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Successor Partners: Gifting or Transferring a Business or Real Property to the Next Generation

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I. Introduction

A significant portion of the wealth transferred to adult children by parents in the United States is in the form of operating businesses. The value of business assets after transfer is often contingent on the ability of the successors to work together. Whenever successors must collaborate as co-owners or managers, the risks to a successful transfer and preservation of wealth are greatly compounded. Next generation partners must not only have the requisite business skills, they must also have the ability to work as a team.

In this article, we will examine the value of succession and estate strategies that create partnership teams in the next generation and describe some of the risks inherent in such strategies. We will also describe a tool called the Partnership Charter that helps control the risk through an intense planning and negotiation process for those family and non-family members who are the intended co-owners.

II. Creating Partnerships: Benefits and Risks of Passing Key Assets to More Than One Person

It is quite common for business owners' estate plans to include passing a key asset jointly to more than one person. In many cases, transferring assets to multiple people may be the only alternative. A vacation home or investment property may be difficult to divide into pieces and spread to different children for emotional, financial, or other reasons. Parents may have more than one child working together in a family business and in cases where only one child works in the business, he or she may not be able to purchase the

business without taking on a partner, such as a key employee. There are many estate-related strategies that include the creation of partners of one type or another among the heirs, or involving an heir and someone else, such as a key employee.

Including multiple successors in an estate plan can help ensure success. A priori, we know that partners taking over a business have a greater chance of success than one person alone because of the increased resources that additional owners contribute (money, skills, experience, etc.), at least if the partners can avoid conflicts with one another. There is also empirical evidence that demonstrates that having partners produces positive, tangible business results beyond what solo inheritors or successors can achieve.¹

Estate plans that create business or real estate partnerships (regardless of the specific type of legal entity) may be laying the groundwork for future success; however, they are simultaneously creating challenges that are not present when assets are transferred to one heir alone. In the multiple-successor scenario, the partners have to cooperate to some degree or the transfer will ultimately fail. This is obviously the case, for example, when the sale of a business during the parent's lifetime will be funded over time from the cash flow of the business. But it is also true in many cases whether or not the parents will be dependent on the cash flow. When one or more children are involved in taking over the business, parents are likely to feel that an asset transfer is a success only if their children get along well as partners. This is the case even if there is only one son or daughter involved and the other part-

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¹ Researchers at Marquette University investigated a sample of nearly two thousand companies and categorized the top performers as "hypergrowth" companies and those at the bottom as low-growth companies. Solo entrepreneurs founded only 6 percent of the "hypergrowth" companies. Partners founded a whopping 94 percent, and many of those companies had three or more founders. In stark contrast, solo entrepreneurs founded nearly half of the low-growth companies.

ner is a key employee. For many parents, the success of the child as an owner is more important than any money they will receive.

Plans that turn heirs into partners also create risks that are absent when an asset is passed to one child alone. All plans that rely on the success of people working together must face one serious drawback: Partnerships are notoriously unstable. It is for this reason that so many advisors warn people to avoid any kind of business partnership. It's also why a poll of business people reported that two-thirds of the respondents thought partners were a "bad idea."²

There are no meaningful statistics available on the half-life of the kind of partnerships we are discussing because a business or jointly held property may take almost any legal form. However, it is much shorter than most people realize. A conservative estimate of the number of businesses with partners that fail within five to ten years may be as high as 50%. Perhaps more revealing, among family businesses the most frequently cited statistic is "30-13-3." It claims that only 30% of all family businesses survive to the second generation (which is taken to mean that 70% fail); only 13% survive to the third generation; and a mere 3% ever see the fourth.³ Whatever the validity of that statistic, there is little doubt that the success rate of family businesses as they pass from generation to generation has a great deal to do with the challenge of having siblings, cousins, and others as partners; and the more partners, the greater the risk. Any family that can minimize those risks improves their chances of success, both for the individuals involved and for the estate plan. Understanding the sources of risk in estate-related partnerships can help reduce the level of risk.

III. Why Is Having Sibling, or Other, Partners So Risky?

Partners have a complex relationship that is both business and personal in nature. There are groups of partners who have trouble managing some aspect of the business side of their relationship and end up unhappy, unfulfilled, fighting or unwinding their partnership. They may have different visions of what the business should be and where it should be headed. They may fight over who's president, or not have faith that their partners are capable of performing their jobs. They may fight over money—how much to put into the business, when and how to make distributions, or how to spend money. Many purely business-related issues provoke conflict among partners and may cause one or more of the partners to believe it is not worth their while to continue together. In one case, two brothers in their forties

became partners when their father retired from the consulting company he had founded. They fought ferociously for twelve months over whether the brother belatedly entering the family business would be a 45 or 50% co-owner. Their fight tore at the very heart of the family, especially because everyone claimed that for all their lives they had been the closest of brothers and "a cross word had never come between them."

