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Identify. Align. Balance.

Trustees & Family Businesses: How the Two Can Co-Exist Effectively

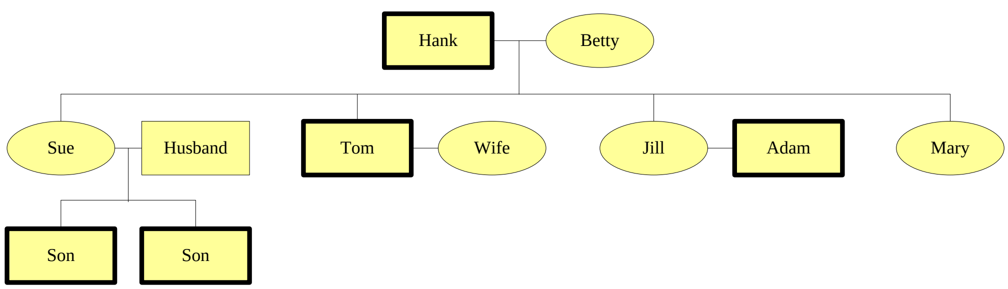
By

Larry D. Hause[1]

Joe let his notes from the trustee committee fall on his desk, the different viewpoints still ringing in his ears: The Blacknair family had approached Joe about his bank serving as co-trustee of their family trusts to replace another trust company who wanted to resign. Joe had just made his initial presentation to the committee, and the response he received was not favorable. Joe opened up the file of the background information he assembled for the committee and began reading again . . .

Hank had built KnoNoiz Inc. into the largest sound proofing distributor and installer in the Western half of the United States. With his wife's encouragement, Hank started taking it easy the last three years, spending more and more time with Betty skiing and traveling and less time in the office. Hank wanted Tom and Adam, his son and son-in-law, to lead the company, so getting the two of them more involved was perfect for Hank. He only stepped in when Tom and Adam couldn't resolve something themselves or if he wanted to offer his opinion.

Hank and Betty wanted to treat their three daughters and son fairly regarding their wealth. After all, Tom and daughter, Jill, who was married to Adam, were involved in the business, but Sue and Mary, their other children, also thought highly of the business and had made sacrifices for it, too. Hank even hoped Mary would eventually join the business. He always thought she was the smartest of his children and would make a great CFO given her experience working with a financing firm in Chicago. Sue, their oldest child, had her two sons working on construction crews during the summer to build muscle and make extra cash, but Hank saw them as "budding" builders.



Hank's vision was for the business to continue to grow, doubling in size every 5-7 years. He felt the business was perfectly positioned to expand and dominate a growing industry. Hank saw Tom running

1 Larry D. Hause, J.D., is a business consultant and attorney with Fredrikson & Byron in Minneapolis (www.fredlaw.com). He grew up in a family business and has worked with closely held and family businesses since 1984. He guides entrepreneurs and other owners, as well as directors and managers, through the myriad of challenges they face when in transition. Larry is a Fellow with the Family Firm Institute and a member of The Attorneys for Family-Held Enterprises. Larry is a co-founder and teacher of The Board School, the nation's first school for owners, directors and managers of family businesses (www.theboardschool.com). He is also a co-author of the book *The Balance Point: New Ways Business Owners Can Use Boards* (2008 Famille Press). See www.famillepress.com.

the business, taking it to a whole new level, and the family benefiting financially through ownership. Hank and Tom had spoken frequently about Hank's vision for the company while traveling together. Tom shared Hank's passion and vision for the future of the business. Betty wanted the family to get along, and she didn't want to be in the middle of Tom and Adam or any of the other family members.

To accomplish his goals, Hank had established irrevocable trusts for the benefit of his three daughters and son, appointing Tom trustee. The trusts were intended to reduce estate taxes and provide an easy way to provide for Betty and for his children to share equally in the financial benefits from the business without getting involved in management. Hank spelled out his goals in the trust instruments, including directing the trustee to retain the business, his wish for Tom to run the company and continue to grow it, and for his family to benefit financially. Hank's attorney also prepared a shareholder agreement appointing Hank as the sole director and CEO of the company and naming his son, Tom, to succeed him. Hank had transferred most of his ownership interests in the business to the trusts through gifts and sales.

Hank had wanted Tom to have some help administering the trusts following his death so he required the appointment of a corporate trustee to serve as with Tom. Hank set up the trusts so Tom would be running the business and would be the sole director and vote the shares so the corporate trustee wouldn't have to get involved in running the company.

When Hank died unexpectedly, Tom continued to run the business as his father did. Hank had disliked paying taxes so each year he paid himself and his top manager's large bonuses to reduce profits. The business never made distributions. Profits were either reinvested into the business or paid out as compensation to management. Tom continued this practice, taking a large salary for himself and annual bonuses of two to three times his salary, just like Hank had done.

The business was quite dispersed geographically across the western United States. Tom continued growing the company expanding into the Southeast. Tom led the development of the company's own proprietary products further increasing profits. The future looked good.

Many years ago, Hank decided the business should acquire a small plane and Hank learned to fly, shuttling himself from location to location. Hank really loved flying, and, because of the business, flying became a tax-deductible "hobby" for Hank. As the business grew, Hank traded up to larger airplanes. At the time of his death, the business owned a twin engine, six passenger plane with a range of 1,000 miles. Hank could get just about anywhere KnoNoiz did business non-stop within 3-4 hours. Tom shared Hank's passion for aviation, having flown with his father from a very young age and became an accomplished pilot himself. With KnoNoiz's expansion into the Southeast, Tom found himself flying commercial more and more frequently, as the twin engine plane just couldn't efficiently travel the longer distances. Tom hated flying commercial and decided the business should purchase a medium size jet at a cost of $7 million so he and his managers could travel more efficiently.

With his increased compensation, Tom began to improve his lifestyle. Tom purchased a vacation home at a private mountain resort in North Carolina accessible only by a private airstrip. He began using the new jet to fly his family back and forth to the "cabin" most weekends. Tom saw no issue with this. Hank and Betty had used the business airplane regularly to fly to and from the mountains for their frequent ski trips and other vacations. Hank liked to say that flying "Hank Air" was one of the perks of running his own business. Tom also used the jet for personal trips to Mexico, the Caribbean and the coasts where their two children attended Ivy League universities. Tom's wife loved to travel, and Tom loved to fly.

Tom also built a new home on the California coast. Along with the new homes came big mortgages. Tom's wife was an interior designer by trade and fine art collector by passion. She quickly filled their homes with extravagant works of fine art, fine furnishings, and tasteful decorating. Tom was living the life Hank and Betty had lived, and felt like he deserved it because he was running the business, just like Hank had done, and the growth in sales achieved since Hank's death had far exceeded Hank's wildest expectations.

Betty continued to live in her home and her financial needs were taken care of by the life insurance she received when Hank died. Although much of the cash was gone when she was killed in a skiing accident, she never needed any financial support from the business. When Betty died, her ownership interest in KnoNoiz was divided equally among the trusts for the children.

After Betty died, Mary asked to see the books for the company to learn how the business was doing. Sue wanted her two sons to lead the construction crews operating in the Southeast given they had both gone to school there and were by then accomplished contractors. Jill was talking to Tom about Adam becoming more involved in the business. As the family saw Tom's lifestyle change, they began to ask the trustees for money too. Mary and Sue asked for funds to put their other children through college. Jill wanted Adam's salary to equal Tom's because Adam was key to the Southeast expansion. Tom told the family that Hank had never paid anyone who didn't work in the business, and that he would want all of the profits reinvested to grow the business he had envisioned, just like he had always done. Tom reminded his siblings how private their father was, and he would have wanted to keep all the business information confidential. Tom directed the corporate trustee not to give anyone information about the business who didn't work there because that, too, was a rule Hank had.

The original trust company tried to respond to the children's inquiries the best it could. The trust officers offered to give Mary copies of the company's tax returns and financial statements. They talked to the children about the financial uncertainty inherent in the business expansion that was underway and the need for one person to be in charge of running the business. They listened to Tom's plans and heard Adam's comments and Sue's and Mary's concerns. They re-iterated to Adam and Sue Hank's wish to have Tom run the business. At the same time, they spoke to Tom about the need to talk to his siblings and to work more closely with Adam. They told Tom that he was going to be held accountable to the financing covenants the bank had in place for the company's debt financing.

