Best Practices to Avoid Intrafamily Transaction Shareholder Litigation

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Avoiding, or at least minimizing, the potential for intrafamily shareholder litigation is constantly on the minds of wealth planning advisers. Wealth planning advisers include trust and estate attorneys, accountants, financial advisers, bankers, and valuation analysts. This discussion addresses the best practices for high net worth families to avoid such intrafamily litigation. Such best practices may be implemented both by the high net worth family members and by their wealth planning advisers.

Introduction

Significant wealth (particularly in the form of closely held business ownership) creates a number of concerns for families. One of the most important concerns is how to properly transition wealth from the current generation to the next generation—not only in a tax-effective way, but also in a cordial manner among the heirs.

Orchestrating and managing intergenerational wealth transfers require a delicate balance among:

1. the timing of the transfer,
2. the amount of the transfer, and
3. the overall cost to effectuate the transfer.

Wealth planning becomes a major time investment, and it can become expensive. This statement is especially true when the intergenerational wealth transfer program is executed incorrectly.

Additionally, wealth transfers, specifically intrafamily transfers, can cause tension between family members and other family-owned business shareholders. This strain can often lead to unnecessary shareholder litigation, both intrafamily and otherwise.

This discussion addresses the best practices prior to, during, and after intrafamily transactions to help avoid unnecessary shareholder litigation. This discussion predominately focuses on issues that affect valuation, but it will extend to succession planning, legal agreement documentation, transaction processes, and corporate planning.

Finally, two recent judicial decisions are used to illustrate the importance of implementing some or all of these best practices.

Laying the Best Foundation for Intrafamily Transactions

Intrafamily transactions are transfers, either by sale or gift, between family members. One of the most common intrafamily transactions is the gift of shares of the family-owned business from the parent generation to the children generation.

Although each situation is unique, well thought out estate planning takes time and effort. With most family-owned businesses, estate planners will effectuate intrafamily transactions in small pieces until:

1. the family business is in the hands of the next generation (or generations) and
2. the parents retain little to no residual interest.

Well orchestrated estate planning requires specialists in the areas of trusts and estates, tax accounting, valuation services, and wealth planning. These advisers are usually separate and distinct from the corporation's accountants and attorneys. This is because intrafamily transactions are complicated and require specialized skills and consistent industry exposure.

As things change from a regulatory or taxation perspective, wealth planning may be accelerated, delayed, or revised. In addition, when family situations change, intergenerational wealth planning is often altered in some fashion. Having a dedicated team of advisers in this specialized area is important for successful intrafamily transactions.

Additionally, one of the important aspects of successful intrafamily transactions is to not only have a special team of advisers, but to have professionals who are both prominent and regarded in their respective professions.

These advisers will act as long-term advisers to the family for many years, if not generations. This will ensure that the intended goals of the parents will play out according to plan, throughout the generations.

Having prominence and respect in the estate planning industry is helpful as these specialized situations require unique solutions and creative thinking.

Further, the team of advisers needs to be able to work together with the family members to accomplish their estate planning wishes. This requires consistent communication between the parties as estate planning procedures are being accomplished.

