation or benefit plans following severance of employment. The company will typically want to pay out any remaining payments as soon as possible.

16. Phantom Stock Plans

Phantom stock plans or stock appreciation rights (SARs) are frequently used as a way to incentivize key non-family employees without transferring direct ownership in the business to them. The following summary comes directly from information provided by Carrie E. Byrnes (Michael Best & Friedrich LLP).

a. **General Description**. Phantom stock shares permit the employee to receive a payment equal to the full value of a share/unit upon the occurrence of a Payment Event. Section 409 SARs permit the employee to receive a payment equal to the appreciation value of share/unit as of a Payment Event.

Payment Event: Payment must begin to occur upon one of the following: death, disability, change in control, unforeseeable emergency, separation from service, or a pre-established fixed date. Payment may be set to occur upon the earlier or later of some or all of these payment events.

Payment Form: Payment may be in a lump sum, annuity, installments, or combination. Payment is made in cash.

Vesting: These rights generally are subject to vesting requirements (for example until the employee has been employed for X years). Change in control, death, or disability may result in acceleration of the vesting.

Valuation: The plan must be clear as to how value will be determined.

ERISA Treatment: These plans are often subject to ERISA because payment is usually deferred to termination of employment or beyond. Participation must be limited to "top hat" employees.

b. **Section 409A Applicability**. Section 409A applies and will limit the flexibility of future changes to the arrangement, but will not have negative tax consequences if the § 409A requirements are satisfied. Payment events are subject to detailed § 409A definitions and rules. Deviations from the § 409A requirements in writing or in operation will result in very negative tax consequences for the employee.

c. **Tax Treatment of Employee**.

At Grant: No tax consequences.

At Vesting: No income tax consequences, but the value of Phantom Shares (but not SARs) may be subject to FICA taxes.

At Payment: The payment amount is taxed as ordinary income and is subject to Social Security and Medicare tax (FICA tax) and income tax withholding (if an employee) unless FICA tax was already paid at vesting.

d. **Tax Treatment of Employer**.

At Grant: No deduction.

At Vesting: No income tax consequences (no deduction, except to the extent FICA tax is paid). The value of Phantom Shares (but not SARs) at the vesting date may be subject to FICA taxes and withholding.

At Payment: A tax deduction is allowed for the amount of the employee's taxable income. The company must pay its portion of FICA taxes and withhold FICA tax (unless already paid) and withhold income taxes on wages.

e. **Advantages to Employee**.

- Possibility of large gains (although some plans limit gains).
- Requires no personal investment; avoids costs and risks of continuing to hold shares after payment associated with actual ownership.
- Deferral of income taxes until payment.

f. **Disadvantages to Employee**.

- Share/unit price changes may not parallel the internal performance standards and/or actual management performance; no gain unless the market value increases.
- Gains may be capped by company-imposed maximums.
- The employee cannot time the exercise of rights to maximize gains, other than by terminating employment.
- No opportunity for capital gain treatment.
- Minimal value as a retirement focused arrangement.
- Payment is subject to the risk of company bankruptcy or insolvency.

g. **Advantages to Company**.

- Promotes owners' interests by aligning the employee's interests (employee gains parallel shareholder gains).
- No need to assist employees with financing since no upfront investment is required.
- Impact on cash flow can be more predictable depending upon payment events that are used in the plan.

- Golden handcuff features include vesting and the connection to the value of the underlying shares/units. The vesting schedule can be very long, and graded, to increase the golden handcuff impact. The company could also consider using performance-based vesting to increase the golden handcuff impact.

h. **Disadvantages to Company**.

- Does not necessarily parallel internal performance standards and/or actual management performance.
- Deferral of deduction until payment date.
- Depending on the structure of payment of debts, the employee could be inadvertently incentivized to terminate employment to access rights under the plan (but that can be addressed with "later of" provisions).
- Administrative complexity is high, but that can be mitigated with a simpler payment event structure.

17. Special Issues for Franchises, Dealerships, and Distributorships

a. **General Description**. Franchises, dealerships (locations for retail sales of manufactured products), and distributorships (warehousing, shipping, and wholesale sales to retailers) are well-established business models that are common among family held businesses.

They are frequently leveraged, initially to reduce the required start-up capital, and later for expansion into additional locations.

b. **Special Issues**. Typical issues for these businesses include having detailed transfer and change-of-control restrictions, transfer restrictions in loan covenants, and loan guarantees.

A breach of these restrictions can trigger default. Default sometimes can be waived, but do not risk a default. The planner should carefully review restrictions in advance of any transfers.

The planners should communicate early with the franchisor or distribution company to address estate planning structures that are being considered. "Reach out early and often." They may appreciate having the opportunity for early input and to avoid surprises.

c. **Techniques that Work Well**. Techniques that often work well for these types of owners include the following.

- Recapitalize into voting and nonvoting stock as a starting point.
- Grantor trusts are often beneficial so that exchanges can be made without income tax consequences.
- Vertical divestiture can be a way of providing for active and inactive children. For example, the operating company may spin out equipment, real estate and intellectual property into side companies, which will receive cash payments under lease arrangements with the operating company. Interests in the operating company can be transferred to active children, and interests in the other side companies can be transferred to inactive children. The arrangement may avoid immediate conflicts between active and inactive children, but when the lease

ends, conflicts may arise in re-negotiations of the lease terms. A caution with vertical divestiture is that the spinoff of valuable assets may leave the operating businesses more thinly capitalized with fewer assets to collateralize borrowing, and the side companies may be unwilling to provide guarantees of the operating company's liabilities. (See Item 12 above for a further discussion of structures involving separate related entities.)

- Life insurance trusts may be a simple way of providing for inactive children to provide them with value without breaking up the company into separate parts.

18. Special Issues for Manufacturing Companies

a. **Liability Concerns**. Manufacturing companies often have special liability concerns. Many of the potential obligations can become personal liabilities, not limited to the corporate structure. Examples include environmental liabilities (under CERCLA), and labor liabilities (under the Federal Labor Standards Act and state labor laws). For this reason, ownership through a trust can be beneficial.

b. **Possible Solutions**. Techniques that may work well for manufacturing company owners include estate freezes, ESOPs (the manufacturing industry typically includes a large well-trained workforce that the company wants to retain and the manufacturing industry utilizes ESOPs more than many other industries), vertical divestiture, and planning an exit strategy with a liquidity event (if an appropriate successor is not available within the family).

19. Special Issues for Real Estate Developer or Manager

These businesses are frequently leveraged. The ownership structure often involves preferred or subordinate interests, and § 2701 may apply.

20. Special Issues for Sports Franchises

a. **Unique Characteristics**. The owners of sports franchises submit to intense self-regulation through their league offices. Initial franchise costs can be very expensive. Debt limits often apply to owners. Relocation restrictions present significant barriers to entry. Franchise values are not supported by the cash flow economics. Strict ownership and transfer rules apply. The league must typically approve all new owners. A very limited supply of franchises is available.

b. **Estate and Business Planning for Sports Franchises**. Start early; a substantial amount of league approval process will be required for any business succession plan.

Bifurcating control and equity is critical for sports franchises because of severe limits on who can control the franchise.

Be attentive to the tax aspects, but do not lose sight of the often more critical non-tax factors and family harmony.

Could the IRS ever argue that a gift of an interest in a sports franchise is incomplete until league approval is obtained? (However, league staff are typically aware of and have approved transfer plans, and the formal vote of owners is typically a formality.)

Promissory notes in intra-family sale transactions may count toward the team's debt ceiling unless a waiver from the league is obtained. Therefore, intra-family transfers that involve debt will typically require league approval.

Vertical divestiture will not work for sports franchises. The league will want the stadium and ancillary assets to be owned by the same owners as the team.

League restrictions likely impact valuation; transfers require league approval.

Trust transfers create an additional complexities. Can a third-party trustee hold interests in the club? What about a private trust company that is owned by the family? What happens when beneficial interests pass to new beneficiaries under the trust agreement? Who is treated by the league is holding the ownership interest – the trustee or the beneficiary?

21. Loan Agreements and Covenants

Many loan agreements and covenants will include transfer of ownership or change of control restrictions. The planner should insist that the client provide copies of all relevant agreements, including arrangements with the franchisor (for franchises) or OEM [original equipment manufacturer] (for dealerships or distributorships). Review the agreements closely to identify restrictions or reporting requirements that could impact planning – or worse, trigger defaults, accelerated maturities, or interest penalties if covenants are violated by an otherwise well-intentioned estate planning transfer or the death of a key owner.

The planner may coordinate with other corporate or business attorneys in reviewing the business and loan documents.

22. Costs

Clients should understand upfront that engagements with family businesses (especially those involving special industries such as those described above) cost substantially more than a basic estate plan, or even an advanced plan for clients with only portfolio assets or other common assets.