But family tensions mounted. Sue, Jill and Mary wanted the corporate trustee to resign thinking it was not sufficiently overseeing Tom and the business nor taking into account their interests as their father had done when he was alive and as he said he wanted to have happen after he and Mom passed away. Tom wasn't particularly pleased with his co-trustee either, as the trust company kept questioning him and was therefore accepting of getting a new trustee if he could find who would honor his father's intent to let him operate the business without interference.

Joe knew the Blacknair family had approached five different trust companies other than his own. He told the committee he knew three had declined to get involved, and the other had yet to respond. Most members on the trust committee of Joe's bank favored passing on the opportunity as well. They thought the family situation was just too messy and were concerned that if they accepted the co-trustee role the family may turn on them if matters didn't go well. They acknowledged that the family and Tom and the business needed help, and the work certainly had the potential to be profitable. But some on the committee reminded Joe that the trust company didn't run companies, and others couldn't see how the risks could be adequately managed. When Joe asked who could help this family if the bank didn't get involved, he was congratulated for his caring but was told the bank can't help every family and business in need.

Joe, sitting up and putting his glasses back on, took out a blank writing pad and began outlining his thoughts on how the bank could get involved and adequately manage the risks and make a good profit.

The Opportunities for Trustees

Helping families like the Blacknairs was the central focus of a market plan Joe had spent considerable time creating over the last two years. Joe saw a huge opportunity for his bank to expand into providing trust services to families owning businesses, real estate and marketable investments. Joe knew that owning anything together as a family, particularly income producing ventures, presented family members and the trustees involved, with unique challenges. But the business opportunity for the bank is huge because of the large amount of family enterprises that are going to be transitioning and the need for effective assistance.

Family enterprises are big business. One source estimates that 95% of all registered companies in the US are family controlled.[2] These family-owned enterprises are said to generate between 40-45% of the GNP of North America,[3] and 64% of the US's GDP (more than $5 trillion).[4] The following survey results indicate that the service needs arising out of the inter-mixing of business and family are likely to continue growing.

- Nearly 60% of majority owners are 55 or older; nearly 30% are 65 or older[5]
- Family members include the CEO and owners in nearly 98% of family enterprises[6]
- Nearly 70% of the family enterprises are more than 25 years old[7]
- 85% of the owners desire to pass ownership to the next generation of the family[8]
- 75% expect family members to hold at least one key management position[9]
- Fewer than 30% have succession plans[10]
- Fewer than 40% have identified successors[11]
- 25% believe that the next generation is not competent to move into leadership roles[12]
- 93% have little or no diversification[13]

The significant number of family businesses that will be changing hands in the near future and the general lack of preparedness increase the risks to families and their wealth. Consider the following from a survey about family enterprise transitions[14]:

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[2] International Family Enterprise Research Academy, "Family Business Dominate" (2003).
[3] Ibid.
[4] J.H. Astrachan and M.C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," Family Business Review, September 2003.
[5] Laird Norton Tyee Family Business Survey, Family to Family 2007 (2007), at page 5 and PricewaterhouseCoopers Family Business Survey 2007/08, dated November 2007, at page 26.
[6] Lard at 9.
[7] Ibid.
[8] Pricewaterhouse at 27.
[9] Ibid at 29.
[10] Laird at 12.
[11] Ibid.
[12] Laird at 15.
[13] Laird at 14.
[14] Raymond Institute/MassMutual, American Family Business Survey, 2003; Wealth with Responsibility Study/2000, Bankers Trust Private Banking, Deutsche Bank Group; statistics on the web site at the Family Firm Institute.

- 40% of family CEOs expect to retire within 10 years, but fewer than half who expect to retire in five years have selected a successor, and the median age of the successors is 8 years younger than the CEO

- Almost a third (30%) of family CEOs have no plans to retire, ever; and nearly another third (29%) report that retirement is more than 11 years away. Since the median age of family CEOs is in the mid 50s, this means that many business leaders plan to die in office

The market seems too big to ignore. But Joe knows that no market, regardless how large, will placate the concerns expressed in the committee about the risks represented by situations such as exists with KnoNoiz and the Blacknair family. Joe knew he needed to show his fellow trust officers and managers how the bank can effectively manage the risks involved with owning family enterprises. Joe started his outline by defining the roles and responsibilities of a trustee involved with a family enterprise.

Role of Trustees

Trustees holding interests family businesses, real estate holdings, or marketable securities (each a "family enterprise" or "family business") are first and foremost owners; they are not managers, directors, or family members. That is not to say that trustees cannot also be managers and directors of the business or members of the family. Indeed, in many cases, trustees have one or more of these additional roles. It is important, however, to emphasize that trustees, as owners of all or some portion of a family business, have roles that are different than those of managers, directors, and family members.

Understanding the role of a trustee is difficult, implementing the role is challenging, performing the role satisfactorily takes practice, and being second-guessed is common. So how is a trustee to navigate this maze? The answer begins with thoroughly understanding the responsibilities of a trustee as an owner.

Responsibilities of Trustees

Trustees of trusts owning interests in family enterprises are subject to specific legal duties and have responsibilities as owners.

<u>Legal Duties of Trustees</u>. Generally, a trustee is required to prudently manage the trust in light of the settlor's[15] intent consistent with the terms of the trust instrument and the interests of the beneficiaries.[16] The following is a list of the legal duties described in *Restatement (Third) of Trusts* that apply to trustees owning interests in family enterprises:[17]

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[15] The "settlor" is the designation given to the person establishing the trust. This person is sometimes also referred to as the grantor, trustor, or creator.

[16] *In the Matter of Trusts Created by Hormel*, 504 N.W. 2d 505, 512 (Minn. Ct. App. 1993); *Restatement (Third) of Trusts*, § ____ (2007).

[17] These duties are of course not all of the duties the law places on trustees. Other duties include the duty to take and keep exclusive control of trust property; the duty to administer the trust while serving as trustee; the duty to keep and render accounts regarding the nature, amount, and administration of the trust; the duty to preserve trust property from damage or loss; the duty to enforce claims available to the trust; the duty to defend actions that may result in loss to the trust estate; the duty to keep trust property separate and not to mingle trust property with property of the trustee; the duty to take reasonable care in selecting a bank and earmark deposits as trust deposits; and the duty to make distributions to beneficiaries as provided in the trust instrument. Laws regarding trustee duties vary somewhat from state to state, and, while most of these duties are imposed by statute, court decisions continue to evolve the duties imposed by statutes and some duties continue to exist in common law.

Duty to invest prudently. This is a duty to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust, including specifically the duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.[18]

Duty of prudence in administration. This is a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust, and exercise reasonable care, skill, and caution.[19]

Duty of loyalty. This is a duty to administer the trust solely in the interests of the beneficiaries or solely in furtherance of its purpose, and to not engage in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests.[20]

Duty to furnish information. Upon request, a trustee has a duty to give beneficiaries information regarding the nature, amount, and administration of the trust.[21]

Duty regarding delegation of power and co-trustees. This is a duty to prevent a breach of trust by a co-trustee. This is also a duty to act in accordance with the exercise of a power held by another.[22]

Several of these legal duties have the potential of either preventing a trustee from retaining ownership in a family business or providing disgruntled beneficiaries redress against a trustee for a business losing value or beneficiaries not realizing their expectations. Both issues are significant challenges that must be overcome for a trustee to own an interest in a family enterprise.

Duty to Diversify. The duty to diversify, which is part of the duty to invest as a prudent investor, is perhaps the greatest hurdle to trustees owning interests in a family enterprise. If the financial return of the family enterprise is less than the trustee could have earned through a diversified investment strategy of marketable securities, the trustee is potentially exposed to liability for the return the trust would have earned had its assets been so diversified. Even the ability to look at the entire trust portfolio in determining whether the duty to diversify is satisfied will often not prevent a trustee from having to sell an interest in a family business because the family enterprise often constitutes a large portion of the trust assets. The law adopts the Modern Portfolio Theory concept of diversification through asset allocation as fundamental to the management of investment risk and it is a pervasive consideration in prudent investment management.