While those brothers had always gotten along beautifully, many successors fail because they cannot get along on a personal level. In some cases, the businesses may be performing well but some or all of the partners may leave the business because they cannot work out their individual differences. They may have personalities that rub the wrong way, or they may have personal values that conflict. Despite what many people believe, even siblings raised in the same household may have personal values that are so disparate that they cannot work together in a cooperative manner. Some partners have unrealistic expectations of their partners and feel let down by them despite having never shared their expectations with their partners. Other partners are plagued by the belief that the arrangement among the partners is not fair, that they have been disadvantaged in one way or another because of what their partners get that they don't. These interpersonal issues are particularly nettlesome when they are played out against the background of the family relationships.

In most cases, partners' conflicts are not just business, or not just personal, but span both the personal and business realms. The issues are an intricate blend of interpersonal complaints and financial, management or ownership issues. But the complexity inherent in partnerships is not by itself a sufficient explanation for why they are so unstable. We know that some partnerships are exceptionally successful. In 15 years of mediating disputes among family and non-family partners, the stories we have heard from partners lead us to the conclusion that the best explanation for why partners experience such difficulty is because they fail to plan in sufficient detail for how they would work together. In the context of estate planning, this means that the problem is not leaving the parents' second home at the beach to all of the children or putting the mother's company in the hands of her daughter and a key employee. The problem is insufficient planning by the clients for how these partnerships would work.

IV. The Roots of Poor Partnership Planning

The simplest explanation for why people who are going to become partners fail to plan adequately is a

² Inc. "Are Partners Bad for Business?" February 1992, p. 24.

³ Beckhard, R., & W. G. Dyer Jr. (1983). Managing continuity

in the family-owned business. *Organizational Dynamics*, Summer, pp. 5-12.

lack of understanding of what goes into creating and maintaining successful partnerships. There has been a dearth of research or even anecdotal information on the subject. Consequently, few people are cognizant of the issues they need to deal with. Not even business schools teach people about the issues that are most likely to bring partners to their collective knees. Many people are under the impression that if they have the appropriate legal documentation in place (shareholders or partnership agreement, buy-sell agreement, operating agreement, etc.), then they have done everything they need to do to structure their partnership. Though these documents are necessary, they serve a limited, legal purpose and unfortunately give people a false sense of security that they have sufficiently prepared themselves for the rigors of being partners.

Planning is short-circuited in many cases because some of the issues that require discussion and negotiation are highly sensitive. Even people who are reasonably skilled communicators stumble when talking about things like power-sharing, authority, decision-making, money, perks, personalities, work ethics and values. This sensitivity only escalates when family relationships are involved.

In many families, the need for future partners to thoroughly plan their partnership is obscured by the fact that the successors have seemingly been functioning like partners, sometimes for years. What people in these circumstances have trouble understanding is how very different it is to actually be partners and have no one “higher up” to turn to when an impasse is encountered. This is especially true when the parent has been relatively uninvolved. Sometimes the mere fact that a parent is still alive can keep partners from confronting one another. That can be positive, but the presence of parents can also cause offspring to forgo discussing and working through their issues in a way that they must if they want to be effective as a team.

Parents, too, bear some of the responsibility for poor planning on the part of their successors. Many parents imagine it is their job to set up the partnership team for the next generation, but partnership planning can only be successful when it is lead by the prospective partners without the parents’ input. The dynamics are very different when adult children work through their differences among themselves, even with mediators, than when they are receiving input, or being monitored by parents. It’s easy for parents who have been in charge for so long and who have had responsibility for defining their children’s roles in the business to believe

it is also their responsibility to determine how their children will work as partners after they pass the baton of leadership and ownership to them. We have also seen numerous instances where adult children are trying to work out their future relationship among themselves and one or more of the children try to involve the parents in the hope that the parents will intercede and tell them how they should work together after the parents are gone. The process can make parents and grown children anxious. This kind of control on the part of the parents, and dependence on the part of adult children, is not easy to grow out of but that is exactly what families in these circumstances need to do if they want the next generation to be successful on their own without their parents adjudicating their relationship.

