

# Managing trust successions for family businesses

**IN ADDITION TO THE USUAL DIFFICULTIES IN MANAGING SUCCESSION FOR TRUSTS, ADVISERS SHOULD BE ENCOURAGED TO GIVE CONSIDERATION TO BUSINESS AND FAMILY VALUES WHEN CONSULTING TO FAMILY BUSINESSES.**



## INTRODUCTION

When implementing a discretionary trust structure for family businesses, legal and financial advisers are required to consider various issues, such as taxation planning (including potential capital gains tax (CGT) consequences) and succession planning. Advisers should, in particular, ensure that the control of the trust passes to the intended successor or successors and, in doing so, give careful consideration to appointor provisions and the selection of the shareholders and directors of the corporate trustee.

In an environment post-trust cloning and splitting (except in limited circumstances where splitting may not constitute resettlement of the trust), there are further difficulties in managing succession for a trust where there is an asset or assets which are to be divided between family members.

Previously, options included “cloning” a trust so that the deed establishing the trust was replicated in exactly the same form through a new trust settlement and the old and new trusts existed side-by-side. In such circumstances, control of each trust could pass to individual family members, eliminating the need for children to manage and control assets together.

The options are now more limited. They include the distribution of assets among successors, albeit associated with CGT and stamp duty consequences. A statement of wishes is another alternative. However, if a statement of wishes imposes binding obligations on a trustee, the rights to the trust asset may become fixed and therefore there may have been a deemed disposal of assets for CGT purposes.

Consideration should be given to all of the above in the context of consulting to businesses, including family businesses. Increasingly, it has become apparent that family businesses are deserving of considerations in addition to the above. The term “family business” is used broadly, but generally refers to a business where the ownership and/or management of the business are influenced by family.<sup>1</sup> Commonly, this assumes that the business has family members of different generations working within the organisation. This view does not take account of the fact that, at its extreme, a family business will have differing tiers of ownership, management and influence by members of a single or extended family. In some family businesses, ownership, management and influence resides within the same people or group of people, and therefore they have almost total influence over the business. In other family businesses, while the family might control ownership, management responsibilities rest in whole or in part with non-family employees. As such, the issue of the influence of the family is of more relevance.

## FAMILY BUSINESS SYSTEMS

Generally accepted wisdom is that a family business is comprised of three separate but overlapping systems: the business system, the family system and the ownership or governance system.<sup>2</sup>

The *ownership or governance system* sets the mission and goals of the business, and controls directorship and the range and breath of ownership.<sup>3</sup> The *family system* sets the roles of and relationships between family members, and ensures that family communication and (where appropriate)

conflict is appropriately managed.<sup>4</sup> The *business system* sets the strategy for the business, and is responsible for all of its internal processes and procedures (eg technology) and ultimately for its results.<sup>5</sup> Within these three distinct systems, there are a number of roles. These include:

- (1) non-family owners who, while involved in the ownership/governance system, are not family;
- (2) inactive family members who do not own or work in the business;
- (3) non-family managers and employees who work in the business;
- (4) family owners who do not work in the business but have an influence over family members who do;
- (5) non-family members who both own and work in the business;
- (6) family employees, being family members who do not have ownership but are active in the business; and
- (7) family members who have ownership and manage the business.<sup>6</sup>

The above groups are responsible for the business, ownership/governance or family systems. However, the roles are not mutually exclusive. For example, roles carried out by family members who have ownership and manage the business overlap with the ownership/governance, business and family systems.

All of the above roles and systems must be pulled together to provide a viable business that services the needs of its customers and suppliers. When providing advice in relation to the establishment of business structures, advisers typically do not take account of these various systems and the people involved in them.