It is possible for a settlor to opt out of the prudent investor rule (and the duty to diversify) by so providing in the trust instrument.[23] But doing so effectively is not as easy as simply providing that the prudent investor rule shall never apply to the administration of the trust. Despite a directive to retain an ownership interest in the family business, the trustee is still required to sell the ownership interest if retention is unlawful or against public policy;[24] impossible or impractical or the expenses of compliance

[18] Restatement *(Third) of Trusts*, § 90 (2007).
[19] *Id.*, § 77.
[20] *Id.*, § 78.
[21] *Id.*, § ____.
[22] *Id.*, § 80.
[23] Restatement *(Third) of Trusts*, § 91 (2007) (modifies the prudent investor rule by imposing on a trustee the duty to not only act in furtherance of the trust's purposes but also to act in accordance with the terms of the trust instrument and applicable law).
[24] *Id.*, § 72 at page 18.

unreasonable;[25] or does not further the purpose of the trust. In addition, the trustee remains subject to the duty of prudent administration, notwithstanding the fact that the terms of the trust instrument purport to waive the duty to diversify, which requires the trustee to regularly consider the need for diversification to address changes in circumstances affecting the business and the beneficiaries.

Duty of Prudence. A trustee has the duty of prudence, which is generally defined as the duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust, and exercise reasonable care, skill, and caution.[26] The terms of the trust can alter this duty except the instrument cannot dispense with the fundamental requirement that the trustee not behave recklessly or act in a manner other than in good faith, with some suitable degree of care, and in a manner consistent with the terms and purposes of the trust and the interests of the beneficiaries.[27]

Duty of Loyalty. The duty of loyalty requires the trustee to administer the trust solely in the interests of the beneficiaries or solely in furtherance of the purpose of the trust, except in circumstances specified in the trust instrument.[28] In addition, the trustee is prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests except as is expressly permitted by the instrument.[29] This duty of loyalty presents several challenges to a trustee owning an interest in a family business.

First, at least some (if not most) trust beneficiaries will work in the family business. Those beneficiaries who are not working in the family business may or may not want to work in the company or continue to have an investment in the enterprise, contrary to the vision and intent of the settlor. Or, the beneficiaries may be minors or unborn beneficiaries and their precise interests are not readily identifiable. The trustee has a duty to deal with all of these beneficiaries in a fair manner, taking into account the settlor's intent and their interests consistent with the terms of the trust. Determining what is fair to beneficiaries having differing interests can be difficult, perhaps impossible with respect to minors and/or unborn beneficiaries.

Second, the trustee could also be a beneficiary of the trust and/or a member of the family and possibly, as an individual, also a manager and/or director, just like Tom's role as co-trustee, the sole director and CEO of KnoNoiz. The trustee is prohibited from acting in his or her self interest except as authorized by the terms of the trust, yet in a family business, actions that may be construed as self-dealing are often required and even desirable. For example, the trustee may be the president and have the authority to hire, evaluate, compensate, and fire other beneficiaries who are working in the business. The trustee may be the only beneficiary who wants to own the family business for the long term and wishes to buy the interests otherwise allocable to siblings who are the other beneficiaries. Conflicts arise when the trustee acts in other capacities in a self-interested manner without taking into account the interests of the beneficiaries and determining whether the actions may be perceived as unfair. The risk of conflict increases when there is no objective standard established by which to evaluate decisions.

Finally, the trustee is required to provide information about the trust and its assets to beneficiaries. But what information about a family business should be distributed to beneficiaries of a trust? Does it matter if beneficiaries do not work in the business? What if a beneficiary's spouse works for a competitor? What if the settlor did not want the entire family to know the details of the business as was apparently the case with Hank? It is difficult for a trustee to determine the proper level of information to provide without an established standard or policy.

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[25] *Id.*, § 73 at page 21.
[26] *Id.*, § 77 at page 81.
[27] *Id.*, § 77 at page 85. See also *Restatement (Third) of Trusts*, §§ 86, 87 and Section 50 (Comments b and c).
[28] Need cite.
[29] Need cite.

The duty of loyalty can be modified by the terms of the trust but the trustee may not be protected from acting recklessly, in bad faith, unfairly, or in a manner inconsistent with the terms and purposes of the trust or the interests of the beneficiaries. As a result, there are limits to what a settlor can allow, thereby protecting the fundamental fiduciary character of trust relationships. On the other hand, even the statement that a trustee cannot act "unfairly" requires a recognition that "fairness" itself depends on the terms and purposes of the trust and a settlor may confer a personal benefit on the trustee, either as a designated beneficiary or as inferred from the terms of the self-dealing authorization. For example, the trustee may be authorized to purchase certain property from the trust on potentially favorable terms. Such a purchase would not be "unfair" even if purchased for less than fair-market value.[30] While the terms of the trust can limit the application of the duty of loyalty, in the case of a family business it can be difficult to foresee all of the circumstances that must be specifically addressed to protect the trustee and accomplish the settlor's intent.[31]

Duty to Furnish Information. At times there are tensions about how much information to provide to beneficiaries of a trust holding interests in a family enterprise. The reasons underlying these tensions are varied. From the viewpoint of the settlor or trustee, the concerns often relate to the beneficiaries getting too much information that relate to management and operations. The concern is that beneficiaries will begin managing the business. From the viewpoint of the beneficiaries, they know they are impacted by the enterprise and seek information and input that will allow them to protect their interest. Their concern is that their ownership interests won't be cared for by management.

There are no clear guidelines on how much information a beneficiary is entitled to receive. Certainly guidelines placed in the trust instrument showing what the settlor wants to provide is helpful. But the trustee must at least provide the amount of information the beneficiaries need for the trustee to determine the interests of the beneficiaries. In other words, the trustee is required to understand the interests of the beneficiaries. This likely necessitates the trustee giving information to the beneficiaries so the beneficiaries can in turn provide information to allow the trustee to ascertain their interests.

Duty Regarding Delegation of Power. A co-trustee has a duty to prevent a breach of trust by another co-trustee. A trustee also has a duty to prevent a breach of trust held by a person who has authority to act on behalf of the trust pursuant to a specific power.[32]

A significant conflict may exist if a trustee knows (or should know) that a co-trustee or another person, who in either case has the sole authority to act on behalf of a trust in a specific area (voting shares of a family enterprise for example), is exercising this authority in a way that breaches such person's authority. Can the delegation of authority to another protect a trustee who knows (or should know) that the other person is exercising the delegated authority in a manner that breaches that person's duty? Does it make a difference if the trustee who does not have the authority giving rise to the problem is compensated for serving as trustee versus a trust protector who may have limited authority but is not usually compensated? Does it make a difference if the actions (or inactions) of the person with the authority impacts the trust assets and purposes over which the trustee without the authority is required to participate?

Given that any trustee has the legal right to obtain access to all information involving the trust, even information relating to activities the trust instrument expressly gives to another, the trustee may be in a vulnerable position if the trustee does not exercise some oversight functions.[33] The duty regarding co-trustees coupled with the right to obtain information regarding the trust may place some duty on a trustee

[30] Section 78, page 99.
[31] Id.
[32] Restatement *(Third) of Trusts*, § 75.
[33] Id.

to oversee the actions of another even when the trustee has no authority to act in the area giving rise to the concern. If this is true, language in the trust instrument or perhaps even statutory language may not protect a trustee from having some duty of oversight. In other words, a trustee may not be able to "stick its head in the sand" and ignore actions affecting the trustee merely because all the authority regarding such matters is delegated to another.

In addition to these specific legal duties as a fiduciary, a trustee that owns an interest in a family enterprise has certain responsibilities as a business owner. These responsibilities are not imposed on trustees because of their trustee status; rather, these responsibilities apply to all owners of private businesses.

<u>Trustee's ownership responsibilities</u>. Shareholders of corporations, partners of partnerships, and members of limited liability companies are the owners of these business entities—that is their basic role. Trustees owning these types of interests are also owners, and, as such, have the same responsibilities placed on them as is placed on other owners.

But what are the responsibilities of an owner in business? Try asking shareholders of a corporation what they do as owners. Often they will respond with a recital of their management duties within the business. When pressed about their duties as owners separate from management, they usually respond with a blank stare. Sometimes their response states the obvious ("we're owners, of course") or reflects receiving money ("we collect dividends"). Most don't know that as owners they have the responsibility to elect directors; provide capital and personal guarantees when needed; determine what they want from the business; determine whether they want to continue as owners; and identify and develop the structures and processes by which the owners, the board, and managers work independently and together. Not only do most owners not know about their responsibilities as owners, but also entrepreneurs, managers, directors, and professional advisers tend to discourage owners of family enterprises from having any involvement in the enterprise. Owners, particularly owners who don't work in the business, are often told to appreciate what they get and be quiet.