Items 23-32 are observations from a panel by Randy Grove, Louis S. Harrison, and Melissa J. Willms–Session 5: Wind Down, Sale, or Transition of Business

23. Overview of Planner's Approach and Role in Working with Business Owners to Achieve Success in Family Business Succession; Overview of Strategies to Pass the Family Business to Active Family Members While Not Disadvantaging Non-Active Ones

The following overview summary is based on an outstanding article by Lou Harrison, *Achieving Success in Business Succession: Strategies to Pass the Family Business to Active Family Members While Not Disadvantaging Non-Active Ones*, J. PASSTHROUGH ENTITIES (July-August 2018).

a. **Unique Challenges**. A complex interplay of various factors makes family business succession planning (from G1 to succeeding generations) very challenging. These factors include:

- Estate and income tax complexities;
- Intergenerational family issues and the desire to treat family members fairly;
- Differing abilities and interests of family members in participating in the family business;

- The family business may produce significantly more cash flow and appreciation potential than a diversified investment portfolio;
- Irrational behavioral tendencies of the family business owner;
- Behavioral finance principles and biases (i.e., fairness bias, discounting future events bias, status quo preference bias, and endowment effect bias);
- The entrepreneur looks upon the business as another "family member" – it is not just a financial commodity;
- The owner will want to talk about this additional "family member" and the owner's dreams and goals for the business and for the family; the planner should spend time listening and validating a G1 owner's desire to try to pass on the business to the G2 and future generations.
- Key underlying concern is what happens to the business when the current owner is no longer running it; and
- Whether the business should be continued by the family at all after the owner departs the business or whether the business should be sold in a planned fashion.

b. **Nonactive Children.** Emphasize with G1 the importance of "keeping noninvolved owners noninvolved." The family business probably constitutes a large portion of the owner's estate so treating nonactive children fairly while still keeping them "noninvolved" is a challenge.

c. **Communicate**. Communicate with all family members about their goals and concerns. Family members do not get to make decisions, but being heard, and hearing from others assists all family members in understanding that the difficulty of treating all fairly while meeting everyone's needs is a challenge that often requires compromises.

d. **Bifurcating Equity into Control/Non-Control**. Creating voting (often about 1-5%) and non-voting (often about 95-99%) equity interests is a frequent starting point. Important non-tax and tax advantages support having voting and non-voting interests. See Item 26 below.

e. **Transfers of Non-Voting and Voting Interests**. Transfers of non-voting equity interests can be made with traditional transfer planning structures (GRATs, sales to grantor trusts, etc.).

   Voting interests may be retained for some time by the founder-owner for control purposes. Transferring voting interests at some point during the owner's life can transition management control to a successor manager and can be advantageous if the voting units can be transferred in tranches over several years to take advantage of lack of control discounts. Otherwise, voting interests could pass under the owner's will to the successor owners who will manage the business.

f. **Cash Flow Puzzle**. The various steps of the transfer plan must, most importantly, take into consideration the need to provide appropriate cash flow to G1, G1's spouse, and other family members. The transfer planning may also involve cash flow issues (e.g., for making GRAT payments or payments on notes in sale transactions). Compensation arrangements may also be used to provide appropriate cash flow to G1, G1's spouse, and active owners.

g. **Vertical Divestiture into Separate Related Entities.** Breaking the business into component parts (real estate, equipment, intellectual property, etc.) with lease agreements for the operating company to continue using those assets for its operations in return for appropriate cash lease payments may facilitate treating the inactive children fairly be transferring to them interests in the passive ownership components. See Items and 17.c above.

h. **Practical Safeguards for Voting and Nonvoting Interests Held by G2**. Conflicts can arise among the G2 owners (revolving predominantly around allocation of cash flow from the business). Nonactive owners may fear that the active owners will take unreasonable compensation in lieu of making distributions. Active owners may fear that the inactive owners will challenge business decisions or interfere with management by the controlling owners. One practical way of dealing with these concerns is to provide "call rights" for the active owners and "put rights" for the inactives. The active owners would have call rights to purchase the interests of inactives under a predetermined valuation approach, perhaps at a premium to discourage the controlling G2 from activating the call rights unless absolutely necessary. The inactive owners would have put rights to sell their interests at some discount to a fair market value (again to discourage exercising the put rights unless absolutely necessary).

i. **Buy-Sell Agreement**. Transfer restrictions, documentation of legal rights to acquire interests in the business under the succession plan, and practical safeguards (as described in the preceding sub-paragraph) are typically incorporated in a buy-sell agreement or shareholders agreement or sometimes incorporated in the organizational documents for the entity. These are discussed further in Item 11, above.

j. **Additional Variables.** Additional variables may include compensation committees, special veto rights for non-controlling shareholders prior to major transactions (merger, financing, sales) or drag along and tax along rights, and possible bylaw mandated dividend or distribution amounts. If ownership interests are left in trusts, trust provisions will have to be customized to leave the appropriate persons in control.

24. Hypothetical

Big Daddy is 70 years old and has two children, Sonny and Dotty. Big Daddy has remarried, and his wife, Wendy, gets along reasonably well with Sonny and Dotty, but she also has several children of her own.

Sonny is a well-respected manager at the company and is the heir apparent to run the company. Dotty plays a small role in business. Sonny and Dotty get along well.

The business is worth about $20 million. Big Daddy owns 81%, Sonny owns 10%, and Dotty owns 9%. Big Daddy has $4 million of nonbusiness assets and a $3 million insurance policy.

Big Daddy's plan is the leave the business to Sonny and Dotty, with Sonny in control. Some of the nonbusiness assets will be left to Wendy and some will be left to his children. The family members are considering giving the nonfamily CFO a 5% interest in the company.

25. Review Entity Documents and Loan Arrangements

The planner must understand the rights of owners and restrictions on transfers or change of control restrictions.

26. Recpaitalization into Voting and Non-Voting Interests

The starting point for family business succession planning is often to recapitalize the equity interests into voting (say about 1-5%) and nonvoting (say about 95-99%) interests.

Important nontax reasons include:

(i) Facilitating the process of beginning to make transfers of some equity interests without G1 giving up control (which is often a big barrier to willingness to begin taking succession and transfer planning steps); and

(ii) Facilitating keeping control of the company with the desired successors.

Tax advantages include:

(i) Avoiding §2036(b) when making transfers of nonvoting interests (see Rev. Rul. 81-15) (and when voting interests are transferred, there must be no oral understandings allowing the transferor effectively to vote the stock, see Rev. Rul. 80-346); and

(ii) Discounting nonvoting interests that are being transferred currently.

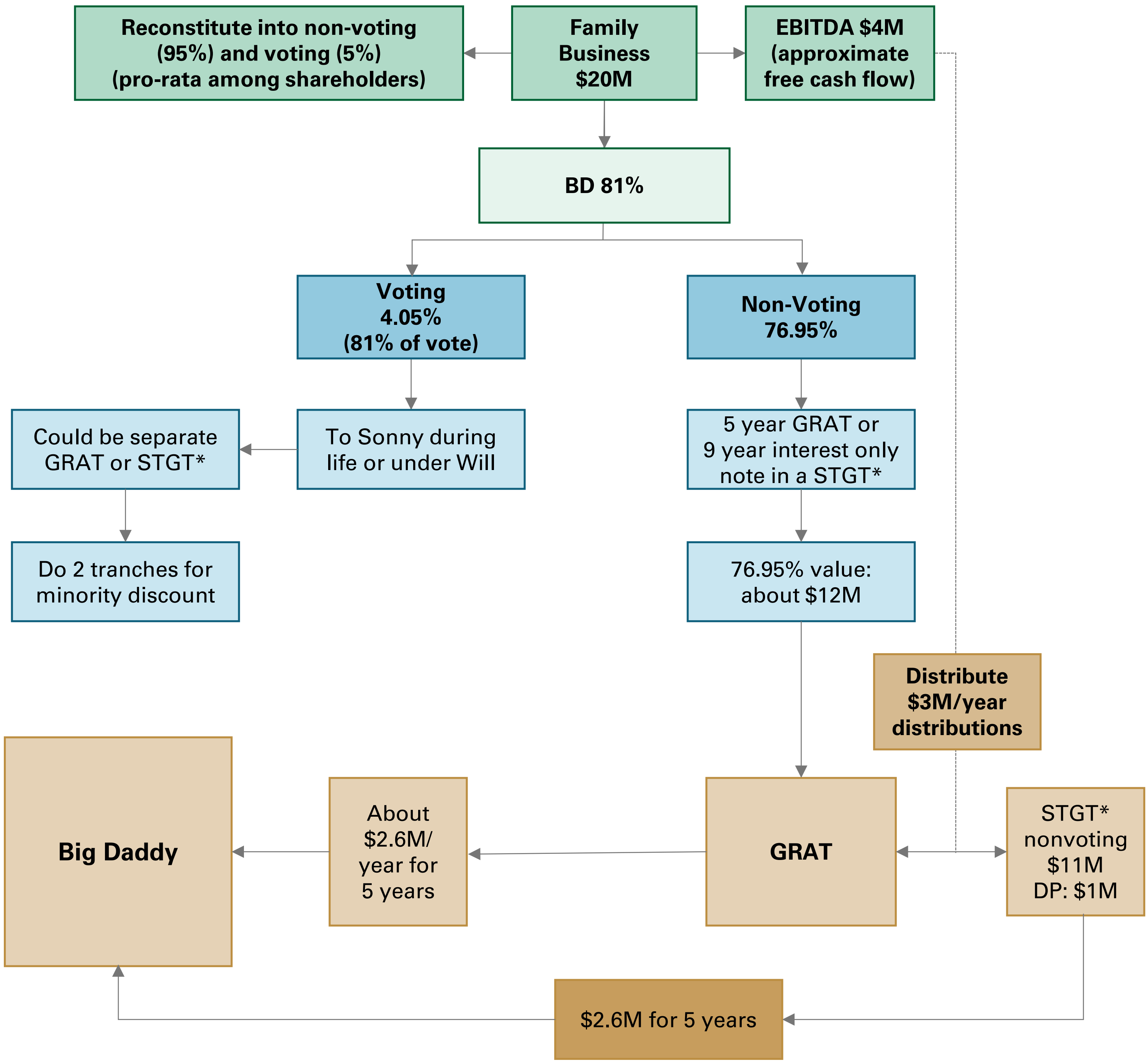
The voting interest preferably will be transferred during the life of G1 (when G1 is comfortable doing so) in several tranches over several years to take advantage of lack of control discounts for transfers in any particular year.

