

*A Failed Legacy ... A Rudderless Family*

*-or-*

*Sustainable Enterprise ...  
Highly Functioning Family ...  
A Wonderful Community Legacy*



*Philip J. Toffel Jr., JD, Managing Partner*

**Sage Hill Family Office** ... *The family office overseeing family business & family legal, financial, legacy, and relationship matters in a thoughtful, results-oriented manner...*

*Saratoga Springs, New York / Delray Beach, Florida*

*Direct: 518-225-4136*

[ptoffel@sagehilladvisory.com](mailto:ptoffel@sagehilladvisory.com)

## *A Failed Legacy ... A Rudderless Family*



*Carl started his business in 1968 after a tour of duty in Vietnam. Carl's father was a World War II veteran who, like most of his generation, didn't share the atrocities which he witnessed in Europe and, as well, preferred not to open up his wounds of hardship stories of the economic woes of his family in the 30's. Carl was seeking a 'fresh start', married his high school sweetheart, Joan, and with a little help from Dad started an HVAC business.*

*Carl struggled at first, but eventually began to attract a following and was able to buy a home for his young family. He hired a few employees in the mid-70's, and the business took off as it became a very sophisticated commercial HVAC enterprise. Carl became active in his 250,000-population community in the Midwest.*

*Carl and Joan had three children ... Carl Jr. (no relation to the fast food enterprise!), Fred, and Beverly. "Junior" and Fred did some tasks in the business as they grew up; Bev had no such requirements by Carl and Joan.*

*They had several loyal employees, whom they paid reasonably well and for whom they developed a fair 401k plan and contributed towards the health plan premiums.*

*Junior and Fred married and stayed in the community but chose to go in directions other than in the family business. Bev married and lived in Chicago with her college professor husband and two children.*

*Carl's business enterprise and his highly astute real estate and financial market investments grew his total net worth to over \$50,000,000 by 2005. Now 65, his and Joan's health had a few hiccups, but all-in-all they were satisfied and stable.*

*In 2008, Carl's real estate investments lost 20% of its value; his unhedged stock market portfolio lost 40%, and his business suffered as several of his large commercial customers' businesses failed. He laid off some of his employees as a result, with many of the employees' families disrupted by the losses in their 401k plan and college education savings, resulting in a stressful work environment.*

*Carl's total net worth was still substantial, however, at approximately \$35,000,000. He and Joan had not done any significant estate planning other than Wills, Living Trusts (which paid out to their three children equally at ages 30, 35, and 40), and a \$5,000,000 life insurance policy costing them \$55,000 per year.*

*Carl was hesitant to re-invest his financial investments after the 2007 financial crisis, thus moving their entire portfolio to short-term treasury bills.*

*In 2010, a local attorney whom Carl knew, suggested to him that it would be wise to take advantage of a one-year exemption in the estate tax law and to transfer shares of his company to his children. Carl took the advice and transferred 15% each to Junior, Fred and Bev. All received voting shares, but they all knew that Dad's vote was the only one that counted.*

*Junior's life was stable but was a little pressured by anticipated college bills ... especially due to the volatile stock market. Fred was going through a divorce, with the company stock now being a central issue raised by his wife's litigious attorney; Fred also now showed interest in entering the successful family business as he turned 35 and was under financial stress ... plus, Fred figured, Dad is now 70 and probably ready to turn over the reins. However, this succession had never been discussed in any depth within the family nor within the company. The company was effectively Carl's ... no Board of Directors, no shareholders' meetings, no real executive committee.*

*Carl brought Fred into the business as a Vice President, with Fred now shadowing Carl. Many of the managers were turned off by Fred's attitude as the self-anointed heir apparent ... thus, they were not supportive of Fred. Junior now also was beginning to offer his opinion of how things were run in the company ... after all, he felt that as the oldest child, as a shareholder, and as a local reasonably successful businessman, his voice was appropriately offered. Bev generally stayed out of family business matters but did voice 'what this meant for her family' ... after all, she was a "part-owner" as well as Junior and Fred!*

*Carl and Joan were not happy with the stress in the family ... Carl was not happy with the stress in the business - Fred's constant need for more money from the business to support his significant alimony and child support payments (exacerbated by his company shares valued at several million dollars in his divorce judgment), and many unhappy managers who were irritated by the assumed role of Fred.*