But owners of family enterprises want to be part of the business for many reasons, including the emotional equivalent that being part of the business has with being part of the family. Even if owners do not work in the business, they often are deeply committed to it. They want to be involved in some meaningful way, but how to do so is not usually identified, leaving them to find their own way. Sometimes the ways these family members seek to connect to their business are helpful and welcomed; sometimes, though, their efforts are not. Trustees owning interests in family businesses have an additional challenge because the law requires trustees to be involved with the business as owners. Without a clear way for owners to be involved, trustees are left with no choice but to create a way to connect to the business. This tends to create additional problems for owners in general and trustees in particular.

As Joe reviewed the responsibilities of a trustee in the context of family enterprises, he could understand why many corporate trustees simply declined to accept the role of trustee or co-trustee in situations where there was conflict or even the hint of conflict. But Joe realized this response doesn't help these families. Nor does it help the bank. After all, family businesses are usually very important commercial customers. Declining to accept the role of trustee would not solve the challenges these families face but simply shift the risk from the trust company to someone else, usually a family member with little knowledge, experience, or skill in acting as a trustee. Without the benefit of a professional fiduciary, many of the bank's commercial customers' transitions might be doomed to failure. And a failed business doesn't make for a very good, long-term customer of the bank.

Compliance with the legal duties and ownership responsibilities. When Joe began working on his marketing plan, he had identified two actions that can significantly help a trustee eliminate or significantly mitigate risks associated from owning an interest in a family enterprise. The first action involves the settlor, in the trust instrument, tailoring the application of the legal duties. The second action involves the trustee establishing and following a system that keeps the trustee in the position of owner and gives the trustee the ability to further the settlor's intent consistent with the terms of the trust and the interests of the beneficiaries as circumstances change for whatever reasons. Joe began to outline how both of these alternatives would help the committee support the bank becoming trustee of the Blacknair trusts.

Modifying Trustee Duties by the Terms of the Trust.

The legal duties imposed on trustees by law can be modified by the settlor. The easiest way to do this is in the trust instrument. For example, a settlor can limit the application of the prudent investor rule and the duty to diversify, which as noted above is particularly a problem for trusts owning family businesses. This is best done by the settlor directing (rather than authorizing) the trust to retain ownership of the family business subject to such conditions as the settlor may determine appropriate. One such condition may be to clarify the relative priority of continuing the business on the one hand and meeting the interests of current and future beneficiaries of the trust on the other hand, particularly as circumstances regarding the business and the beneficiaries change. The duties of prudent administration, loyalty, and delegation of responsibilities can also be modified to the extent necessary to address many of the unique issues involved with having a trust own interests in any particular family business.

Using something more than "boiler plate" is required. Language that reflects the facts unique to the situation rather than standard terms better demonstrates that the settlor gave the matter personal attention and hence reflects his or her specific intent, which in turn minimizes the opportunities for beneficiaries to introduce evidence outside of the trust instrument to support a contrary intent. And, as is reasonably expected, the more clear and specific the language is in the instrument, the more credible it is that the language expresses the settlor's intent. Sufficient clarity and personalization usually occurs when the trust instrument recites the settlor's specific goals regarding the succession of the business, his or her concerns and the challenges that can reasonably be expected to arise regarding these goals, and how the settlor wants to see these concerns and challenges handled.

But not all trust instruments are so carefully crafted, and those that are cannot realistically anticipate every circumstance with the clarity necessary in all circumstances to guide the trustee and prevent a beneficiary from taking legal action against a trustee. Further, regardless what the trust instrument provides, the trustee still has to exercise some discretion in balancing the intentions of the settlor and the interests of the beneficiaries.[34] In these circumstances, a trustee can still own an interest in a family business with reasonable assurances of not being found liable for breaching a duty by establishing and following a system that keeps the trustee in the role of an owner, identifies the settlor's intent and the interests of the beneficiaries, and allows the trustee to balance the settlor's intent consistent with the terms of the trust instrument and the interests of the beneficiaries as concerns and challenges arise. Implementing this "balancing system" can protect a trustee even if the trust instrument does not sufficiently address the trustee's duties relative to the family business.

Using the Balancing System to Comply With Trustee Duties

A system that keeps the trustee in the role of an owner; identifies the settlor's intent and the interests of the beneficiaries; and allows the trustee to balance the settlor's intent, the terms of the trust instrument,

[34] *See* supra, page __.

and the interests of the beneficiaries regardless of the circumstances, may sound impossible. Such a system probably is impossible to create if the trustee (or the settlor) is insistent that the role of the trustee be expanded into management, organizational governance, and/or the family.

Obstructions to the balancing system. The temptation to expand the trustee's role beyond ownership must be great because of the perceptions that many trustees are either involved in management of the business or there are concerns trustees will become involved in management. For example, attorneys often advise against using a corporate trustee to own family businesses by saying: "You don't want a corporate trustee because you don't want them to be running your business. They want to sell businesses, not keep them, because it is easier to manage cash than a business." To be fair, it is not uncommon for corporate trust officers to also refer to "running" or "managing" family business when talking about their trust department holding family business interests on behalf of trusts. And, some corporate trustees do prefer to sell family businesses and hold marketable investments because of the fewer risks, greater familiarity, and ease involved with holding publicly traded securities. To be fair, of course, there are also corporate trust departments who have established specialized groups to hold interests in family enterprises

The attorney's advice and the perception within many corporate trust departments are based on two commonly-held assumptions. The first assumption is that owners "run" businesses. The second assumption is that corporate trustees prefer to manage cash rather than administering a trust that owns stock in a family business. Certainly there are situations when one or both of these assumptions exist. And if the law imposed a duty on trustees to "run" a business owned by the trust, a corporate trustee would have good reasons for not wanting to serve as trustee. No corporate trustee (or any reasonable person) wants to be liable for running a business when the business is already paying managers to do precisely that—run the business. It is not reasonable for a corporate trustee to be expected to have the skills and experience to run businesses especially when most companies hire managers who have made a career out of operating businesses.

Fortunately, the law does not impose any duty on a trustee to "run" a business owned by a trust. In fact, the law does not even impose a duty on a trustee to oversee management. That duty is reserved for directors.[35] Yet the assumption persists that corporate trustees run businesses, and, as a result, many corporate trust departments have either taken themselves out of the market entirely or decline to serve if conflict or potential conflict exists. Either action leaves families with fewer alternatives when they need help the most and keeps corporate trustees from brining real value at a time when it is most appreciated. There may be two reasons that keep alive the perception that trustees "run" businesses. Both reasons relate to the idea that a trustee "steps into the shoes" of the person or persons establishing the trusts.

Often trustees are asked to own shares of a family business that is transitioning from the entrepreneur to the next generation similar to KnoNoiz.[36] Entrepreneurs usually are the center of their business, meaning that the business is organized around serving the entrepreneur and achieving his or her objectives, just like KnoNoiz served Hank. An entrepreneur does not often distinguish between ownership decisions and management decisions; entrepreneurs just decide what they want and get it done. Entrepreneurs often see this as one of the cornerstones of their success. The entrepreneur's ability to get things done because he or she has the authority to make all major decisions is usually an extremely effective way to run a business. When entrepreneurs no longer want to "do everything," they will often seek an "heir apparent;"

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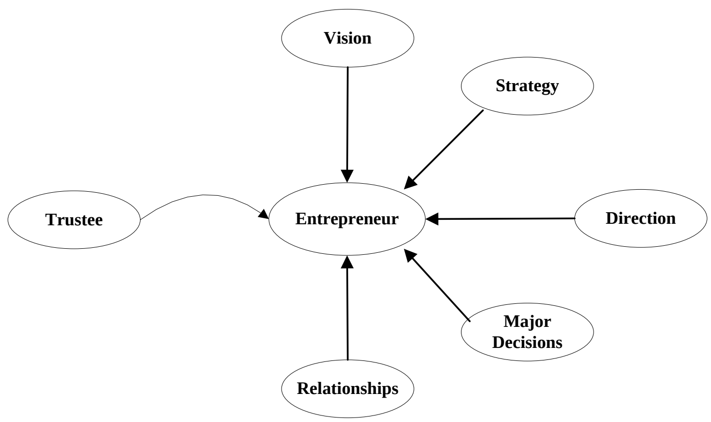
[35] Owners are required to evaluate directors as noted below.