V. Lowering Risk through Effective Planning: The Partnership Charter

To lower the risk of conflict, adult children who are becoming partners with one another, or with key employees or some other person, need to discuss, negotiate and come to thorough understandings and written agreements on numerous business and interpersonal issues. A structured method for accomplishing this is a tool which we have developed based on our experience working with family businesses and partners in transition—the Partnership Charter.⁴ The business issues that are addressed in the Charter process include: (1) the partners’ strategic plan for the business; (2) ownership matters; (3) roles, titles, authority and managing the business; (4) how money goes into and comes out of the business; and (5) governance. The interpersonal issues include (1) personalities, (2) personal values, (3) expectations of one another, and (4) the question of fairness.

There are two additional topics covered in the charter process that have to do with the future. One is scenario planning as it relates to the partners. The other is a multistage plan for how the partners will resolve disputes if they arise. Each of the topics that comprise the Partnership Charter was included because some partnerships have foundered over the issue. By discussing and reaching agreements before conflicts arise, partners inoculate themselves for the vast majority of destructive conflicts.

None of the topics in the Charter process is novel. There are, however, several qualities of Partnership Charters that distinguish them from less rigorous and more ad hoc approaches to partner and family business planning. First, they are produced through a systematic

⁴ David Gage, *The Partnership Charter: How To Start Out Right With Your New Business Partnership (Or Fix The One You’re In)*, New York: Basic Books, 2004. The book was written for people with partners, or planning on becoming partners. It is also the

textbook for Gage’s course entitled, “Managing the Family Owned Business,” which he teaches in the business school at American University.

process that facilitates effective and thorough discussion of the entire range of business and interpersonal issues that cause conflicts among partners. Second, the Partnership Charter process includes tests (personal styles, personal values) and exercises that provide insights and candid information to give form and substance to the participants' discussions and negotiations. The structured process, tests, and exercises help keep people from short-circuiting some discussions that are difficult to have without data to work with and a framework that says, in effect, "Ignore these topics at your own risk." Finally, the Partnership Charter is a document as well as a process. The partners' have not completed the Charter until they have reached consensus on all of the issues. This forces a degree of specificity and a level of commitment that less formal processes and legal documents will not achieve.

Partnership Charters are non-binding documents that are different in their purpose, form and content than partnership agreements, shareholder agreements, operating agreements, or buy-sell agreements. They embody the "deal" among the partners in all of its tangible and intangible aspects. Parents frequently give their children's charters to their estate-planning attorneys as one source of information for preparing their estate plans. They also give them to other attorneys for the purpose of helping draft other legal documents. Most importantly, the partners themselves use them for years to come as a guide for working together on a day-to-day basis and to help them make periodic reviews. Charters are meant to be living documents that the partners review and revise periodically to keep their partnership vital in light of changing realities.

VI. The Role of a Partnership Charter in Succession and Estate Planning

It is sometimes said that succession planning should be on the minds of business founders from the moment they start their businesses the same way that pilots have to think about landing from the second they take off.⁵ Whenever it becomes clear that "the successor" will be more than one individual, the planning should entail putting the successor team to the test using the Partnership Charter process.

A typical example of the way the Partnership Charter is used in helping successors assume control of a business occurred recently in the ownership transition within the Matsen Insurance Brokerage Company. The insurance and financial services firm that Ralph Matsen founded in California was in the business of helping people make intergenerational transitions, so Matsen had a feel for the challenges inherent in partner situa-

tions. Like most seasoned entrepreneurs, he had a solid management team in place as he neared retirement. His son and the three other executives had all been with his company for at least a decade, and the four of them had been largely running the business for a couple years. Despite their track record and despite the fact that they appeared to be naturals for taking over, Matsen knew the difference between co-executives and co-owners. He encouraged the foursome to work out their own charter and he told them that he would not be meddling or hovering around while they were working on it. He understood that doing so would distort what they were doing.

The four executives hired two mediators (a psychologist and a former estate-planning attorney) to conduct a three-day Partnership Charter retreat. Even though the future owners had been working together for years, with the help of feedback on their leadership styles and personal values, they were able to develop new, clear agreements about how they would work together more effectively. They clarified their expectations of one another, what their roles and responsibilities would be and how they would hold one another accountable. They brainstormed every conceivable type of scenario that might threaten the health of their partnership and devised guidelines for how to deal with them. They agreed on a multi-step procedure for resolving conflicts that might arise.