Importantly, advisers do not take account of the inherent conflicts between business and family values. Some of the key differences between business and family values are:

- a business primarily exists to increase shareholder wealth by being profitable and efficient. Conversely, families exist to develop and support family members, with a primary focus on relationships.<sup>7</sup> As such, family businesses can often take a much longer-term view than a non-family business. Family relationships in effect last a lifetime, whereas business relationships are often only for a short duration and are not of fundamental importance to those involved;
- family businesses tend to be hierarchical, usually based on seniority or the position within the family (eg eldest son);
- under-performance by family members engaged in a family business is often tolerated;
- remuneration or other rewards for family members tends to be based more on who they are, not what they contribute to a business. This kind of environment can be juxtaposed with non-family businesses, where employees are rewarded for results and are advanced purely based on performance;<sup>8</sup> and
- succession in a family business is often not planned, and frequently only occurs on death or some other traumatic event, such as divorce. Conversely, succession occurs in other businesses on retirement, promotion, resignation or termination. One of the advantages of succession in a family business is that training can begin early, with mentoring being treated as a lifelong process. However, family issues may create an inability to choose an appropriate successor or successors. This inability is cited as one of the major reasons for the high mortality rates of family businesses.<sup>9</sup>

### ADDITIONAL MEASURES TO BE TAKEN

Frequently, the diverse (and often competing) values between business and family are not taken into account by advisers when recommending the

use of a trust in the establishment of a family business, and they are frequently not taken into account when providing recommendations for its succession.

Simplistically, if succession for a family business was being considered and that was the sole consideration, a trust would not be the recommended structure. A trust may not allow consideration to be given to the potential conflict between business and family values. However, a trust does have the ability to act as an inhibitor against a person leaving the family (or its business or investments) in circumstances where no one can effectively claim an interest in the trust or his or her entitlement or inheritance.

Increasingly, families are turning to the following options to minimise conflict and better manage the divergent values between family and business:

- (1) convening family meetings;
- (2) establishing family councils, where certain members of the family are either appointed or elected to oversee the family's workings and may, for example, appoint those members of the family who will act as directors of the family business enterprise. The family council is not necessarily limited to the consideration of family business issues but may also consider family investments, family relationships, the advancement of the family in non-business pursuits, and the setting of the philanthropic strategies of the family; and
- (3) establishing family constitutions (previously, frequently called deeds of family arrangement) whereby the family records its internal agreements. This can be as simplistic as setting the rules for the family council or, alternatively, providing an outline of inheritances, the division of assets on death, and other related rights and entitlements.

### REVIEWING THE TRUST DEED

In addition to the above measures, in order to balance business and family values, the power of appointment remains critical for family trusts. The appointor effectively has control of the trust, as it is the appointor that usually has the power to appoint or remove the trustee or trustees of the trust. Furthermore, the trust deed will usually

provide for the power of appointment to be passed on to another person or people nominated by the appointor. Reviewing the trust deed is imperative to ensure that control of the trust passes to the intended (and appropriate) successor or successors. The intended successor should be adequately trained and equipped to control the trust.

Other provisions of the trust deed requiring particular attention include the dispute resolution provisions. Careful consideration should be given to these provisions in the trust deed where multiple children have control over the company or trust and have differing views as to its execution.

### CONCLUSION

Merely recommending a trust for a family business or, in the current environment, reviewing the mechanics of the trust deed alone does not address or manage the differences between the tenets of the business, family and ownership/governance systems. Accordingly, advisers should be mindful of these considerations in the context of consulting to family businesses.

*Dan Simmonds, Principal  
Marie De Stefano, Lawyer  
Harwood Andrews Lawyers*

#### References

- 1 J Hilburt-Davis and W Gibb Dyer Jnr, *Consulting to Family Businesses*, Jossey-Bass/Pfeiffer, San Francisco, 2003, p 5.
- 2 Ibid.
- 3 Ibid, p 7.
- 4 Ibid.
- 5 Ibid.
- 6 Ibid, p 48.
- 7 Ibid, p 9.
- 8 Ibid.
- 9 Ibid, p 27.