[36] The term entrepreneur is being used to describe the owner-manager who either founded the business (the first generation or founder) or is the person who has the power to do what he or she wants in the business when he or she wants to do it.

someone who can “step into their shoes” and “run” the business as they would, which is precisely what Hank did when he chose his son, Tom, as his successor.

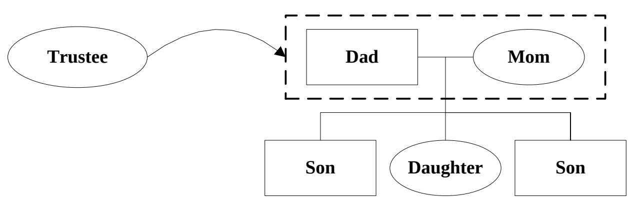
If the trustee’s role is seen as succeeding the entrepreneur, it would be reasonable to assume that the trustee has the same control and power of the entrepreneur. Such a perception creates no boundaries between ownership and management so it is easy to understand how a trustee who legally is only an owner could be viewed as having the responsibility to “run” the business. If the trustee is seen as just “stepping into the shoes” of the entrepreneur, there should be little wonder why most entrepreneurs, attorneys and corporate trustees would have little interest in involving a corporate trustee with a family enterprise. However, Hank would never have wanted the corporate trustee to “run” the business. It was clearly his intent that Tom run the business.

Figure 1 Trustee replacing the entrepreneur



Another explanation for the perception that a trustee “runs” the business arises from the parental approach that many trustees have traditionally applied to the administration of trusts. Trusts historically have been used to transition the benefit of family wealth to successive generations without giving younger family members outright ownership of the wealth. The person with the wealth (the settlor) entrusts assets to a person (the trustee) who holds the assets for the person or persons the settlor wants to receive the benefit of the transferred assets (the beneficiaries). This arrangement places trustees in the position of being a surrogate to the person or persons establishing the trusts, say the parents or grandparents. In essence, the trustee “steps into the shoes” of the “parents” regarding the family wealth. The trustee is charged with investing and distributing the wealth in a manner similar to how the parents would do so if they were involved (that is, following the intent of the “settlors” or parents).

Figure 2 Trustee in the parent role



In this manner, trustee-beneficiary relationships begin to reflect parent-child relationships with all of the attendant dynamics in normal (and sometimes abnormal) parent-child arrangements. In the United States, at least, psychologists say parenting has changed significantly over the last two generations (some may even argue that the change is not for the better).[37] Children are less willing to obey their parents simply because they are parents. Children want to know why certain decisions are made or they want to participate in the decision making. While the nature of parenting has changed, the nature of trust administration has not changed nearly to the same extent, resulting in trustees often making decisions or taking a position without involving beneficiaries, who, in turn, view such actions as arbitrary and inconsiderate of their interests. In the family enterprise context, the "parental" approach to trust administration can often lead to a trustee assuming the role of becoming actively involved in many aspects of the company because, as the "parent," the trustee would make all the important decisions and oversee the entire operation.

This parent-child dynamic plays out even more deeply in family businesses when entrepreneurs seek to transition the family business to their children. Prior to the children having a beneficial ownership interest in the business, they usually have no real say in how the business is run, nor do they expect to have a say because it is "Mom's" or "Dad's" business. But when the child receives a beneficial or outright ownership interest, they naturally seek to become involved, wanting to know why decisions are made and to participate in the decision making process. The child may still defer to the parent, so long as the parent continues to be involved, but often, as soon as someone other than a parent assumes the "parental" role (such as a trustee), the children begin to seek new ways to be more involved. The family dynamics become even more troubling when "Mom" or "Dad" asks one of their children to take on the parental role for their other siblings.

You can see these dynamics play out in the KnoNoiz case. Hank and Better were the head family leaders, making all the decisions for the family. Their children accepted this. But as soon as Hank and Betty died, and Tom stepped into the "parental" role, the other children immediately sought ways to become involved. Mary asked to see the books, Sue wanted her children and Jill wanted her husband to become more involved in the business, and everyone wanted to receive distributions. Tom responded as he felt Hank would respond. But Tom and Hank never realized two important things: first, Tom could never fully replace Hank, because Tom could never become "Dad" to his siblings; and, second, when the other children became beneficiaries, they would begin to seek ways to participate.

If trustees "stepping into the shoes" of the entrepreneur are why trustees expand their role beyond ownership, creating a legal agreement to limit a trustee's role will likely not be enough because such actions by trustees reflect a core attitude and belief about the role of a trustee. Changing an attitude and belief requires an intellectual and a behavioral shift. Appropriate documentation can assist with the intellectual shift by explaining the system, structures, and process involved and explaining what the settlor wants to accomplish and why. But behavioral shifts require practice, repeating many times the functions of ownership to further the settlor's intent in a manner that is consistent with the terms of the trust instrument and the interests of the beneficiaries. In other words, the system embedded in the documents must be implemented, followed, and practiced for a trustee to provide value to the family. It will usually be more effective if this behavioral shift is practiced and learned with the entrepreneur's involvement.

The problem with a trustee "stepping into the shoes" of an entrepreneur, parent, or other person with the power to make decisions in many different areas is essentially that some of the areas the trustee definitely belongs in and others the trustee definitely does not. Take the example of the trustee replacing the entrepreneur. An entrepreneur (Hank, for example) performs the functions of owner, manager and board. Hanks was the center of his business. All of the significant decisions ran through him. Even as Tom and Adam assumed more responsibilities, Hank continued to involve himself in key management decisions. Any trustee "stepping into Hank's shoes" would be doing so automatically with respect to ownership

[37] **[need cite]**

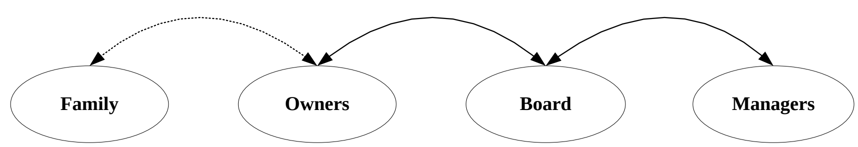
functions but certainly not with respect to management or board functions. Yet the distinction is usually not clear. Trustees often either “step into” or are “dragged into” management and board decisions, whether they want to or not.

This is not to say that a trustee exercising owner, manager and board functions is bad, ineffective or inappropriate. The point being made is that many conflicts within family enterprises are traced to a lack of clear and distinct roles and responsibilities between the family, owners, managers, and board and a lack of understanding how these groups work together. For example, family members and owners usually don’t know how they are involved in a family enterprise, but they know they are connected and will usually find a way to provide their input. Often their input is given directly to management who usually are family members. Sometimes the input is welcomed, but quite often owner involvement results in managers feeling constrained or criticized. Managers may then try to exclude owners or other family members from any involvement, believing, like Tom, that they are responsible for running the business. This puts management in the role of deciding what it means to be owners and how family is involved, potentially heightening tensions that may already be strained.

The greater the conflict or potential for conflict within a family enterprise system, the more important it is to clarify the roles and responsibilities of the principle groups involved (that is, family, owners, managers and board) and to develop a system for these groups to connect or work together. Ignoring everyone’s interests or forcing a particular solution usually doesn’t make conflicts go away. Such actions tend to make the conflicts explode or go underground where the dissension continues to fester until a later time. What is needed is a system that aligns everyone’s particular interests in a way that reflects that is possible based on current reality. The balancing system is designed to do this.

Explanation of the balancing system.[38] The balancing system assumes there are at least four functional groups in every family enterprise: managers, owners, the board, and the family. Each of these groups has separate and distinct responsibilities. While separate, these groups do not exist in a vacuum, they are inter-connected.

Figure 3 The four principle functional groups



The roles of owners and managers in the balancing system are similar to common understanding: owners own the company and managers run the business. The roles of the family and the board in the balancing system, however, are quite different than what is usually perceived. The role of the family in the family business depends on how the owners want the family involved. The defining role of the board is to balance—to balance the collective interests of the owners with those of the managers and the company.