There were certain ownership and management issues that the four executives would likely not have dealt with except for two important reasons. First, they dedicated a large block of time to looking at every aspect of their partnership. It is rare for people to dedicate that kind of time to focus just on their partnership. People will spend intense time on business planning but rarely on partnership planning. Second, while it is common for people becoming partners to have conflicting needs and interests, having business mediators involved in the charter process helps ensure that all of the hidden agendas and differences will get surfaced and negotiated. Mediators conduct thorough, confidential interviews with all of the parties. Although reluctant to admit it, most people becoming partners have some information that is important to them that others are not privy to or aware of. A major advantage of the mediation approach is the confidentiality it provides people in private meetings with the mediators. These meetings, when conducted by experienced mediators who know what to look for, have the power to get people discussing uncomfortable issues that may seem petty but are important to deal with. Many partner disputes we have mediated revolve around what sound like petty issues, but they were simply issues that should have been discussed but never were.

⁵ Kenneth Kaye, "Happy Landings: the Opportunity to Fly Again," *Family Business Review*, vol. XI, no. 3, pp. 275-280,

The charter process allowed the four successors to decide for themselves that it was a good idea to become partners, and they agreed on exactly how they would do it. The process gave everyone more clarity about the details of the plan and more confidence that they were truly addressing the topics they needed to cover. Of course, successors have to understand going into the process that the business owner has the right to turn down what is essentially a succession plan of the successors' making. They also have the right to determine the timing of the transition. While the successors deserve the right to work on a charter to help them decide if they want to work together and how they will run their own, future partnership, the owner certainly has the right to examine what they devise and decide if he or she wishes to one day turn over the business to the ownership and management entity that the future partners have designed. If the successors develop something the owner believes is unworkable for any reason, he or she is not obliged to transfer the business to them.

To insure future partners against the risks inherent in co-ownership, people need a structure in which to discuss sensitive, difficult issues and a process that fosters open and candid discussions. This candor is critical for dealing with issues in great detail and removing the sliver of ambiguity that exists in most partnerships and sooner or later provokes conflict. A mediation-retreat format capitalizing on the confidentiality of individual interviews is often a key to the success of the process. Utilizing feedback from personal styles and personal values tests and structured exercises makes the discussions of how to create effective working relationship more productive. Finally, memorializing the agreements covering both the business and interpersonal sides of being partners protects partners from destructive conflict.

Parents who are planning on transferring business or real estate assets to a successor team often need the help of advisors to determine the timing of the work on the successors' partnership. The parents can take the initiative by telling their children that they would like to start succession and estate planning and by sharing their thoughts about their needs and preferred succession timetable. The parents and estate planner may also discuss with the children the need for them to take the next step. Parents need to know whether or not a team is viable before plans are designed. Successors deserve to know whether or not they can and want to work with one another before it becomes too late to pursue alternatives. Sigmund Warburg, the founder of the Swiss banking giant, UBS, proclaimed, "All events should be crossed in imagination before reality." The time for this work is certainly as early as possible once the

players are identified, bearing in mind that the process also helps in the identification of the eventual partners.

In family businesses, who should be involved in the charter process can be a tricky question to answer. Siblings may work in the business, leave, and later return. The safest thing to do is err on the side of inclusiveness by inviting every sibling who has an interest, however nascent, in being a partner. If this is not done, a child may later complain that he or she was treated unfairly by not being given a chance to be a partner.

"Partner" in this sense may mean simply owning as well as working in the business, but this is an issue that needs to be addressed within each family. We have seen many siblings have mature, businesslike discussions about who should be an owner and the problems with having both working and non-working owners. These discussions become critical as the partner, or co-owner, team expands from the second to the third generation. It is important for co-owners to renegotiate their Partnership Charter whenever the composition of the ownership team changes. Although that seems like a lot of work, because owners are so critical to the health of a business and because the charter is the owners' basic insurance against conflict, it is efficient as well as effective in the long run to renegotiate it each time.

There is no guarantee going into the process that the children will like what they experience in this "road test." In many instances, we have seen siblings, or a sibling and a key employee work on a charter and realize that they do not wish to commit to a partnership with each other. Typically, in these situations there is much relief because people realize that their partnership probably would have experienced problems later. People are then free to begin making other career plans, and parents are able to find alternative exit and estate strategies.

When an agreement among parents and successors is attained, the estate planner can begin developing an overall estate plan that incorporates the understandings the parents and the future partners reached. Families will then also have a need for professional help with activities such as financing the purchase of the business, creating professional development plans for children, conducting cash-flow planning, etc.

The success of the Partnership Charter process is not dependent on confirming people's initial expectations or desires regarding the future successor team. The success of the process stands on people having clarity about who will constitute the team and greater confidence in the ability of the partners to eventually take over, work well together, and maintain and grow the asset they acquire.