*Family gatherings were polite on the surface, but Bev's family was now spending more time during holidays with her husband's parents and siblings, and Junior and Fred were only together now when Carl and Joan had holiday gatherings. As you can tell from the photo above, Carl and Joan, Fred and his girlfriend, and Fred's children aren't very happy ... Junior and Bev aren't there for Thanksgiving.*

*Well ... Carl and Joan died in 2012 ... here's what happened:*

- *Their estate was valued by the IRS @ ~ \$30,000,000; their assessed estate taxes were \$8,000,000*
  - *The \$5,000,000 life insurance policy paid for a portion of the tax*
  - *Financial assets and investment real estate were liquidated to cover the remainder*
- *The company was now owned equally by Junior, Fred, and Bev; the Operating Agreement stated that majority vote was required for major decisions ... Fred was ignoring this 'technicality' and making unilateral decisions; he spoke with company managers but followed his business intuition in his decision-making. The business was now suffering from Carl's absence and from Fred's approach. A few of the managers left to go with a competitor.*
- *Fred created an Advisory Board comprised of a few of his buddies in the community*
- *The Community was now becoming more and more aware of the family disruption*
- *Fred unilaterally increased his salary and bonus to support his lifestyle*
- *Junior and Bev brought a shareholder's lawsuit against Fred for violation of the shareholders agreement*
- *The third-generation cousins now rarely were together; Junior and Bev were not on speaking terms with Fred*

*Were Carl and Joan unique in the troubles which occurred in their family, their business, their key employees' lives, their legacy and reputation in the community? CLEARLY NOT ... in fact, it's more often than not. Among successful family business enterprises, only 30% make it through the second generation and only 12% make it through the 3<sup>rd</sup> ... Thus, the ones who make it through successfully with happy supportive families, supported loyal key employees, and successful wealth transition are the exception. But you will see as you read on that it is very doable with the right attention: strategically, tactically, and proper execution & management throughout the process.*

Family business founders' **perception** of their risks of optimal sustainability risks are much different than what historically has happened.

Risk Perceptions:

37%	Poor Business Management / Spending
26%	Economy / Investments
16%	Taxes (estate, income) / Political (government intervention)
7%	Poor family communication; family relationships

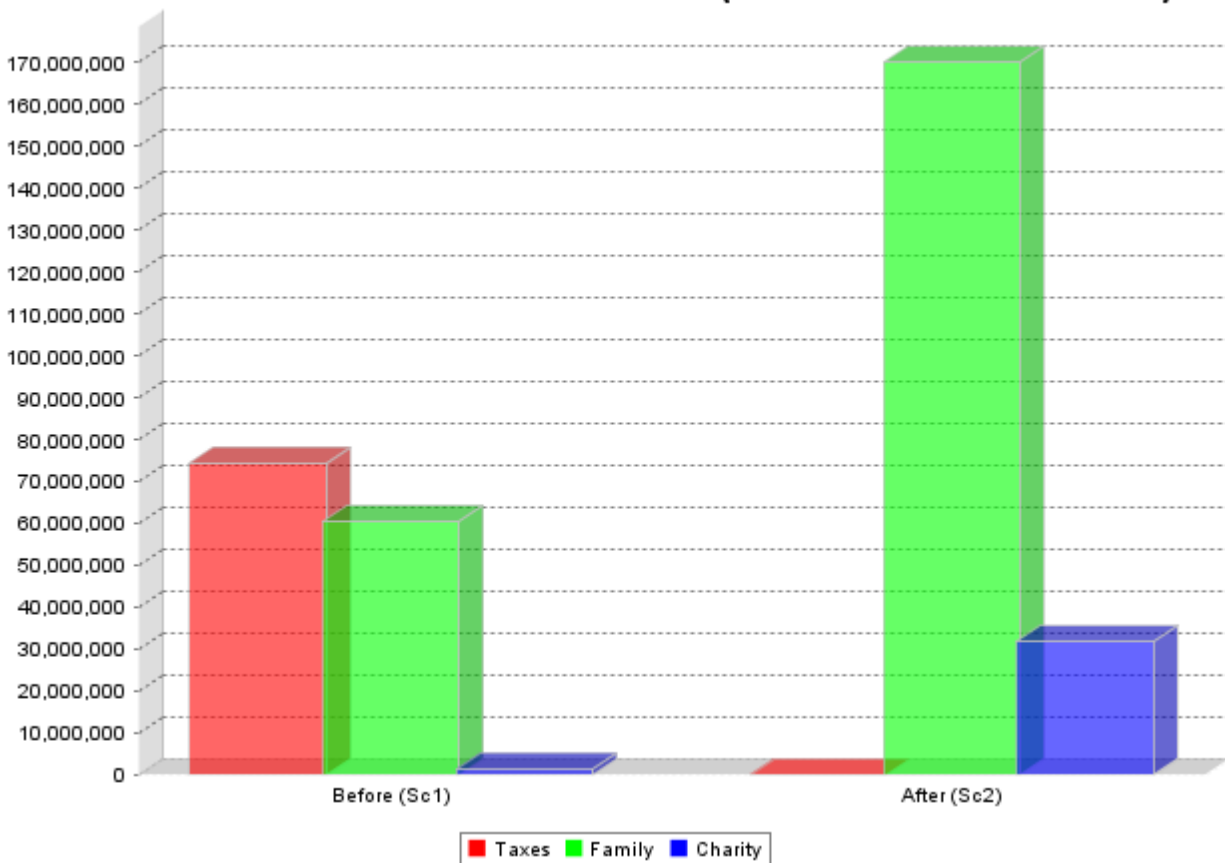
Reality:

60%	Family communication / trust failure
25%	Unprepared heirs
< 15%	Poor financial / estate planning

Clearly, this does not mean that if one communicates well with family and you prepare your heirs for succession well that you can ignore proper practical financial and legal estate planning ... of course not. However, it's the inverse which too frequently occurs: that the family business patriarch and matriarch create practically sound estate plans and financial plans ... but that they ignore proper planning for key employees, they don't communicate with their children and key employees (as stakeholders in future success), and that they don't properly prepare their heirs and successors as the founders move on with their lives ... and prepare for a robust legacy for those whom they typically want to continue to succeed (family, loyal employees, chosen charities, community).

Admittedly, the pure financial ramifications of the financial, legal, philanthropic, and tax planning, execution and management are indeed profound and must be accomplished with best practices in all areas. Following is representative of what can be accomplished with proper forethought:

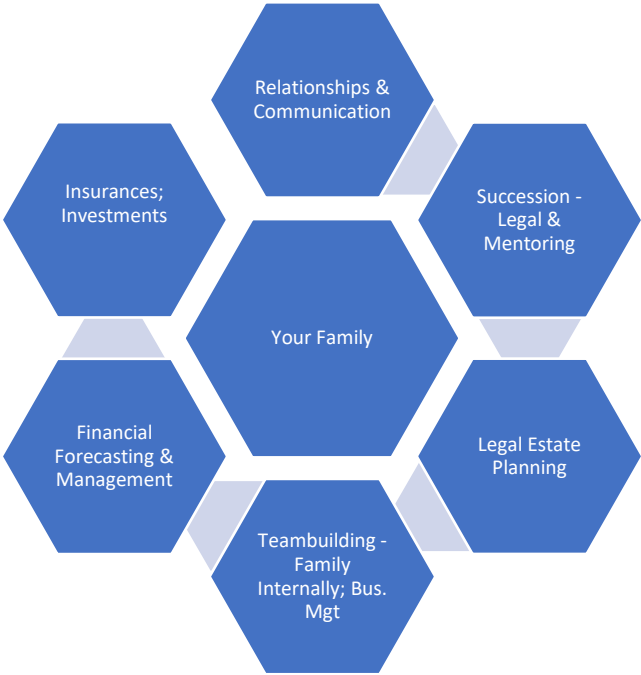
## Estimated Estate Distribution Year 25 (Scenario 1 vs Scenario 2)



*BUT ... **Simultaneous** STRATEGIC planning integrating family relationships, planning for key management employees, sound financial planning, and strong legal estate planning is critical. Don't proceed to TACTICS until your strategic plan is in place...make sure that EXECUTION is competitive among brokers and consistent with the tactics and strategy, particularly in areas such as life insurance, investments, and benefits planning (We suggest and manage a Request-for-Proposal Protocol which forces competition among transactional producers re contract terms, fees and commissions) ... the plan doesn't end after execution, as ongoing MANAGEMENT is critical to ensure that "the ship stays afloat and properly captained through troubled waters".*



*Such simultaneous planning, execution and management incorporates numerous important areas, a few of them being ...*



## ***A sustainable enterprise ... a highly functioning family & a wonderful community legacy***

*By contrast from Carl and Joan, take a look at Bob and Ellen (Bob in the red cap and Ellen to his left), Ellen's Mom & Dad, their children and in-laws, and grandchildren ... a hard-working family from Dallas, Texas.*



Bob and Ellen approached their family agribusiness and the business-of-the-family much different than Carl and Joan. They started planning for this to be a sustainable multi-generational enterprise early on ... as long as the business continued to grow in a successful financial manner and as long as future generations of the family had interest in managing and leading the business.