Boards balance by directing—directing owners and directing managers. The board directs owners by requiring owners to fulfill their ownership responsibilities. For example, a critical ownership responsibility is for the owners to identify and communicate to the board the interests all the owners have as a group. It’s hard for management to operate a business for the benefit of the owners if the managers don’t know what the owners want. The board also directs managers to fulfill their responsibilities. One

[38] The balancing system is explained in detail in *The Balance Point*, *New ways business owners can use boards,* by Cary J. Tutelman and Larry D. Hause (FamillePress 2008). This article expands the balancing system to provide solutions to address the unique challenges encountered when trusts own family businesses.

such responsibility of management is to identify and communicate to the board the interests of the enterprise. Usually this is done through business plans developed by management. If the interests of the owners and managers differ, the board aligns the competing interests, not by choosing sides, but by directing the owners and managers to reconsider their respective interests until the interests of both groups align or are balanced. This system makes owners responsible for making ownership decisions and managers making management decisions. The board, acting as the "balance point," manages the process so owners and managers are involved but so each stays within their boundaries and performs their respective roles and responsibilities.

The specific responsibilities of owners, board members, and managers will differ from enterprise to enterprise, but, in general, these three groups have the responsibilities described in Figure 4.

Figure 4 General responsibilities of owners, board, and managers

Owner	Board	Management
1. Develop an owners' manual 2. Develop an owners' plan 3. Elect directors 4. Evaluate the board 5. Determine how family members who are not owners are involved with the company 6. Stay informed	1. Ask for, evaluate, and accept an annual owners' plan from the owners 2. Ask for, evaluate, and approve management's strategic plan along with any updates, and annual plans along with budget updates 3. Help resolve differences between the owners' plan and management's plans 4. Make sure owners and managers adhere to the planning schedule 5. Hire, evaluate, determine compensation for, and fire senior management as defined by the owners 6. Decide whether to pay dividends 7. Decide special matters such as approving acquisitions, mergers, sale of assets, actions outside the ordinary course of business, and other decisions as required by applicable law or the owners	1. Develop a strategic (long-term) plan for the enterprise 2. Develop an annual plan for the enterprise 3. Manage the enterprise in a manner that is consistent with these plans[39]

While the roles and responsibilities of the managers, board, and owners are separate and distinct, they must also be integrated because these individuals are all part of the same system. For example, owner decisions can affect how the board directs management and, therefore, how management runs the day-to-day activities of the company. Owners of family businesses often discuss their values. In many businesses, however, the owners' values aren't visible inside the company because owners have not communicated them to the board or management has not promoted them to the employees and the board hasn't required management to do so. In the former case, managers and directors have to guess what the owners want. In the latter case, either management or the board has "decided" that it is not their responsibility to ensure that the owners' values are visible inside the company. In either case, the integration of ownership, board, and management falls apart (if it ever existed to begin with). Each group acts separately with its own agenda. On the other hand, when ownership, board, and management are fully integrated, owners identify their values in the owners' plan, management understands that they need to instill the owners' values inside the company, and the board holds management accountable for this and asks for tangible evidence that it is done.

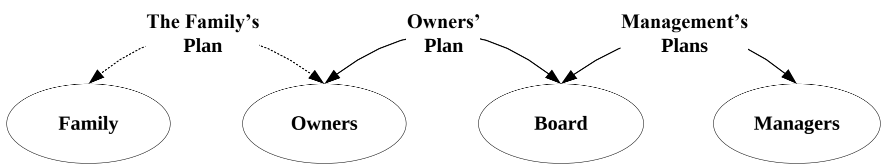
[39] There are fewer responsibilities described for managers than for owners and the board. But that doesn't mean managers do less than owners. Much of what managers do relates to the running of the company rather than how managers relate to the owners and the board. The responsibilities listed for managers are only those primary responsibilities that relate directly to the balance system.

The board's decisions directly affect the extent to which the owners' interests are followed and how management runs the day-to-day business activities. A board that understands the owners' interests will approve management's plans only if those plans are consistent with the interests of the owners. If the board doesn't understand the owners' interests, it won't be able to evaluate management's plan effectively. If the board approves a management plan that is inconsistent with the owners' interests, the board, owners, and management will not be integrated. A board that is integrated with the owners and managers evaluates management's plan and, if it finds inconsistencies, determines whether management's plan or the owners' plan (or both plans) need to be reworked to remove the inconsistency.

Management decisions directly determine how the interests of the owners are treated inside the company. Management and the board are not integrated when management adopts policies without knowing whether they contradict the values of the owners, or when it knowingly adopts policies that are inconsistent with the owners' values and does not seek board approval. Management that is fully integrated with the board and owners knows the owners' values and understands that the board must approve policies that are consistent with the interests of the owners.

The owners decide how to integrate family members who are not owners, such as spouses and younger family members. Owners who integrate non-owner family members seek input from the larger family on matters that affect the extended family. Examples might include preparing the next generation for ownership, addressing family employment concerns, and developing family philanthropy efforts. Figure 5 illustrates how the balance system integrates managers, board, owners and non-owner family members.

Figure 5 Integrating the four principle groups



When the interests of these groups are not integrated, the system breaks down and individual interests become more important than the common good, resulting in conflicts at all levels.

There are two fundamental components of the balancing system that are critical to helping trustees significantly reduce the risks associated with owning family businesses. The first is the owners' manual, and the second is the owners' plan.

Owners' Manual. The owners' manual identifies the different roles and responsibilities of each of the functional groups involved with the family enterprise. Owners, of course, can tailor the basic duties of each group to fit their particular company. In any case, putting these arrangements in a written document helps everyone understand how each group contributes to the success of the enterprise.

The owners' manual also describes the basic framework for the balancing system. The balancing system's framework gives owners, including trustees, a mechanism to provide meaningful and appropriate input regarding the family enterprise without having to expand their responsibilities and liabilities by managing the business or sitting on the board. The framework of the balancing system can be contemplated in the trust instrument. But even if the trust instrument is silent relative to the family business, the balancing system framework can, and in many cases should, be put in place through shareholder agreements that are binding on all owners and the enterprise.

Owners' Plan. The key component to the effectiveness of the "balancing system" for trustees owning family businesses is the development of a single statement identifying the values, needs, and goals all the owners have for their business. The balancing system refers to this statement as an owners' plan.

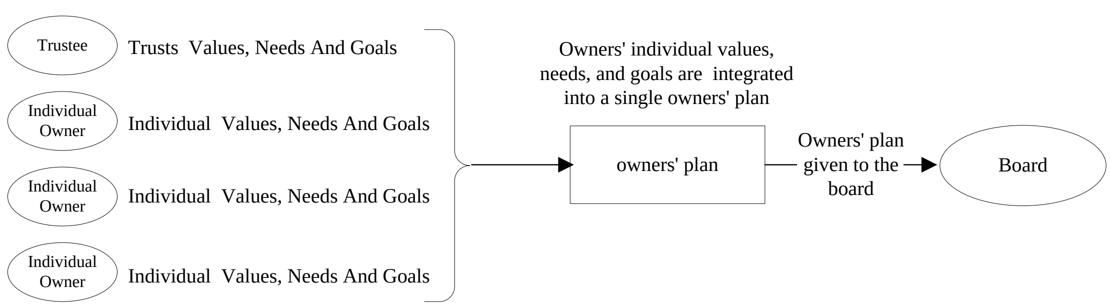
The owners' plan is the means by which owners, including trustees, provide their input into the business. The owners' plan ensures that all of the board's activities and all of management's plans and day-to-day operations reflect the wishes of the owners. The owners' plan is a single statement supported by all of the owners that provides only one set of "marching orders" for directors and managers. Having clear direction from the owners eliminates the problem of directors and managers "serving two masters" or having to "guess" what each of the owners want. When the owners develop a unified statement, the owners, directors, and managers can better function as an integrated unit.

The owners' plan states the values, needs, and goals (that is, the "interests") of all the owners as a group. Just what these are depends on the particular ownership group and the type of business. Generally:

- Owners' values are the basic principles that drive all planning, decision making, and behaviors relating to the company. Owners' values define what is most important to the owners as a group. Other words used to describe this portion of the owners' plan include owners' principles, commitments, guidelines, and ethics.
- Owners' needs are what owners want now but are lacking or what they have and want to retain.
- Owners' goals are what owners want long term. From these goals, the owners make specific recommendations affecting the board and management.