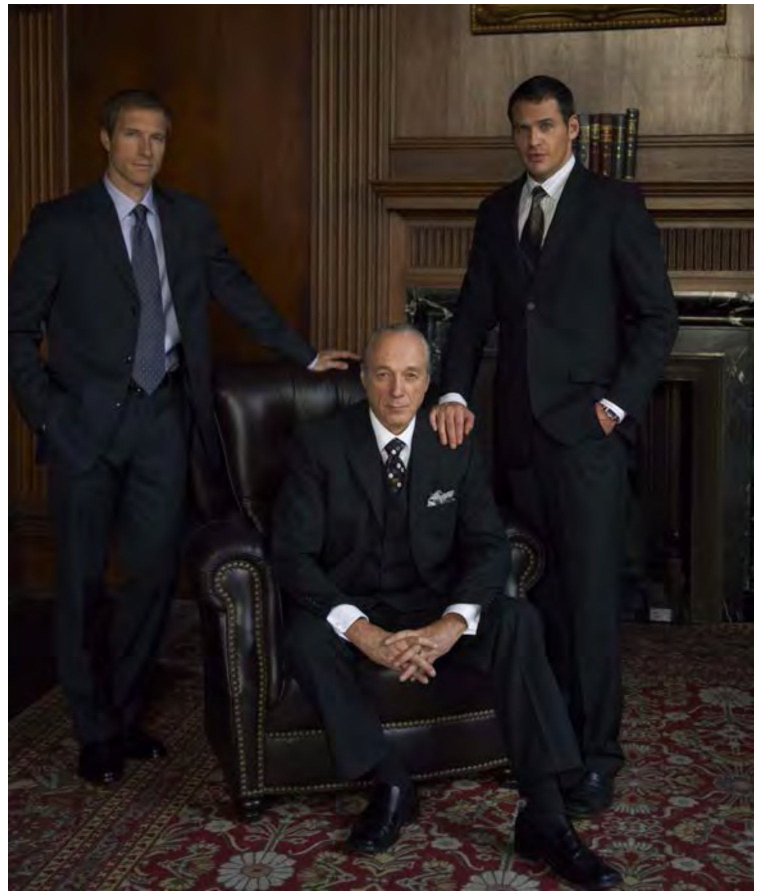
Often, annual or bi-annual meetings of these advisers take place to discuss current issues and processes. With families of high and ultra-high net worth, family offices become a component to this communication aspect and act as central hubs of information.

The family and the advisers should all understand the estate planning steps that are being made, and everyone should be in agreement concerning those procedures. These matters can be especially difficult for the next generation to understand and agree upon.

Lastly, intrafamily transactions require well thought out plans, procedures, and processes for implementation. All parties should be on board with how complicated, extensive, and expensive the implementation of certain intrafamily transactions will be.

A proper estate plan should be drafted by a trust and estate attorney and followed by the advisers, not precluding necessary changes and edits from time-to-time.

The foundation to intrafamily transactions can be summarized as follows:



- Have an organized, trusted, experienced, and long-term team of estate planning advisers.
- Communicate often with your advisory team and the next generation to ensure the goals and objectives are clear and understood.
- Draft and follow a well thought out estate plan that can be amended periodically.

Having these elements in place will ensure that the foundation of the family's estate plan is sound and most effective—both financially and procedurally.

The Valuation Analyst's Role in Intrafamily Transactions

Most people understand the roles of trust and estate attorneys, wealth advisers, asset managers, accountants, and estate planners in intrafamily transactions. The one role that is often underutilized in intrafamily transition planning is the valuation analyst.

Valuation analysts play an important role in intrafamily transactions. Not only do valuation

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analysts provide autonomous and unbiased advice and valuation analysis, but they also provide fairness, expertise, and adequate disclosure documentation.

Prior to an intrafamily transaction, valuation analysts can assist in structuring a transaction that meets all parties' goals and objectives. Valuation analysts can assist legal counsel in understanding the valuation considerations and effects of changes in legal agreements and transitional documents that could affect the value of interests under proposal to be sold, gifted, or exchanged.

During an intrafamily transaction, independent valuation analysts provide unbiased advice and opinions. They can be relied on to provide their expertise and estimate of fair market value of the subject interest without unneeded bias. Potentially nonindependent and biased opinions may be provided by:

1. investment bankers;
2. other family members;
3. internal accountants;
4. anyone with a contingency fee;
5. anyone with an interest in the asset, property, or security being valued; or
6. anyone with a relationship that may be affected due to a lack of follow-through on certain client requests.

Valuation analysts may also be helpful in assisting parties in negotiation as a third party and providing adequate disclosure and other forms of documentation in related-party transactions, which may be necessary for tax filing disclosures.

After an intrafamily transaction, valuation analysts usually (and should) provide assistance in defending their analysis if the valuation is at all questioned by the Internal Revenue Service, the Department of Labor, the Department of Justice, the U.S. Securities and Exchange Commission, or any other federal agency; or if the transaction is ever litigated by another shareholder or family member.

Above all, a valuation analyst's expertise is instrumental in effectively implementing intrafamily transactions.