*As well, they realized that some of their children would very likely have no interest in the business, but that their passions would take them in different professional directions and to other parts of the country potentially.*

*Bob and Ellen spent a great deal of time talking between themselves, as well as with their family professional advisors, about developing a plan which was fair ... yet they decided that fair does necessarily mean equal for them. A few themes began to become paramount to them:*

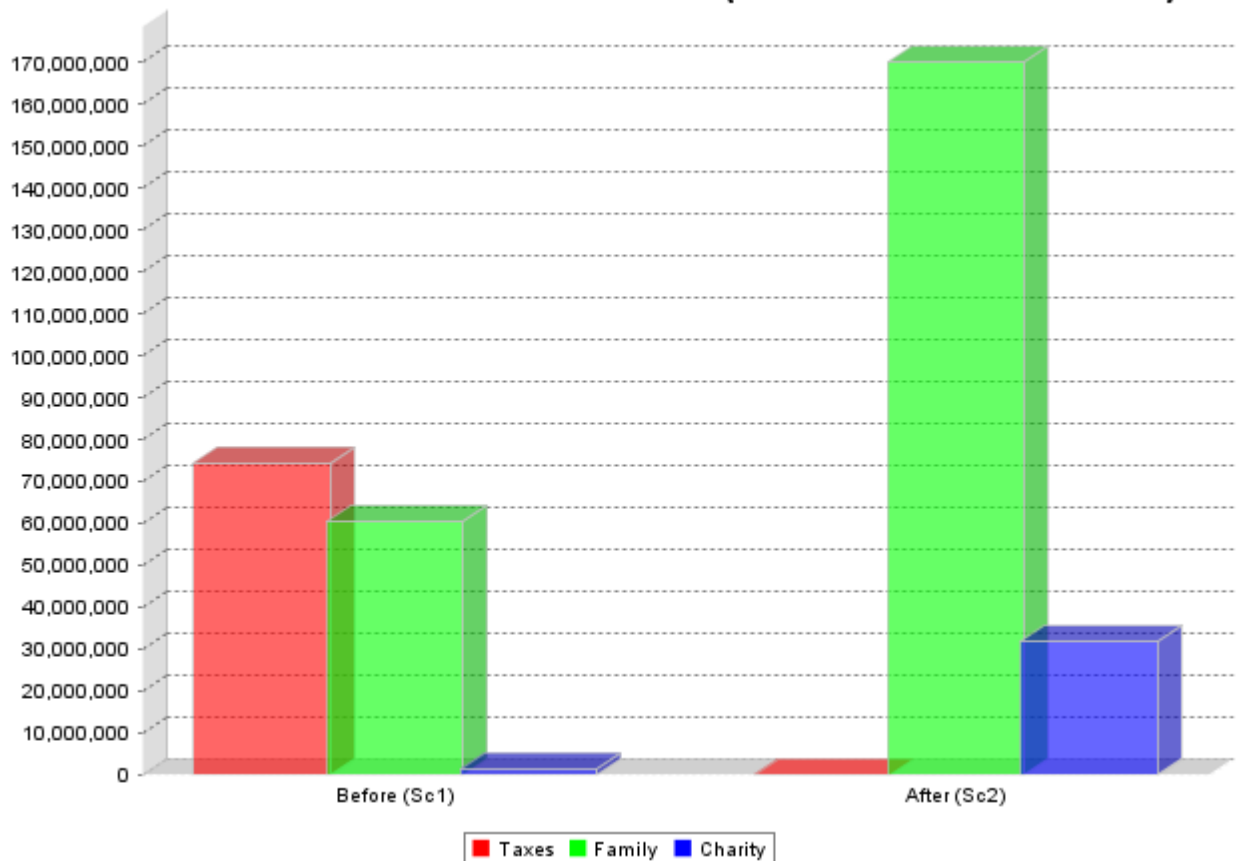
- *“Legacy” wealth transferred for their children and children’s families is different than “Earned Wealth” (i.e. wealth earned through time, energy, education, and risk taken by children who decide to be in the business)*
- *No Entitlement: financial support for their heirs would provide some “tailwind”, but they were required to demonstrate contributions to the family, the community, and to be productive members of society. In that sense, the legacy assets are there for health, education and support. A structure was established for trustees to exercise their discretion within general parameters established by Bob and Ellen*
- *Creditor Protection: as a successful family, they acknowledged that they are accountable if negligent in any way; however, they wanted to protect themselves against any potential “nuisance lawsuits” or that the business would end up in the middle of any potential divorce action*
- *Estate Tax Avoidance: they had become very aware that estate taxes and farm businesses had seen many changes over the years. They did not want their business to be required to be sold in order to satisfy an estate tax liability.*