An owners' plan accepted by all the owners requires a structure and process the owners can use to identify their collective values, needs, and goals. This usually requires each owner to first identify their individual values, needs, and goals and then work with other owners on a common set of values, needs and goals that all the owners can support. Figure 6 illustrates the concept of going from individual owners to a collective owners' plan.

Figure 6 Integrating individual plans into a common owners' plan



A new owners' plan is best presented to the board on a recurring basis; perhaps each year. In reality, the owners' plan from year to year may not change substantially, but the discipline of the owners preparing an owners' plan and presenting it to the board each year offers several advantages. Owners and directors have more opportunities to learn about the collective interests of the ownership group. Support among owners on a particular matter is often more easily achieved if owners know they will reconsider the issue in a year. Changes that may result in owners having different needs or goals can be identified and addressed sooner, allowing more time to resolve any differences when the differences are hopefully small.

The owners' plan evolves over time as the values, needs and goals of the owners evolve. For example, as owners age they become more interested in retirement and transition causing them to consider how they will sustain themselves long term and dispose of their shares. When ownership of an enterprise transitions from say the 2nd generation to the 3rd generation, the needs and goals of 3rd generation owners may be different than those of their parents. Doing an owners' plan on a regular basis ensures that these changes are identified and taken into account by the appropriate group.

Applying the balancing system to a trust arrangement. There are several specific steps that can be implemented to afford a trustee the protection offered by the balancing system. Each is discussed below. Some of these steps are optional; some are not, and that is also noted.

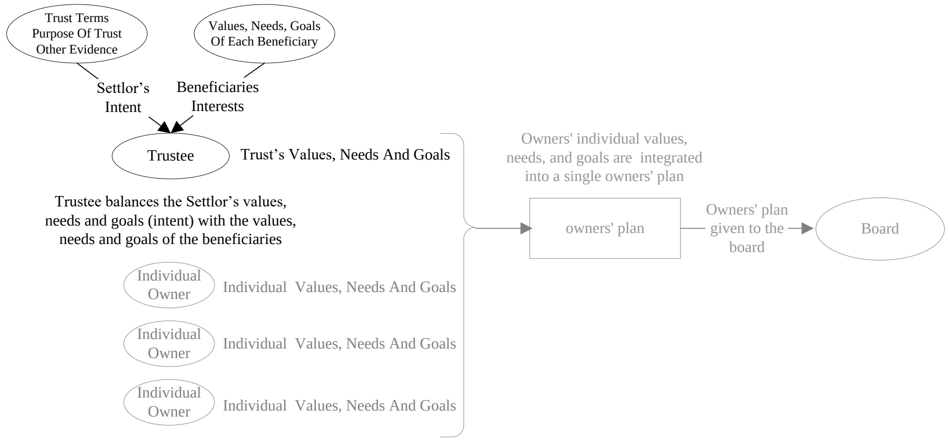
Step 1. The first step is to include the structure and process of the balancing system in the owners' manual and the governing legal documents for the entity (e.g. a shareholder control agreement, voting agreement, partnership or member agreement, bylaws, etc.). Giving the planning process legal ramifications ensures the trustee a way to provide owner input into the business.

Step 2. The second step, and the most critical, involves the trustee acting as a second "balance point." Where the balancing system requires the board to act as the balancing point with respect to aligning the interests of the owners and the manager/enterprise, the balancing system in this context requires the trustee to act as the balance point to align the interests of the beneficiaries with the settlor's intent. This step defines the settlor's intent, identifies the interests of the beneficiaries, and reconciles any differences that exist between the two interests.

When the trust instrument expressly describes the settlor's succession goals for the enterprise and family, the challenges and concerns the settlor perceives might impact the succession goals, and how the settlor wants those challenges addressed, the settlor's intent should be discernable from the trust instrument. If the instrument is generally silent in this respect, the settlor's intent can be identified from other extrinsic sources similar to what a court would allow into evidence in order to identify the intent of the settlor.

The settlor's intent as expressed in the trust instrument or otherwise is paramount, but not exclusive. The interests of the beneficiaries also need to be identified because a trustee is charged with administering a trust to further the intent of the settlor consistent with the terms of the trust instrument and the interests of the beneficiaries. Identifying the interests of each beneficiary informs the trustee about whether each beneficiary understands and supports the settlor's intent, thinks that the purpose of the trust has changed, believes that his or her interests are consistent with the settlor's intent and can be met by retaining ownership of the family enterprise, and if there is sufficient compatibility among the interests of all beneficiaries. The trustee then is charged with finding consensus among the settlor's intent and beneficiaries' interests by consolidating this information into a single statement describing the values, needs, and goals of the trust. This step is illustrated by Figure 7.

Figure 7 Balancing the settlor's intent and the interests of the beneficiaries



Similar to how the board balances the interests of the owners and managers based on their respective plans, the trustee aligns the interests of the beneficiaries with the intentions of the settlor. For example, even if the settlor's intent is clear, the duty of prudent investment, prudent administration, and loyalty requires a trustee to consider in a fair and impartial manner the interests of the beneficiaries and whether the purposes of the trust can still be accomplished and accomplished at a reasonable cost and within acceptable levels of risk. The duty to provide information to beneficiaries is likely met by making sure the beneficiaries have what information they need to help the trustee understand the nature of their interests. If a co-trustee is involved or another person has the authority in the trust instrument to act unilaterally, this process can inform a trustee how the actions of such co-trustee or other person are aligned with the settlor's intent and the interests of the beneficiaries. Some balancing is always required, and the balancing system helps trustees comply with their duties by giving them a system to annually align the interests of the beneficiaries and the settlor by identifying the values, needs, and goals for the trust.

Involving the beneficiaries has advantages. For example, an action that might otherwise violate a trustee's duty of loyalty may be authorized by consent properly obtained from or on behalf of all the trust beneficiaries even though the consent is not intended to modify the terms of the trust. If consent to such a transaction is obtained from or on behalf of one or more of the trust beneficiaries, a trustee who engages in the transaction may commit a breach of trust but is not liable to any beneficiary whose consent has been properly obtained.[40]

Having the trustee act as a balance point does not require the trustee to give the interests of the beneficiaries greater weight than the beneficiaries would have without using the balancing system. The extent that the interests of trust beneficiaries are considered is always dependent on the settlor's intent.[41] In other words, the interests of a beneficiary depend on the terms of the trust instrument, interpreted in light of all the circumstances, including specifically the settlor's intent. When the trust instrument expresses the settlor's intention clearly, there is little if any difficulty. When, however, the trust instrument is ambiguous or silent, it may be difficult to determine the extent of the interests the settlor intended to create.

Having the trustee act as a balance point does recognize that the trustee is charged with making sure that the trust is being administered to further the intent of the settlor consistent with the terms of the trust instrument and the interests of the beneficiaries. This requires the trustee to make sure the interests of the

[40] Section 78, page 100.
[41] § 49 of the Restatement (Third) of Trusts; Scott on Trusts, § 13.2, p. 817.

settlor and the beneficiaries are aligned, the interests of the settlor and beneficiaries are aligned with the realities regarding the enterprise, and, with a pot trust, that the interests of the beneficiaries are aligned.

If the interests of the beneficiaries cannot be aligned with the settlor's intent, the trustee needs to either work with the beneficiaries to adjust their interests or consider clarifying or reforming the settlor intent, possibly through court involvement. If, in a pot trust for example, the interests of multiple beneficiaries are not aligned, the trustee needs to either work with the beneficiaries to adjust their interests so they are aligned or consider reformation (perhaps with court approval) that separates the beneficiaries, divides the trusts, reallocates or diversifies assets, or otherwise attempts to meet the interests of all the beneficiaries. If the interests of multiple beneficiaries cannot be aligned as a group or the interests of the beneficiaries and the intentions of the settlor cannot be balanced, the trustee always has the option to seek court direction for how to balance the competing interests so as to protect the trustee and allow for the development of a statement of values, needs, and goals for the trust. The balancing system will provide the trustee with clarity of the issues that can be presented to the court in a thorough and helpful manner.