27. Possible Plan to Satisfy Objectives

A possible plan to satisfy the family's objectives is illustrated in the chart included below (prepared by Lou Harrison).

Applying typical valuation multiples, a business worth $20 million might have EBITDA (earnings before interest and taxes and depreciation and amortization, thus approximating free cash flow) of about $4 billion. All of the outstanding stock will be converted into voting and nonvoting shares, so Big Daddy's 81% shares would be converted to 4.05% voting shares and 76.95% non-voting shares. The voting shares will be transferred to Sonny under Big Daddy's will (or preferably during Big Daddy's life over various different years so that a non-control interest is transferred in each particular year for valuation purposes). The non-voting interests could be transferred to grantor trusts for Sonny and Dotty. If the company distributes $3 million per year, the nonvoting stock (worth about $12 million with discounts) could be transferred with a five-year GRAT, or a nine-year sale to grantor trust transaction, the cash flow being sufficient to make the GRAT annuity payments or the note payments in the sale transaction.

Big Daddy Planning



* Sale/gift to grantor trust

28. Strategic Approach to Get Buy-In From Big Daddy

Despite the fact that the family's succession goals could be implemented beginning immediately with the plan described above for a family business having significant cash flow, the owner may be unwilling to start implementing the plan. A distinction may exist between what the owner says he/she wants to achieve and what he/she will actually do. The planner must understand inherent financial behavioral biases, and discuss the succession plan with the owner in light of those inherent biases.

a. **Bias 1-Fairness Principle**. The G1 client may think that G2 has not yet done enough to justify to receiving the shares currently, and the client may view his obligation to pay $1 million per year of income taxes attributable to the grantor trust income as unfair. The planner may respond that in the overall planning scheme, "my job is to make you poor." Focus on what Sonny has done in the business, and what the client would want the future to be like for him. Discussing what is going on with the daughter's family and the parent's overall long-term goals for her family is a way of minimizing the significance of the fairness notion in making current transfers to her. Another way to approach this "fairness" bias is to implement the transfer plan in steps.

b. **Bias 2-Discounting Future Events**. People discount future events at unreasonable rates. For example, the client may view the estate tax problem that will arise in 15-20 years as the beneficiary's problem. The client's response may be "let me check with my spouse and I'll get back to you," which is a euphemism for "we can talk again in five years." The planner may discuss that if an estate tax exists at the client's death, ways of dealing with the tax (other than a possible forced sale of the business) include planning for estate tax deferral under § 6161 or § 6166, using Graegin notes (if still allowed at that time), and third party loans. Those are possible solutions but they may impact the business operations, and some employee positions may have to be eliminated.

c. **Bias 3-Status Quo Bias**. The status quo bias is a preference for the current state that biases against change. "Don't do anything today that can be put off until tomorrow." Individuals have a strong tendency to remain at the status quo because the disadvantages of leaving it loom larger than advantages because of loss aversion – the pain of giving up an object is greater than the joy associated with acquiring it. The planner might focus on an acquaintance of the client who has had a mortality event. Quoting Abraham Lincoln, "you cannot escape the responsibility of tomorrow by evading it today."

d. **Bias 4-Endowment Effect**. People often demand much more to give up an object than they would be willing to pay to acquire it. Giving up something meaningful is especially difficult.

e. **Pointers for Motivating Action**.

- The key is getting the client to own the issue.
- This is not something the planner is trying to talk the client into doing. The planner merely points out issues, but the client must ultimately own the problem.
- "Not making a decision is making a decision."

- Emphasize that having G1 involved in the planning with the children can greatly facilitate avoiding fights and resentment in the long run between the children. G1's involvement in working though issues with everyone around can be key to long-term success.
- "Remind me – what do you really want to see happen?"
- "Your ability to run the business will change at some point."
- Timing is an important element of the planning process. "Do you want to plan based on an efficient approach, or plan based on an emergency?"
- Ask the client to think about what would happen with the business near term if the client died suddenly.
- Approach the problem in segments, leaving the client with total control in the initial steps (and the client may not give up control until after the client's death). Focus on the owner's (and the owner's spouse's) continued cash flow for life. An initial step would be to get the current basic estate plan in place.
- The owner is an entrepreneur, thinking at all times about the business. If at all possible, have the owner come to the planner's office, to avoid the numerous interruptions that invariably will occur if the meeting is at the company offices.
- Ask the owner when a sale to a third party would be considered. If that question is not asked directly, it likely will not be addressed. The owner should seriously consider whether a sale of the business to a third party ultimately would be in the best interest of the owner's family and the business.

f. **Four Elements of Business Ownership**. Throughout the entire succession planning process, the owner should focus on the four elements of business ownership and how the owner wants each of those elements to apply to the respective successors and family members. The four elements are vote, income, equity, and growth.

29. Deferred Compensation

Deferred compensation arrangements may be a key part of the plan to provide cash flow to the owner and the owner's spouse for their respective lifetimes.

Structuring the deferred compensation plan early is important, when the plan legitimately serves the purpose of motivating the owner to continue providing services to the company. It cannot merely be put in place when the business is being transferred and the owner is leaving employment.

The deferred compensation plan may provide benefits both to the owner and to the owner's spouse following the owner's death. This may be essential in assuring an income stream to the owner's spouse for life.

The deferred compensation plan is a liability that discounts the value of the company for transfer tax purposes.

A caution about deferred compensation is that the plan could have an impact on the financing arrangements that the company has in place currently or anticipates for future purposes. Check with the company's lender to make sure that the plan is compatible with the financing needs of the company.

Very detailed rules under Section 409A must be satisfied with any deferred compensation arrangement. See Item 15.i above.

30. Key Employees

The succession planning must take into consideration the ability to retain key employees and key management persons. Be very wary about transferring ownership interests in the business to key employees. "Why do you want the CFO to actually be an owner? What if he/she moves to another company?" The issue is motivating the key employee to stay with the company and that can be achieved with other compensation approaches, such as a phantom stock plan designed to allow the key employee to share in the growth of the business and have "skin in the game," but avoid the headaches of possibly dealing with an ex-employee that has an actual ownership interest in the company. Phantom stock plans are addressed in Item 16 above.

ESOPs involve a lot of complexity and annual compliance requirements. As discussed in Item 18 above, they are sometimes used in the manufacturing industry more than in other types of industries.

An owner may give thought to having the company ultimately be bought by key employees. Company owned life insurance is sometimes used for that purpose to help fund the buyout at the owner's death. Realize, however, that may result in the owner to some degree funding his or her own buyout. Planning for employees to buy the business causes significant stress to the business and may not be consistent with the owner's overall estate plan.

31. Sale to Third Parties

a. **Consider Possible Sale**. The owner should at least consider if a sale of the business to a third party would be in the best interest of the owner's family. If that is the case, the owner will need to decide upon an appropriate time for the sale and go through a process of seeking prospective purchasers in an orderly and timely fashion to avoid having a forced sale process following the owner's death. Alternatively, the owner should be open to consider any offers to purchase the business.

b. **Categories of Buyers**. Possible types of buyers include a management buyout, a financial buyer (for example, private equity funds that may look to flip the company in 5 years), or a strategic buyer (the owner will know who those possible strategic buyers are). A strategic buyer may be willing to pay a higher purchase price than the other types of buyers, depending on the circumstances.

c. **Type of Sale.** Sellers traditionally prefer a sale of interests in the entity, and buyers traditionally prefer a purchase of the assets of the business (to avoid liabilities of the entity and to allow depreciating the purchased assets). The planner should work closely with the company's accountant regarding the tax implications to the seller; asset sales sometimes have comparable tax effects to a seller, and the company's specific situation must be analyzed.

   Section 338 allows a corporation that makes a qualified stock purchase of another corporation to treat the acquisition as an asset purchase rather than a stock purchase for federal tax purposes, so the tax basis of the assets held by the target company are stepped up to the purchase price. A sale of S corporation stock to another corporation is often treated, as a result of making the election under § 338(h)(10), as a sale of the underlying assets for tax purposes, with the gain increasing the stock's basis, followed by a deemed liquidation of the S corporation. The § 338(h)(10) election is also available for sale of stock of C corporations, but does not provide the same benefit to shareholders because the corporate gain on the deemed sale of assets does not increase the shareholders' stock basis.

