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The Family Implications of Trusts

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At a recent conference I attended, an excellent presentation raised questions about the impact of the use of trusts in family business transition planning particularly to the degree that trusts create "passive" shareholders. [1]

As I discussed in Upside Down Planning (click here), I believe that the most successful transitions in family businesses occur when successors are empowered and are proactive, rather than when "passivity" is designed into the process.

The use of trusts for family business transition planning is becoming increasingly popular. Trusts have many positive benefits including the minimization of transfer taxes, protection of assets from creditors, and creating a fiduciary responsibility to manage assets for a beneficiary. And in fact, The Uniform Trust Code (UTC) (amended in 2003) increases these fiduciary responsibilities of trustees. Recent changes in the law now permit greater flexibility in the design of trusts that can encourage a more proactive approach for the beneficiaries.

Yet while there are distinct tax planning advantages to the use of trusts, they often undermine successful family development and the growth of responsible adults.

By definition, the beneficiary of a trust is passive and the trustee has the responsibility to protect the interest of that beneficiary. For example, I work with a family-owned business where each of the four siblings had their voting stock held in trust, and the trustee was their deceased father's attorney. The attorney had the responsibility to vote the shares for all four siblings. These siblings, however, were in their late 30s and had conflicting approaches to the strategy of the business. Yet they could not be proactive and take responsibility as shareholders to provide direction to their major investment, namely their family-owned company.

In this case and many others, what is the "best interest of the beneficiary?" Normally this is defined in financial terms and trustees often take a fairly conservative approach to the financial interests of the beneficiary. However, "best interest" does not address the psychological needs and interests of the individuals and their relation as family members.

The use of trusts in transition planning often undermines the process of developing responsible shareholders who understand enough about the operations of the business and the responsibilities of the Board of Directors to make informed choices. To be successful as shareholders they must develop the necessary skills through education, the ability to make wise choices and decisions, and operate within the framework of appropriate governance structures for the business.

As Hier and Hampton stated so well in their presentation: " Trusts can remove decision-making authority of family members and weaken initiatives for shareholder education . . . The existence of a trust can remove the incentive to create participative family governance structures; the existence of a trust document can lead to the mistaken conclusion that no other governance structure is needed or possible. Trustees can see boards and other governance groups as interfering with their ability to exercise proper fiduciary responsibilities."

What are the alternatives in designing trusts that promote healthy adult responsibility, rather than creating passive shareholders?

- Make sure the trust documents include the requirement to work with effective governance structures for the family business, including a Family Council, shareholder meetings and the Board of Directors.
- Create requirements for joint decision-making rather than investing all of the power in a single trustee.
- Build in a process to create flexibility so that a different trustee can be named every three to five years.
- Require that the trustee have responsibilities, not only to protect financial investments, but also to provide education, information and regular communication to the beneficiaries.
- Identify methods to keep the beneficiaries actively involved in the processes of governance of the business so that they become responsible shareholders.

[1] Andrew P. Hier and Marion McCollom Hampton at Evanston, IL, April 28, 2007