Some trustees may believe that a clear directive by the settlor avoids a trustee having to consider what the beneficiaries want, but the law is not that protective. The law is clear—the trustee has to have some reasonable knowledge about the circumstances affecting the beneficiaries of the trust. No trustee can ignore the beneficiaries. The balancing system requires trustees and beneficiaries to work together within their respective roles and consistent with their duties and responsibilities—beneficial interests must be identified and trustees must balance the settlor's intent and the beneficiaries' interests.

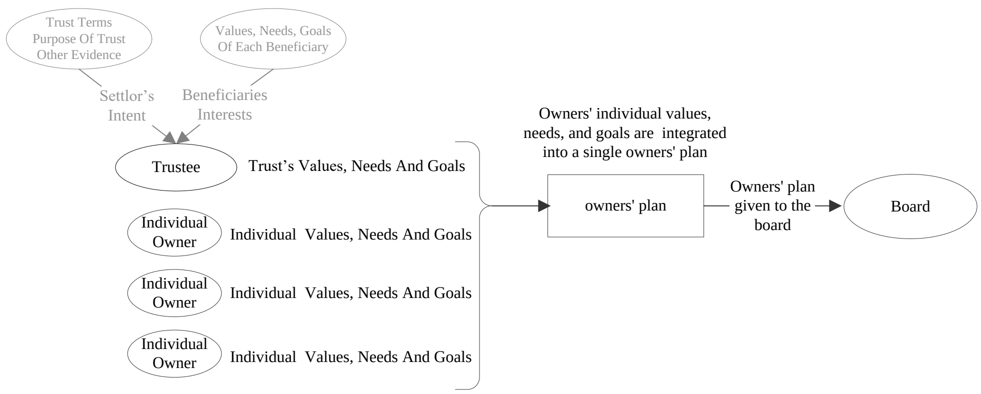
Some trustees may claim they are abrogating their duties by involving the beneficiaries. While trustees must seek information from and engage in open communication with beneficiaries, this does not mean that a trustee must do what beneficiaries want. Rather, the trustee must evaluate all information to determine what is in the best interest of all the beneficiaries and balance these interests with the settlor's intent. The trustee retains the authority to balance the intentions of the settlor and the interests of the beneficiaries. The balancing system involves the beneficiaries in identifying their interests so the trustee can determine if the interests of the beneficiaries are aligned or are not aligned with the intent of the settlor. This is exactly what the law requires of trustees—to administer the trust to accomplish the settlor's intent consistent with the terms of the trust and the interests of the beneficiaries.

Some trustees may argue that this approach stirs up disagreements and conflict. Identifying existing disagreements is precisely the benefit of the balancing system. If there are differences, the balancing system assumes it is better to identify the disagreement sooner rather than later so the differences can be resolved. Ignoring underlying issues doesn't reduce a trustee's risk; it simply enables disagreements to grow over time until they become real conflict, which turn into real disputes with real consequences for the trustee, just like it was doing for the corporate trustee of the Blacknair trusts. Understanding the role of the trustee within a balancing system and employing a balancing process manages the inherent risk of being a trustee by seeking to identify issues early and resolve them before they turn into disputes.

Some trustees may say that, if the settlor's intent is not clear, the trustee has to determine the intent of the settlor. If the settlor's intent is not clear, the trustee is required to ascertain the settlor's intent from all available sources. It is not the position of the trustee to substitute the trustee's judgment for what the trustee believes is the settlor's intent. In other words, the trustee is charged with determining what the settlor wanted to accomplish, not what the trustee would do. This requires the trustee to be independent and "other-centered" rather than being "self-centered." The trustee can solicit the help of the beneficiaries to identify the settlor's intent if the beneficiaries have information that is relevant. However, care needs to be taken to ensure that the beneficiaries are participating in a manner designed to ascertain the intent of the settlor and not to further their own interests.

Step 3. Once a trustee develops the values, needs, and goals for the trust by aligning the settlor's intent and the interest of the beneficiaries, the trustee then participates with the other owners to develop a common statement that expresses the values, needs, and goals of the entire ownership group (Figure 8). If the other owners are also the beneficiaries, this work is relatively straightforward. If there are owners who are not beneficiaries of the trust, the interest of those other owners may or may not be consistent with the interests of the trust. Again, the trustee needs to work with the other owners to develop a set of common values and objectives that are consistent with the interests of the trust. If that can happen, great. If that is not possible, the trustee and the other owners will need to consider changes that separate the owners, divide the business, reallocate or diversify assets, or otherwise attempt to meet the interests of all the owners.

Figure 8 Trustees work with owners to develop owners' plan and presentation to the board



Step 4. The statement identifying the values, needs, and goals of all the owners, including the values, needs, and goals of the trust, is then presented to the board (Figure 8). The board evaluates the statement. Once the board accepts the statement of the owners, the statement is given to management who then prepares their plans for the business that responds to the interests expressed by the owners. The board then evaluates management's plans and, once approved, makes sure that management is running the business consistent with those plans. The owners, in turn, evaluate the board to make sure that the entire system is operating effectively.

If the balancing system had been utilized in the KnoNoiz case, Hank, during his life, might have come to understand that his different roles in the business could be transitioned to different people or groups of people with a new process of working together that would address many of the issues that developed after Hank and Betty passed away. For example, during Hank's lifetime and with Hank's involvement, an owners' manual could have been developed for the business, openly discussing how other family members would participate in the business as owners. Policies could have been developed for such sensitive issues as family employment, compensation, distributions, and personal use of business assets. Hank, as director, could have directed Tom as trustee to work with the beneficiaries to develop an owners' plan, consistent with Hank's intent for the business, and direct Tom as management to develop strategic and annual plans to achieve the values, needs and goals of the trusts as owners. Hank could have decided whether those plans were in alignment and directed the plans be revised if they were not. This system could have been practiced under Hank's direction, and afforded Hank an opportunity to determine whether consensus could be reached, and pursue alternate strategies to the transition if it could not. When Hank died, Tom, the corporate trustee and the beneficiaries would have all understood and had experience in their new roles, greatly easing the transition. Tom would not have been positioned as a "replacement" or "surrogate parent" for Hank, but understood as having an interdependent role that must be integrated and balanced with other roles as part of a comprehensive system.

While using the balance system during Hank's lifetime might have been advantageous, it could also have been useful if implemented after Hank passed away. The corporate trustee had the ability to implement a system whereby the family expressed their interests in a controlled manner and to hold Tom accountable to a plan identified by the corporate trustee as owner. While Tom likely would have resisted such actions, the corporate trustee would be fulfilling its duty of administering the trusts to accomplish Hank's intent consistent with the terms of the trust instrument and the interests of Betty and all of Hank's children. Most importantly, however, the corporate trustee would have been in the best position with the necessary information to ensure that the interests of Hank, his family and KnoNoiz were aligned.

Some trustees may argue that this approach is too much work or too complicated. It is not being suggested that the balancing system needs to be used whenever a trustee holds an interest in a family enterprise. It is also not being suggested that this system needs to be used in its full format in those when a trustee holds interests in a family enterprises experiencing challenges or conflict. Quite often the systems corporate trustees are using, especially those corporate trustees that have established in-house resources for family enterprises, are sufficient. What is being suggested is that:

- the balancing system can bring value to a family owning assets together, especially when there are actual or the potential for differing interests to be held by family members
- the use of trusts and other legal arrangements, while critically important, will not avoid conflicts from causing disruption within the family or the family enterprise
- the balancing system can help corporate trustees:
  - accept an appointment in situations where they may otherwise decline;
  - address a problem they currently have within their client base; and
  - expand the value they can bring to existing or potential clients.

Conclusion

At last Joe finished preparing for his next meeting with the committee. He felt good. The balance system lets the bank get actively involved in helping families manage the myriad of risks that are associated with families owning businesses and other enterprises. The differing interests that can often arise among various family members and multiple owners and between ownership and management can be addressed. The balance system allows the bank to help those families and family enterprises with the greatest need while minimizing if not eliminating the bank's risks, including challenging situations such as what the Blacknair family faces. Using the balancing system sets Joe and his group apart from the competition. They can effectively manage the risks associated with owning interests in family enterprises thereby increasing additional opportunities to become involved in more challenging family enterprise situations.

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