If the business is a partnership, timing of the sale of the company and the termination of the partnership is important to make sure that the cash is distributed in the same year as the termination of the partnership so that capital gains can be offset by accompanying capital losses.

d. **Estate Planning Attorney's Role in Sale Process**. The estate planning attorney can play a significant role in the sale process. Aside from arranging for relevant transfers of ownership interests preceding the third party sale, the estate planning attorney can also be involved in the actual sales process. Potential roles include (1) estate planning, (2) tax planning, (3) advising as to the form of consideration, and (4) acting as a consigliere during the sales process.

e. **Transfers Preceding Sale to Third Parties**. If an owner anticipates a sale to a third party, the owner may want to make gifts or sales of interests in the business to family members, typically at lower values than the anticipated purchase price with the third party. The timing is critical to avoid an IRS argument of substance over form and anticipatory assignment of income, treating the owner as having sold the interest to the third party and having transferred sale proceeds to the family member. When has the sale proceeded to the point that the intra-family transfer will not be recognized? In the charitable area, some cases (such as *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999)) apply a facts and circumstances test (determining whether the "right to income has ripened"), but other cases (such as *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002)) apply a bright line test announced in Rev. Rul. 78-197 (which applies if the owner and charity did not have a legal obligation to sell the stock prior to the charitable gift). The bright line test does not apply to non-charitable transfers, leaving just the facts and circumstances test.

An issue that arises frequently is that an owner may think that a sale could happen in the near future, but does not know if the sale will happen or how quickly it will happen. The owner will want to act promptly to implement desired transfers.

A transfer may be possible even after a letter of intent is signed, because many sales do not get completed following a signed letter of intent (although the signed letter of intent may have a significant impact of the valuation at the time of the transfer). The best practice is to complete the intra-family transfers before a letter of intent is signed to sell to a third party. As a practical matter, if the sale is completed, the court will be viewing whether a mere anticipation of a sale vs. a practical certainty of a sale existed at the time of the transfer, but that decision will be made in hindsight, with the court knowing that the sale in fact did take place.

Another possibility is to make the intra-family transfers in several tranches over several years, taking the position that each separate transfer is of a non-controlling interest (entitled to a lack of control valuation discount). The issue is whether the step transaction doctrine could be used to aggregate the transfers.

When intra-family transfers are made after discussions/negotiations have begun regarding a possible sale to a third party, appraisers valuing the transferred interest should be advised fully of the state of the discussions and negotiations. (As long as a letter of intent has not yet been signed obligating the prospective purchaser to purchase the interest at a specified price, the appraiser's knowledge of mere discussions/negotiations may have little practical impact on the appraised value of the interest.)

f. **Sale Process**. The planner should advise the owner that he/she has taken a second job. The owner must continue to run the business (the first job) so that the earnings do not fall (which could reduce the value), but the process of going through all of the due diligence and negotiation steps required in selling the business (the second job) will be quite time-consuming as well.

The possible forms of consideration for a sale include cash proceeds, payout under a note, payments under a noncompete agreement or payments under a salary continuation plan. The owner will also consider to what extent the owner may wish to retain some interest in the business at least for some period of time, and how key employees should be treated.

Many details will have to be negotiated in the purchase agreement. As a starting point, the purchase agreement should not conflict with the letter of intent, but many details will be left for negotiation, including representations and warranties, holdback baskets (funds that will not be released until representations have been satisfied or until other specified events have occurred), purchase price allocations, the preparation of financial statements, determining cash that can be distributed from the business (in excess of needed net working capital), and various other terms and ancillary agreements (such as escrow agreements for holdbacks, confidentiality agreements, resignations, employment agreements, lease consents, assignment and assumption agreements, spousal acknowledgements, etc.).

Throughout the sales and due diligence process, the key is to disclose everything. Nondisclosures can come back to bite the owner-seller.

32. Family Business Mission Statement

The materials include an outstanding Family Business Mission Statement questionnaire, designed to help the business owner focus on overall family and business planning issues, prepared by Michael V. Bourland (Fort Worth, Texas). That form is attached as an Appendix, with Michael's permission.

Items 33-34 are observations from a panel by John T. Rogers, Jr., Paige K. Ben-Yaacov, J. Lee E. Osborne, and Professor Mary F. Radford–Session 6: Keeping it Together—Ethical Considerations in Representing Family and Business

33. Who Is The Client? Representing the Founder, the Entity, or All Owners

a. **Multi-Party Representation for Families**. Neither the ABA Model Rules of Professional Conduct (Model Rules) nor the ACTEC Commentaries on the Model Rules of Professional Responsibility (ACTEC Commentaries) discourage representing multiple family members with respect to a particular matter. Model Rule 1.7(a) creates a presumption that the attorney cannot provide common representation, but Model Rule 1.7(b) says the presumption can be overcome if (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client, (2) the representation is not prohibited by law, (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal, and (4) each affected client gives informed consent, confirmed in writing.

The ACTEC Commentaries favor multiple representations in many situations, observing that a lawyer may appropriately represent more than one member of the same family in connection with their estate planning or more than one of the investors in the business because (1) the class may be better served by such common representation, (2) the representation can result in a more economical and better coordinated plan, and (3) estate and tax planning is fundamentally nonadversarial in nature. The ACTEC Commentaries suggest that the attorney meet with prospective clients separately to allow them to be more candid in revealing potential conflicts or problems that might affect the common representation.

b. **Entity Representation**. Model Rule 1.13(a) states that "a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." If the constituents act to the detriment of the organization, the attorney must respond in a manner to protect the organization and not just continue advising the primary constituent. The attorney representing an entity must look out for the best interest of the entity rather than a constituent, even though the attorney has represented the primary constituent in the past.

Model Rule 1.13(g) states that an attorney representing an organization might also represent any of its directors, officers, employees, members, shareholders, or other constituents subject to the conflict of interest rules in Rule 1.7.

The Model Rules specifically refer to an "organization" as a corporation, partnership, limited liability company or an unincorporated association. That does not explicitly include limited partnerships, but the Model Rules acknowledge that limited partnerships may be treated differently than other partnerships. The general consensus is that in representing a limited partnership, the attorney represents the general partner rather than all partners or the entity itself. A minority approach, however, takes the position that because the general partner owes fiduciary duties to the limited partners, the attorney that represents the general partner also owes duties to the limited partners.

c. **Separate Roles**. A single individual may be represented in multiple roles, including as an individual, as trustee, as partner, or as corporate director. The ACTEC Commentaries to Rule 1.7 states that an attorney may represent a person in various capacities.

d. **Potential Conflicts in Family Businesses**. Multiple potential conflicts may exist among the various owners of family businesses. For example, with respect to voting rights, some may want a simple majority and others may want a super majority. For buy-sell agreements, an owner that is compelled to sell pursuant to the agreement may complain that the purchase price under the agreement is inadequate.

e. **Engagement Letter**. The engagement letter should make very clear who is represented. If multiple parties are represented, they should consent to the attorney's representation of the other parties. Excellent engagement letter forms are available in the ACTEC Engagement Letters (3rd ed.) (available at

https://actecfoundation.org/trust-and-estate-professional-resources/engagement-letters-for-lawyers/). Forms are available for representing (1) only the entity, (2) the organizers jointly and not the entity, and (3) both the entity and the organizers jointly.

f. **Varying Viewpoints as to Preferred Approaches**.

Representing Founder Individually. One panelist prefers representing the primary owner of the entity, not the entity. The attorney can then clearly represent the best interests of that particular owner. Conflicts may inherently arise with respect to the interests of other owners. Representing the founding owner individually rather than the entity allows the client to speak to the attorney freely about fiduciary duty issues without concern of the attorney's duties to other owners. This approach results in the disadvantage of losing what could be a significant amount of corporate work for the business, and may be more inefficient in requiring that multiple lawyers be involved.

If the attorney represents just the founding owner, the other owners may mistakenly believe that the attorney represents them also. If the client ever asks the attorney to send something to the other family members or owners, the attorney can make clear in the cover letter that the attorney does not represent them and encourage them to have their own separate counsel. If the attorney prepares a document that will be signed by the various owners, include a provision making clear that all parties acknowledge that the firm does not represent them, that they have been advised to obtain separate counsel, and that they have either obtained separate counsel and have relied on that counsel, or have decided to proceed without obtaining separate counsel.

Representing Multiple Parties and Entity. Another panelist typically represents the founder initially, then the business, and eventually other family members. In the attorney's viewpoint, having separate representation for the founder, the entity, and all the other owners is impractical. With multiple representations, upfront discussions are critical to clearly identify the clients, duties regarding the sharing of information, and the confidentiality of information. The attorney must examine competing ethical issues to be addressed and document the resolution of those issues as best possible. "Big Daddy will not be happy if you tell him you cannot represent the company."

34. Duty to Provide Information and Duty to Preserve Confidentiality

The attorney has ethical duties to communicate with the client and to preserve confidentiality. The separate duties may conflict in multiple party representations.

a. **Duty to Communicate**. Owners who consider themselves clients of a lawyer will believe that the lawyer has an affirmative duty to convey matters of importance related to the business. Cases have varied with respect to the extent to which limited partners have the right to examine records relating to the partnership that the general partner shares with the attorney. *McCain v. Phoenix Resources, Inc.*, 185 Cal. App. 3d 575 (1986) concluded that limited partners are not precluded from examining records relating to the partnership business "simply because such business was conducted through a law firm." On the other hand, *Buford White Lumber Co. Profit Sharing and Savings Plan & Trust v. Octagon*, 740 F. Supp. 1553 (W.D. Okla. 1989) concluded that limited partners are not always entitled to access to information received in the course of the representation when the attorney primarily represented the general partner.

b. **Duty of Confidentiality**. The duty of confidentiality is the flip side of the lawyer's duty to disclose. Model Rule 1.6 requires that an attorney maintain confidentiality of information in the course of a representation unless the client gives informed consent to disclosure. The engagement letter should address as specifically as possible the treatment of confidential information, waivers of confidential information, and what happens if a waiver is revoked.