Best Practices

Although not representative of all examples, the following list presents "best practices" that family-owned companies should implement before, during, and after intrafamily transactions:

- Clearly written and agreed-upon estate plan
- Clearly written and agreed-upon succession plan
- Clearly written operational agreements that set forth the shareholder operational involvement in the company, including elections of board members and management
- Open access to company documents and procedures to ensure transparency between family shareholder members
- Access to regular annual shareholder meetings
- Ability for family shareholders to oversee and observe board of directors meetings
- Access to regular annual valuations by a reputable valuation firm for family shareholders to more effectively and efficiently coordinate individual estate planning objectives
- Clearly written rules and procedures of family shareholders involvement (or lack of involvement) in the company affairs, including influence on dividend distributions, selling one's interest to a third party, or registering the private company for an initial public offering
- Requirement for a certain number of years of outside experience or education/expertise for certain management members and board roles within the company
- Requirement of an advisory board or board of directors with some (if not all) independence and that board committees would include such independent advisers (e.g., audit, compensation, and governance committees)
- Have a policy in place (1) to select directors based on experience and qualifications, (2) to vote in directors and remove directors, and (3) to periodically (e.g., annually) review directors
- Align incentive plans and policies with the efforts and work provided by each family member in the company; this should mirror compensation provided to nonfamily members (which may include long-term incentive plans, such as stock appreciation

rights, for nonshareholder management and directors)

- Defined policy for shareholder distributions and stock repurchases
- Provide within the shareholder agreements that any litigation that may take place will be through binding arbitration in one state rather than public court proceedings in various jurisdictions

Judicial Precedent Examples

There are numerous judicial decisions related to intrafamily litigation. This section takes a closer look at two cases: *Edler v. Edler*[1] and *In the Matter of Zulkofske*.[2]

Edler v. Edler

In *Edler v. Edler*, Steven and Richard Edler were brothers who co-owned Edler & Sons Trucking & Excavating, Inc., a trucking and excavating company that was originally started by their father.

Before their father retired, Steven was the father's partner while Richard was a truck driver. When the father retired, the company was reformed with Steven owning 60 percent and Richard owning 40 percent.

Over a short period of time, Steven started to oppress Richard by taking away his salary, making him an hourly employee who was required to submit time cards, and taking away his corporate check writing privilege.

Richard was also away from the business as a result of having cancer. When he tried to return to the business, his employee status was terminated, and he was replaced as corporate vice president by Steven's wife.

Richard sought judicial dissolution of the company due to Steven's oppressive conduct. The parties jointly retained a valuation analyst to calculate the fair market value of Richard's 40 percent interest.

The analyst applied the adjusted net asset value method (an asset-based approach valuation method), valued the company as a going-concern business enterprise, and applied a combined 30 percent discount for lack of control and discount for lack of marketability.[3]

The court concluded it was inequitable to apply the lack of control and lack of marketability discounts. The court recognized that a discount for lack of control discourages the equitable purpose of protecting a noncontrolling shareholder from a squeeze out.

The exclusion of Richard by Steven from the company created the same situation faced by a dissenter shareholder in a closely held corporation. The court summarized that, "[t]he shareholder not only lacks control over corporate decision making, but also upon the application of a discount receives less than proportional value for that loss of control."

The same rational applies to the rejection of the valuation discount for lack of marketability.

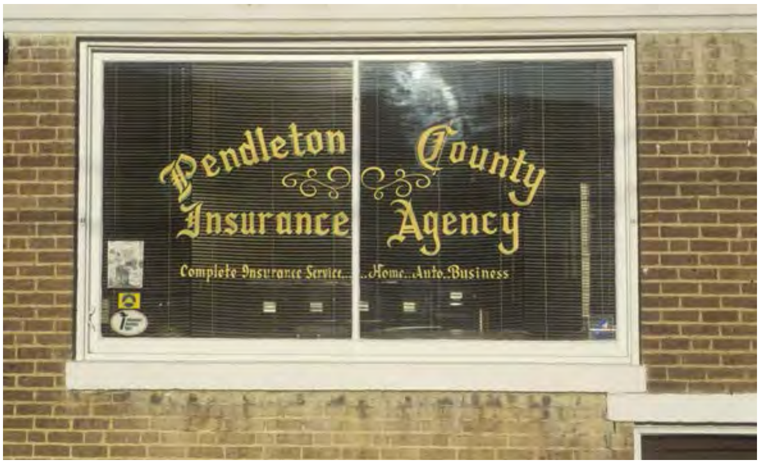
The court ordered Steven to buy out Richard's interest, minus a 6 percent liquidation discount. Steven appealed the court's determination of oppression as well as its rejection of the discounts for lack of control and lack of marketability. Richard appealed the application of the liquidation discount.