Items 35-43 are observations from the Seminar at the Summer Meeting: Modern and Practical Challenges of Minors in Estates and Trusts.

One panel by Professor William P. LaPiana, Gerard Brew, and Bruce Stone, titled "Who(se) Are You?," dealt with the importance of correctly identifying family members in light of technology advances and changing social views of how a parent-child relationship is created.

Another panel by Jane Gorham Ditelberg, The Honorable Christine Butts, and Judge James G. Riley (Ret.), titled "Navigating Between the Hard-Knock Life and East Street When Passing Assets to Children," addressed intestacy rights of descendants, the management of property for minors, and guardianship issues.

The last panel by Raymond Joseph Koenig, III, Shane Kelley, and Robert N. Sacks, titled "(Not Your or) My Generation: Litigation Issues Involving Children," addressed various litigation issues involving minors including virtual representation, the role of trust protectors and guardians ad litem, DNA testing, representing young adults, emancipation of minors, and dealing with parents who live off their minor children.

The musings below are a few selected highlights of these discussions.

35. Precise Description of Children and Descendants (Including Adopted Children, Non-Marital Children, Posthumous Children, and Descendants Through Assisted Reproductive Technology); Forms

a. **Importance of Precise Description**. The changing history of the legal treatment of adopted children and non-marital children evidences the importance of precisely describing what descendants are intended as takers in estate planning documents.

For adopted children, under the old traditional "stranger to the adoption" doctrine, where a testator or settlor who was a "stranger" to the adoption (i.e., was not a party in the adoption proceeding), the presumption was that the person would not have wanted to include adopted children in a class gift to issue, children, descendants, etc. That doctrine was eliminated over the years by case law and statutes. In cases construing trusts, the choice of law was critical, and issues arose as to whether the law at the time the trust was created or at the time of the vesting of assets under the trust agreement controlled. Similarly, the law has developed for "illegitimates" (now referred to as non-marital children) by case law and statutes, as now reflected in the Uniform Parentage Act (2017).

Clear drafting to describe the testator or settlor's intent is imperative. Forms addressing a variety of situations are included below. These forms are supplied by Bruce Stone (Coral Gables, Florida), and they are included below with his permission.

b. **Subtle Elimination of a Child (or Potential Existing Child) and That Child's Descendants as Beneficiary**.

I am married to Mary. I have two children who were born of our marriage: Gerard and Bill. Whenever used in this last will and testament, the term "my children" includes only Gerard and Bill, and any other children born of my marriage to Mary or adopted by the two of us after the execution of this last will and testament. The term "my descendants" includes my children and their descendants (whether natural or adopted).

c. **Subtle Elimination of a Child and That Child's Descendants as a Beneficiary, Including under a Contingent Disposition to Heirs**.

If I have no children living on the death of the survivor of Mary and me, or upon the termination of any trust under this last will and testament (to the extent that the beneficiary does not effectively exercise any power of appointment over the remaining trust assets), the Trustee will divide the remaining trust assets in two equal shares. One share will be distributed to my heirs at law, and one share will be distributed to Mary's heirs at law, determined in each case as if neither of us had ever been married and as if neither of us had ever had a natural child from any relationship or a child by adoption.

d. **Express Elimination of a Child and That Child's Descendants as Beneficiary**.

For all purposes of this last will and testament, my son Donald will be treated as if he and all of his descendants had died before me, so that neither he nor any descendant of his shall ever receive any benefit under this last will and testament, nor have any role in the administration of my estate.

e. **Blended Family; Inclusion of Children from Spouse's Prior Marriage and Their Descendants as Beneficiaries**.

I am married to Mary. We are citizens of the United States. I have two children: Alice (who was born from a prior marriage) and Bruce (who was born from my marriage to Mary). Mary has a son, Gerard, who was born from a prior marriage. Gerard will be treated as my child (and his descendants as my descendants) for all purposes of this last will and testament even though he is not my biological child and even though I have not legally adopted him.

f. **Adopted Child Included If Adoption Commenced Before Age Two; "Adoptions Away."**

A legally adopted child will be regarded as a descendant of the adopting parent if the petition for adoption was filed with the court before the child's second birthday, and the descendants of that child will be regarded as descendants of the adopting parent. A legally adopted child will not be regarded as a descendant of the adopting parent if the petition for adoption was filed on or after that child's second birthday. If the legal relationship between a parent and child is terminated by a court while the parent is alive, that child and that child's descendants will not be regarded as descendants of that parent. If a parent dies and the legal relationship with that deceased parent's child had not been terminated before that parent's death, the deceased parent's child and that child's descendants will continue to be regarded as descendants of the deceased parent even if the child is later adopted by another person.

g. **Children Born Out of Wedlock ("Non-Marital Children"); Child of Biological Father**.

A person will not be regarded as the child of that person's biological father if the father was never married to the child's mother unless:

(a) the biological father acknowledged parentage of the person at any time after conception in a written instrument signed by the biological father and genetic testing establishes that he is the biological father;

(b) the biological father openly raised and acknowledged the person as his child; or

(c) parentage was established by adjudication.

h. **Assisted Reproductive Technology Children Clauses.**

(1) **Child of Surrogate Mother Not Included as Beneficiary**.

A woman who is both the genetic and birth mother of a person will be treated as a parent of that person, whether the person was conceived by sexual intercourse or by means other than sexual intercourse, unless the woman's parental status was terminated by adoption, subject to the following. A woman who, without any intent to function as a parent following birth, carried a person to birth under an agreement with that person's intended parents or parent will not be treated as that person's mother, and that person will not be treated as the child of that woman, whether or not the woman is a genetic parent of that person.

(2) **Genetic Father If Married**.

If a person was conceived by sexual intercourse of the genetic parents, the person will be treated as the child of the genetic father if the genetic parents were parties to a marriage, civil union, domestic partnership, or substantially similar legal relationship with each other when the person was conceived or at any time after conception.

(3) **Child Not Conceived by Sexual Intercourse**.

If a person was conceived by means other than sexual intercourse, the person will be treated as the child of a genetic parent only if that parent provided his or her genetic material with the intent to become a parent acknowledged in a written instrument signed by that genetic parent which was not revoked by a subsequently dated written instrument signed by that genetic parent before gestation began.

(4) **Intended Parent of Child Conceived by Sexual Intercourse**.

A person will be treated as the child of another person who was not married to (or in a civil union, domestic partnership, or substantially similar legal relationship with) the birth mother of that person and who intended to be a parent of that person (whether or not the intended parent is a genetic parent of that person) under an agreement with the birth mother that was not revoked before the child was in gestation, whether or not the agreement is legally enforceable.

(5) **Status Dependent on Time of Gestation (Treatment of Posthumous Children)**.

A child who was in gestation on the death of a person treated as a parent of that child under any one of the preceding clauses and who is born alive after the death of that person will be treated as living on that person's date of death. A child born after the death of a person who would otherwise be treated as a parent of that child under any of the preceding clauses will not be treated as that person's child if that child was not in gestation on that person's date of death.

36. Equitable Adoption

a. **Description**. Many (but not all) jurisdictions recognize the doctrine of equitable adoption. The doctrine enables a child to be treated as the child of a prospective parent (for purposes of inheriting from the prospective parent and for other purposes as well, such as receiving assets under a trust as a child of the prospective parent) even without a formal adoption, as long as the prospective parent acted in a manner that caused the child to believe he or she either was adopted or would be adopted, and the child relied on such behavior. (Some states, such as Texas, no longer require action in reliance.)

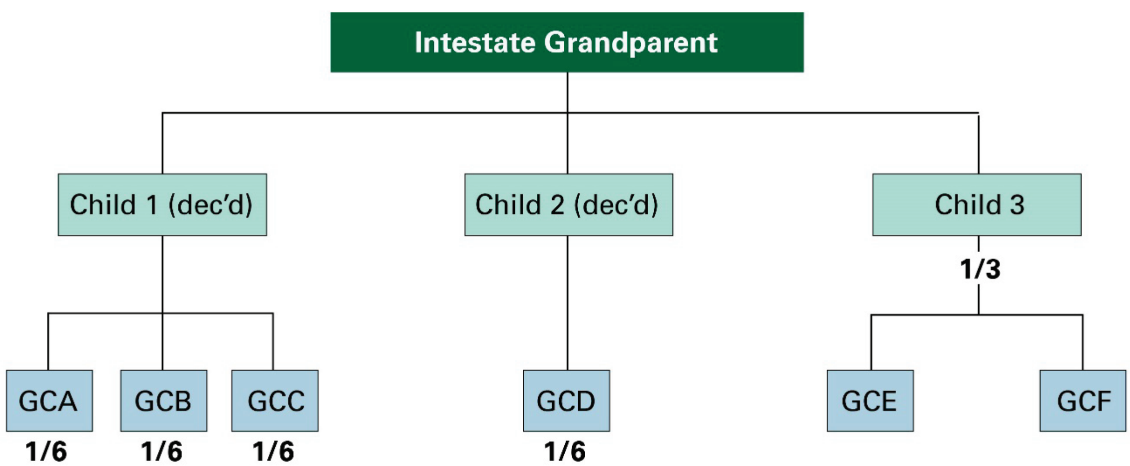
b. **Death of Prospective Parent or Child before Adoption Completed**. Courts have addressed, with mixed results, whether a child will be treated as having been equitably adopted even though the prospective parent or the child dies before the equitable adoption proceeding has been completed.

37. Changing Demographics

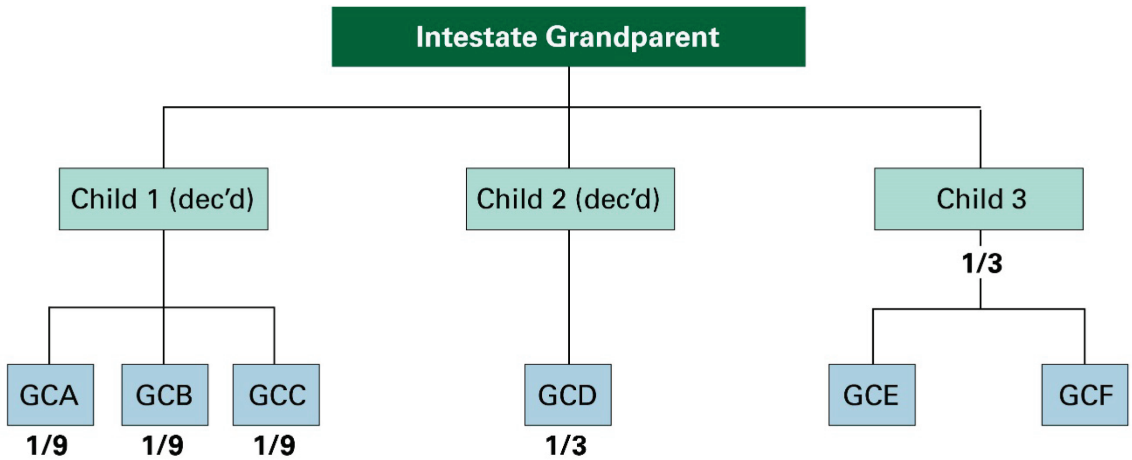
Approximately 63% of children in the United States live with both natural parents, down from 75% in 1960. Approximately 27% live with a single parent, and 5% live with a foster family or grandparents.

38. Intestate Distribution Plans; *Per Capita* and *Per Stirpes*

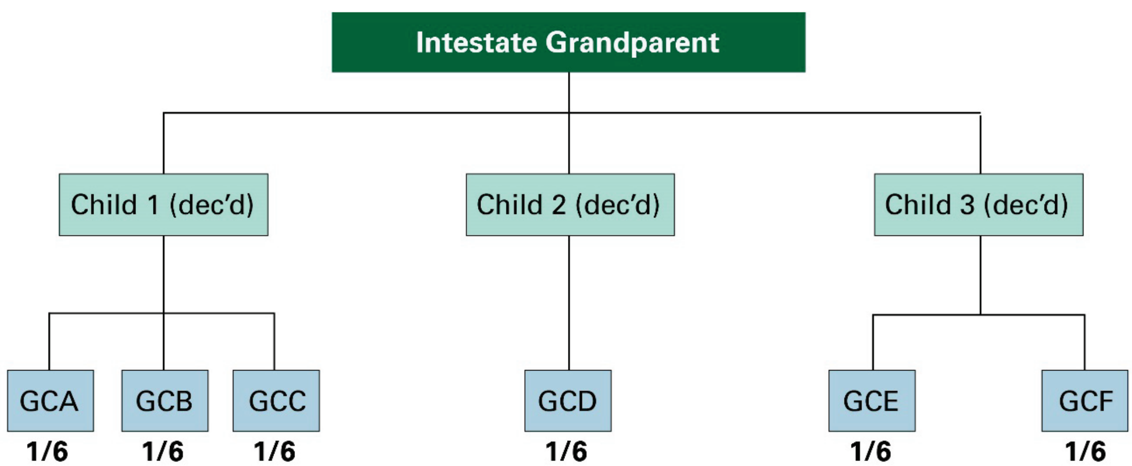
a. **Per Capita at Each Generation**. The Uniform Probate Code applies a "*per capita* at each generation" approach. UNIF. PROB. CODE § 2-103. When an intestate estate passes *per capita* at each generation, the estate is divided into as many shares as there are surviving descendants in the generation nearest to the deceased and deceased descendants in the same generation who left surviving descendants. Each surviving descendant in the nearest generation receives one share. The remaining shares are combined and divided into equal shares. For example –



b. **Per Capita With Representation**. About half the states follow a "*per capita* with representation" intestate distribution scheme. Under this approach, each descendant inherits only that portion of the property that the parent through whom the descendant inherits would be entitled if that parent were alive. For example –

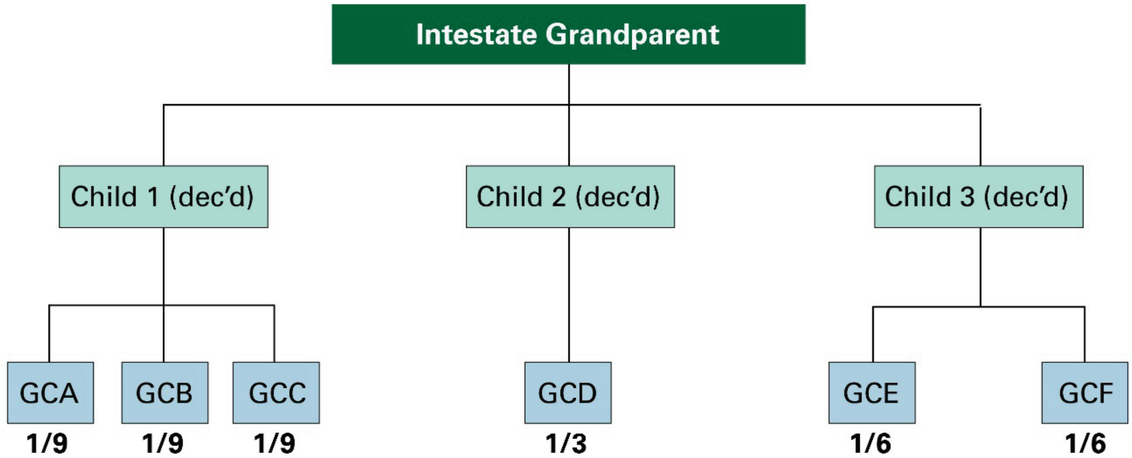


If all of an intestate's children predecease, the grandchildren of such decedent take equal shares. For example –



c. **Strict *Per Stirpes***. About a half dozen states apply a strict per stirpes intestate distribution approach. Under this approach, each branch of the family tree receives an equal portion. In contrast with the *per capita* with representation approach, even if all of the members of the first generation predeceased the decedent, the members of the second generation share only the portion to which their parent would have been entitled had such parent survived the decedent.

For example, the distribution pattern if some but not all children survive is the same as in the first diagram for the *per capita* with representation approach. But if all of the children are deceased, leaving only grandchildren –



d. **Trust Dispositions**. When assets are left to descendants under a trust, the trust agreement should be drafted to make clear which of these approaches applies.

39. Providing for Guardian or Guardian's Family From Child's Trust

In drafting trusts, consider whether the guardian of a beneficiary may need financial assistance from the trust, despite receiving distributions for the beneficiary's direct expenses. For example, the guardian may need a larger home or a bigger or safer car. The trust could authorize distributions that indirectly benefit the beneficiary but that facilitate the guardian being able to take responsibility for the beneficiary. These could include purchasing a larger home, or purchasing a home in the community where the beneficiary lived, or paying a stipend to the guardian so the guardian will have more time to spend raising the beneficiary.

In addition, the trust might authorize distributions for the benefit of the guardian's other family members, such as camps, lessons, enrichment activities, vacations, or private school tuition in order to avoid singling out the beneficiary from the other children in the guardian's household.

40. Emancipation

In some states, a minor at least age 14 can be emancipated from the child's parents in one of three ways: (1) marriage; (2) active military duty; or (3) judicial emancipation. Requirements for judicial emancipation in California are (1) the minor is at least 14 years of age, (2) the minor wants to live separate and independent of the parents and they consent, (3) the minor can manage his or her own finances, (4) the minor can make money legally, and (5) emancipation would be in the minor's best interest. The emancipated minor then acquires most of the rights and responsibilities of an adult, but cannot vote or drink alcohol until the legal ages for those activities.