The court of appeals emphasized the stock purchase agreement and stressed the nature of the closely held family corporation. The fact that Steven was trying to squeeze out Richard constituted a breach of fiduciary duty, and it went against the agreement's purpose urging family members to continue their active association with the corporation.

The appellate court confirmed the trial court's valuation, and it rejected the application of discounts.

In the Matter of Zulkofske

In the Matter of Zulkofske, Peter and Virginia Zulkofske were a brother and sister who each owned 50 percent of the Brookhaven Agency, a retail/property casualty insurance company located in suburban New York. Family conflict prompted Virginia to petition the court for dissolution and accounting of the business.



Peter's son Nicholas was responding for his father, and claimed that Virginia did not own any shares of the company. However, Virginia was able to produce stock certificates proving her 50 percent ownership.

It was agreed that grounds for dissolution existed, and the court was requested to proceed with the winding down of the company's affairs.

At the last minute, Virginia asked that, rather than an order of dissolution, the Court consider a statutory appraisal and buyout of her shares at fair value. Virginia had a valuation analyst who specialized in valuing insurance agencies and who could testify in court.

The court offered to delay the proceedings so Peter's son could retain a valuation analyst, but Peter declined.

Peter's son Nicholas claimed that he produced and owned approximately 60 percent of the business. He confirmed that he was paid commissions on all his sales.

The valuation analyst hired by Virginia valued the insurance agency as of December 31, 2011, using an income approach and earnings-based valuation method. The valuation analyst concluded a value of just over $764,000, or $382,000, for her 50 percent share.

The court did not find it credible that Nicholas owned any of the corporate business. The court determined this was a successful continuing enterprise. And, the court concluded that the valuation analyst retained by Virginia was a credible valuation analyst with years of experience in the insurance industry.

The court directed Peter to purchase Virginia's shares for 50 percent of the corporate value, or $382,000.

What Went Wrong in These Cases?

From reading these judicial decisions, we can see that what went wrong in each matter is similar. In both cases, there should have been a clearly defined, written, and agreed-upon estate plan of the patriarch that originated each business.

It also appears that there was little transparency between family members and shareholder members. This could have been resolved if there were clearer rules for shareholder involvement or lack thereof.

Conclusion

Intergenerational wealth planning is a complicated and ever-evolving process. Naturally, as wealth increases, the opportunities and likelihood of shareholder litigation (specifically intrafamily litigation) increases exponentially.

There are many considerations when transferring the family business to the next generation. Successful transfers take several years to develop and successfully execute. Families need to start early in this planning process. Carefully developed strategies are important.

The results of an effective transfer can be very rewarding financially and emotionally for both generations. Assistance from professionals who work in this area and understand family issues and business issues are recommended to help family members have the best possible chance of reaching their goals.

Effectuating intrafamily transactions is an important component of the intergenerational wealth planning process. Advisers should constantly be considering the best practices to propose and implement each family's unique situation.

Having long-term advisers and implementing best practices will assist in the avoidance of unnecessary intrafamily shareholder litigation.

Notes:

1. Edler v. Edler, 745 N.W.2d 87 (Wis. Ct. App. 2007).
2. Zulkofske v. Zulkofske, 957 N.Y.S.2d 267 (N.Y. Sup. Ct., Suffolk County, June 28, 2012).
3. HMO-W Inc. v. SSM Health Care System, 611 N.W.2d 250, 256-257 (Wis. 2000).

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