41. Guardian Ad Litem

a. **Purpose**. A minor can be bound by the results of a legal proceeding by (1) virtual representation, and (2) having a guardian ad litem. "Ad litem" means "for the action," so a guardian ad litem is a guardian appointed for that particular legal action. The guardian ad litem can be appointed on the judge's own motion in a legal proceeding at any time.

b. **Powers**. The powers of the guardian ad litem are quite broad, including the power to bind the minor in litigation. The guardian ad litem cannot waive fundamental rights of the minor, however, such as waiving a trial.

c. **Potential Liabilities**. The guardian ad litem does not have an attorney-client relationship with the ward; therefore legal malpractice liability is inapplicable. California courts have recognized that quasi-judicial immunity applies for guardians ad litem on the theory that they are quasi-officers of the court. The protection from liability is not absolute, however; the guardian ad litem can be liable for fraud or willful misconduct. The guardian ad litem must always act solely in the ward's best interest.

d. **Distinction from Attorney Ad Litem**. An attorney ad litem is the advocate of the ward. If the ward is able to express a position, the attorney is required to be an advocate for that position on the client's behalf. Courts sometimes appoint an attorney ad litem to represent a ward, but at least one panelist believes that the better practice is to appoint a guardian ad litem.

42. Virtual Representation

a. **Description.** Virtual representation is one way of binding a minor to the result in a judicial proceeding. At least 42 states have virtual representation provisions, and the trend is to include extensive provisions designed to allow trustees and other litigants to purportedly bind minor, unborn, and potentially unknown beneficiaries. Many of the states' virtual representation provisions are based on the Uniform Trust Code. Some states (such as Florida) have gone beyond that to add the concept of a "designated representative," which can be appointed by the settlor in the trust agreement to represent and bind a trust beneficiary and to receive any notice, information, accounting, or report.

b. **Constitutional Concerns**. Virtual representation provisions are very useful in providing finality in trust litigation disputes, but the concept runs counter to the "due process of law" rights of an individual to participate in legal proceedings and defend his or her interests. The U.S. Supreme Court has addressed these constitutional issues in several cases, and some of the Court's reasoning supports the virtual representation concept, at least for certain types of parties, in estate and trust litigation matters. In *Mulane v. Central Hanover Bank & Trust,* 339 U.S. 306 (1950), the trustee of a common trust fund sought judicial approval of an accounting and gave notice to beneficiaries by publication in a local newspaper. The court noted that while the type of notice required traditionally depended on whether the action was an *in rem* or *in personam* action, those distinctions are not very helpful in trust and estate litigation because those actions involve both personal and property rights. The court analyzed various competing factors involved with trust disputes, which can involve numerous parties with varying degrees of interest in the litigation and the desire of litigants for expeditious and efficient court proceedings that finally determine the rights of parties without the risk of future litigation over the same issues. The Court observed that the Due Process Clause of the Constitution does not require actual notice in all cases depending on the nature of the dispute. A distinction can be made between known beneficiaries who have a current interest and contingent beneficiaries or those whose whereabouts are unknown (for whom constructive notice by publication would be sufficient). The Court based its decision in part on the assumption that the parties who did receive actual notice would provide sufficient protection for all potential beneficiaries, as they had the same motivation in protecting their interests (which is the same concept underlying the rationale of the virtual representation statutes).

In 2008, the Supreme Court addressed the virtual representation concept in a Freedom of Information lawsuit. *Taylor v. Sturgell*, 553 U.S. 880 (2008). The court identified six traditional categories of issue/claim preclusion (preventing parties from pursuing claims when the same issue had been litigated by another party) that have withstood legal challenges. Four categories that are relevant to trust and estate litigation are (1) existence of a "substantive legal relationship" between the person to be bound and a party to the prior judgment, (2) adequate representation by someone with the same interests (specifically identifying trust and estate litigation as an example), (3) litigation through a proxy or agent of a previous litigant, and (4) the existence of a "special statutory scheme" which may foreclose litigants if the "scheme is otherwise consistent with due process" (identifying probate proceedings as an example of a valid statutory scheme).

c. **Uniform Trust Code**.

Section 301–Representation, Basic Effect. Notice provided to a person who may represent and bind another person has "the same effect as if the notice were given directly to the other person." The consent of a person who may represent and bind another person is "binding on the person represented if the person does not object to the representation before the consent became effective." The representation provisions do not contain any limitation with regard to age or competency, but the provisions apply to competent adult beneficiaries as well as minor, unborn, or unascertained beneficiaries. (Using virtual representation to bind a competent adult beneficiary may be subject to a constitutional attack under the reasoning of the *Mulane* and *Taylor* cases.)

Section 302–Holder of General Testamentary Power of Appointment. A person holding a power of appointment that is both (1) testamentary and (2) general may bind persons who are permissible appointees or are takers in default, but only if no conflicts of interest exists. Because persons who hold powers of appointment typically are also beneficiaries, the conflict of interest provision limits the utility of this provision.

Section 303–Fiduciaries and Parents. Fiduciaries, agents, or parents may represent beneficiaries, but only if no existing conflict of interest exists. The Comments explain that "[a] typical conflict would be where the fiduciary or parent seeking to represent the beneficiary is either the trustee or holds an adverse beneficial interest." Particularly helpful (but somewhat controversial) is the provision allowing a parent to bind his or her minor or unborn child if a guardian has not been appointed as long as no conflict of interest is present.

Section 304–Person Having Substantially Identical Interest. A minor, incapacitated person, unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable may be represented by another person having a "substantially similar interest" if no conflict of interest exists. This section is limited to persons who could not otherwise participate in the litigation—it does not apply generally to competent adult persons (unlike §§ 301-303). Therefore, representation under this provision may be safer from constitutional attack than under other sections. The Comments provide, as an example of a "substantially identical interest," a trust providing for distribution to a class of beneficiaries with an adult member of the class representing the other members of the class who are minors or unborn. A remainderman may represent a contingent remainderman on issues that do not involve a conflict of interest, such as approval of an accounting, but not with respect to an action to terminate the trust in favor of the remainderman.

Section 305–Court Appointment. The court may appoint a representative to represent a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown." The planner should make sure that the court order appointing a representative provides specifically that no conflict of interest exists (even though the absence of a conflict is not expressly required in the statute).

43. Representing Young Adults

Special issues arise in representing young adults. Some of the characteristics of these young adult clients are as follows.

- The have little understanding of legal proceedings or how litigation works.
- They are unsophisticated about financial matters.
- They often react emotionally, wanting to fight about every issue or withdraw from participation.
- They may not return phone calls or participate actively.
- They prefer to communicate by text messages (the panelist simply tells them that he does not operate that way),

Some best practice tips in representing young adults are as follows.

- Do not assume a paternalistic role; be the client's lawyer and advise as to available options.
- The young adult client may be angered by an attorney if the client perceives the attorney as stepping into the role of the parent who created the problem in the first place in the client's viewpoint.
- If the attorney must contact the client, a text message is more likely to get a response than a phone call, but do not provide advice via text messages.
- Keep focused on the long-term goal.
- Carefully advise the client not to post anything on social media about what is happening in the case. A post that "I talked with my friend about what the lawyer told me" could blow the attorney-client privilege.

APPENDIX

Development of a Family Business Objectives Statement
(AKA Family Business Mission Statement)

Written by and

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ACTEC 2018 SUMMER MEETING

STAND ALONE SEMINAR: LIFE CYCLE OF A BUSINESS ENTITY

June 20-21, 2018

Chicago, Illinois

Wind Down, Sale or Transition of an Entity

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

Development of a Family Business Objectives Statement
(AKA Family Business Mission Statement)

A. Long-Term, Mid-Term, Short-Term Goals for the Family Business

1. Do you plan to continue ownership and control of the Business by Family Members OR do you want to sell the Business (and if so when)?

   Continue ownership of Business ____________

   Sell Business ____________

   a. as soon as possible ____________
   b. next 2 years ____________
   c. next 5 years ____________
   d. next 10 years ____________
   e. ___ other ____________

2. Do you want the Business to grow and expand OR do you want the Business to maintain its current size?

   Grow and expand ____________

   Maintain current size ____________

3. If you want the Business to expand, do you want expansion to be limited to the present geographic market areas?

   Yes ____________ No ____________

   Do you want the Business to expand to new metropolitan areas (and if so to which areas)?

   Yes ____________ No ____________

   New Metropolitan areas: ________________________

   Do you want the Business to expand to new states (and if so, to which states)?

   Yes ____________ No ____________

   New states: ____________________________________

4. If the Business is to expand, do you want to expand through acquisitions of existing operations OR by establishing new operations OR both?

   Acquisitions of existing operations ____________
   Establishing new operations ____________
   Both ____________

5. If the Business is to expand, do you want expansion of the Business to be limited to the present line(s) of business OR do you want to establish new line(s) of business OR both?

   Present line(s) of business ____________
   Establish new line(s) of business ____________
   Both ____________

6. If the Business is to expand, will the expansion be conducted through:

The existing Business entity	____________
A subsidiary of the existing Business entity	____________
A new entity	____________
Combination of above	____________

7. If a new entity is used, will the Family Members have the same ownership in the new entity as the existing Business entity?

   Yes ____________ No ____________

8. Will additional benefits be provided to the employee-Family Members who participate in the expansion of the Business?

   Yes ____________ No ____________

   If yes, which of the following benefits will the Business elect to use to compensate the key employee-Family member?

   Increased compensation Yes ______ No ______

   Bonus packages based on the profitability of the old and new businesses

   Yes ______ No ______

   Equity options in the new entity Yes ________No ______

   Phantom Equity Plans/Equity Equivalency

   Plans in the new business Yes ______ No ______

9. What <u>approval</u> will be required before the Business can pursue expansion plans?

Majority vote of the Governing Body	Yes	______	No	______
Majority vote of the Owners	Yes	______	No	______
2/3 vote of the Governing Body	Yes	______	No	______
2/3 vote of the Owners	Yes	______	No	______
Unanimous vote of the Governing Body	Yes	______	No	______
Unanimous vote of the Owners	Yes	______	No	______

10. If the Business is to expand and grow, would this expansion be funded by internal cash flow, borrowing, or raising additional equity capital, OR a combination of the above?

Internal cash flow	____________
Borrowing	____________
Additional equity	____________
Combination	____________

11. Do your goals for the Business include one or more public offerings?

    Yes ____________ No ____________

Would you consider taking steps to make the Business more suitable for taking the Business public such as:

Audited Financial Statements ____________

Outside Members on Governing Body ____________

Hiring Investment Banker to analyze public company option ____________

Discussing options with Underwriters for taking company public ______ ______

12. Please write a brief summary of your view regarding growth and expansion of the Business.

____

____

____

B. Equity Ownership

1. Will equity ownership in the Business be limited to only "Family Members" **[as discussed below in Section B(2)]** OR will both "Family Members" and "non-Family Members" be allowed to own equity in the Business?

   Family Members only __________________

   Both Family Members and non-Family Members__________________

2. If equity ownership in the Business <u>is limited</u> to "Family Members", then who would be considered a "Family Member"?

   Children (including adopted children) ______

   Grandchildren______
   Spouse ______
   Parents ______
   Grandparents______
   Siblings ______
   Aunts ______
   Uncles ______
   Cousins ______
   In-laws ______
   Others ______

3. If equity ownership in the Business <u>is not limited</u> to Family Members, then who else could own equity in the Business?

   A key employee Yes ______ No ______

   An unrelated third party financial partner Yes ______ No ______

   Others____

4. Would an owner of the Business be required to work in the Business in order to own equity in the Business? Yes____________ No__________

If so, for what time Period? _________________.

If not, should there be differences in the classes of equity (i.e., voting and non-voting) held by Family Members based upon whether they work in the Business.

Yes ____________ No ____________

5. Would a Family Member be able to transfer equity by gift to members of his or her family without the consent of the other owners?

   Yes ____________ No ____________

6. Should there be a mandatory purchase of the equity of a Family Member by the Business upon the occurrence of the following events?

   Death of a Family Member ____________

   Disability of a Family Member ____________

7. Should the Business and/or other Family Members have an option to purchase equity of a Family Member upon the occurrence of any of the following events:

   Death of a Family Member ____________
   Disability of a Family Member ____________
   Attempted sale of equity to a third party ____________
   Termination of employment of a Family Member from the Business ____________
   Divorce of Family Member where spouse is awarded equity by divorce decree ____________
   Death of spouse of a Family Member where deceased spouse does not leave equity to Family Member spouse____________

8. In the event an employee-Family Member should voluntarily terminate his or her employment with the Business should the other Family Members or the Business be required or have the option to purchase the withdrawing Family Member's equity in the Business?

   Yes ____________ No ____________

   What should be the purchase price for the withdrawing Family Member's equity?

   Predetermined Fixed Amount Per Share ____________

   Book Value ____________

   Fair Market Value ____________

   Other Value ____________

   How should the purchase price be paid?

   All Cash Up-front ____________

   Part Cash/Part Note (i.e. financed) ____________

   All Note ____________

Should a withdrawing Family Member be required to enter into a covenant-not-to-compete as a condition to the purchase of his or her equity?

Yes ____________ No ____________

9. Should there be differences in the classes of equity (i.e., voting and non-voting) in the Business based upon the following:

   Age of a Family Member Yes ________ No __________

   Experience in working in the Family Business Yes ________ No __________

10. Should equity ownership in the Business be equally divided among the second generation families?

    Yes ____________ No ____________

11. How can a Family Member who does not already own equity in the Family Business acquire equity in the Business?

    By gift or inheritance Yes ______ No ______

    By purchase of equity based upon the full fair market value Yes ______ No ______

    By purchase of equity pursuant to an Equity Option plan Yes ______ No ______

`12. Do you wish to use Phantom Equity/Equity Equivalency plans in lieu of equity ownership for the Family Members who do not own equity in the Business?

    Yes ____________ No ____________

C. Employment of Family Members In Business

1. Will all Family Members be guaranteed a job in the Business?

   Yes ____________ No ____________

   If a job is to be guaranteed, will a Family Member be guaranteed a job in management OR a job based upon the skill level of the Family Member?

   Management ____________

   Skill level ____________

2. Will a college degree be required in order for a Family Member to participate in the management of the Business?

   Yes ____________ No ____________

3. Should there be a training program for a new employee-Family Member of the Business?

   Yes ____________ No ____________

   If so, should the training program be limited to new employee-Family Members who satisfy the criteria to become a member of management of the Family Business?

   Yes ____________ No ____________

If there is a training program for new employee-Family Members, how many Family Members should oversee the training program?

1 ______
2 ______
3 ______
Other ______
The Governing Body______

D. Compensation of Family Members Employed In Business

1. Will all employee-Family Members receive the same compensation or will compensation levels vary based upon such factors as position and responsibilities, experience, performance, length of service, etc.?

   Same compensation ____________

   Varying compensation ____________

2. Will employee-Family Members receive a minimum salary (i.e. no Employee Family Member will be paid less than $40,000 per year regardless of position)?

   Yes ____________ No ____________

3. How will employee-Family Members in the Business be compensated?

Below fair market value	Yes	______	No	______
Fair market value based on industry standards	Yes	______	No	______
Above fair market value based upon industry standards	Yes	______	No	______

4. Who will determine the compensation of the employee-Family Members?

Chief Executive Officer	Yes	______	No	______
Governing Body	Yes	______	No	______
Advisory Board to the Governing Body	Yes	______	No	______
Other	Yes	______	No	______

5. Will a key employee-Family Member receive special compensation treatment based upon an increase in value of the Business?

   Yes ____________ No ____________

   Based upon an increase in profits?

   Yes ____________ No ____________

6. If the employee-Family Member is to receive some special compensation arrangements, will it be paid:

   On an annual basis through bonuses?

   Yes ____________ No ____________

By issuing Phantom Equity bonuses to be paid upon sale of the Business?

Yes ____________ No ____________

Upon sale of the Business through use of a covenant not to compete, bonus or severance pay arrangement?

Yes ____________ No ____________

7. Should the Business pay fees to its Governing Body?

Yes ____________ No ____________

8. Should the Business, if taxed as a C-corporation, consider revising its structure in order to be taxed as an S corporation?

Yes ____________ No ____________

E. Other Business Activities

1. Will an employee-Family Member be restricted from pursuing other business activities outside of the Business while he or she is an employee of the Business?

Yes ____________ No ____________

What approval will be required before an employee-Family Member can pursue another business activity outside of the Business:

Majority vote of the Governing Body	Yes	______	No	______
Majority vote of the Owners	Yes	______	No	______
2/3 vote of the Governing Body	Yes	______	No	______
2/3 vote of the Owners	Yes	______	No	______
Unanimous vote of the Governing Body	Yes	______	No	______
Unanimous vote of the Owners	Yes	______	No	______

2. Will the vote of the Owners/Governing Body-Family Member desiring to engage in another business activity be counted in the above votes?

Yes ____________ No ____________

3. If an employee-Family Member is allowed to pursue another business activity should there be a compensation adjustment for that person?

Yes ____________ No ____________

Who determines the salary adjustment?

Governing Body	Yes	____________	No	____________
Owners	Yes	____________	No	____________
Advisory Board to the Governing Body	Yes	______________	No	____________

4. Should there be a limitation on the amount of time an employee-Family member of the Business can spend on an outside activity?

Yes ____________ No ____________

What limitations of time, if any, should be placed on the employee-Family Member?

None	______
10 hours a week	______
15 hours a week	______
20 hours a week	______
30 hours a week	______
40 hours a week	______

F. Management Succession Plan

1. Can a person other than a Family Member be the Chief Executive Officer of the Business?

   Yes ____________ No ____________

2. Can an in-law be considered for the position of Chief Executive Officer of the Business?

   Yes ____________ No ____________

3. Should a person reach a certain education level before such person can be eligible for the position of Chief Executive Officer?

   Yes ____________ No ____________

   What education level should a person achieve before he or she can be considered for the position of Chief Executive Officer?

High school degree	____________
College degree	____________
Graduate degree	____________

4. How many years should a person be employed by the Business before he or she can be considered for the position of Chief Executive Officer?

5 years	______
10 years	______
15 years	______
20 years	______
Other	______

5. Who should be <u>involved</u> in making the decision of who the new Chief Executive Officer of the Business will be?

The existing Chief Executive Officer	Yes	______	No	______
The Governing Body	Yes	______	No	______
The Advisory Board to the Governing Body	Yes	______	No	______
The Owners	Yes	______	No	______

Should greater than majority approval of the electing body be required in the selection of the new Chief Executive Officer?

Yes ______ No ______

If greater than majority approval is required, what percentage approval is necessary?

60% ______

66-2/3% ______

75% ______

100% ______

Other ______