- *Independence from being totally reliant on the family business: like any business, they realized that it is easy to gain a sense of wanting to control their destiny (and that of future generations) through what-they-know ... and only through what-they-know, thus avoiding investment in other assets outside of their family business*

*Bob and Ellen took the long view, realizing that industries change ... especially since 1970 when they started theirs, and certainly even much more in today's world. Thus, they wanted to re-invest some of the financial fruits of their labor in assets which had the highest possibility of sustainability for the infants in their lives today for the next 90 years +/- in those children's lives, plus further generations of the family!*

*What did Bob and Ellen do? Well ... in summary, they accomplished a plan to do **this**:*

**Estimated Estate Distribution Year 25 (Scenario 1 vs Scenario 2)**



***And this:***



*Here's a Summary of **WHY** and **WHAT** Bob and Ellen did:*

*All too often, people (and professional advisors and managers) go directly to **WHAT**. A Client ... a successful family business Owner ... will / should always think first of the **WHY**!*

**WHY** Bob and Ellen developed their WHAT:

- *Love of family*
- *Passionate about family inter-support and intra-support*
- *Passion for each other's (Bob – Ellen) well-being*
- *Loyalty towards key employees*
- *Passionate for community, church community*
- *“We’ve worked too hard to leave future generations’ security to chance ...”*
- *“Let’s help each following generation of family to be wiser and smarter ...”*
- *No arrogance or entitlement permitted*
- *Be humble*
- *Do things the right way!*

**WHAT** are some of the steps that Bob & Ellen took, with guidance from Sage Hill?

- *Committed together to the WHY's*
- *Created South Dakota-based Dynasty Trusts, one to own shares in the family business and one to own other assets:*
  - *Trust A – Family Business*
    - *Creditor protection*
    - *State Income Tax Exempt (subject to situs of real estate and business operation assets)*
    - *Modest Trustee Fees – Administrative Trustee*
    - *Gift + Sale of business shareholdings to Trust*
    - *Ellen = Beneficiary A*
    - *Future lineal descendants whom are employed by the family business = discretionary beneficiaries for health, educational, and support*
      - *Memo-to-Trustees from Bob & Ellen establish themes for Trustee to apply discretion*

- *Implemented a Phantom Stock Plan for employees as key executives of the organization mirroring growth in enterprise value*
- *Established Trust B – Financial Assets for benefit of family members and in-laws who are not active in the family business*
  - *Made Family Business loans \$ to Trust B for multi-generation life insurance policies*
    - *Loan refunded to Business / Trust A via cash value / death benefits*
    - *Based upon life insurance contracts insuring multiple generations of family (+ potentially in-laws), IRR goal = 10% +*
      - *Income Tax-Free*
      - *Pre-Tax Equivalent IRR ~ 15%*
    - *Followed Strict Sage Hill RFP Protocol*
      - *Competitive bidding among insurance consultants / brokers / companies*
      - *Diversification of Insurers*
    - *Insuring multiple generations provides strongest likelihood of sustainability of family legacy*
    - *Family Name = strong character community value*
  - *Created a Pool of Long-Term Growth Assets*
    - *Hired Sage Hill Investment Management*
      - *Shift market risk to investment banks*
      - *Issuer diversification for credit risk protection*
      - *Match maturities with cash flow needs of beneficiaries*
  - *Provided Short-Term Income Needs*
    - *Match cash flow needs with income distributions / instrument maturities*
  - *Enabled Trust as a loan source for family members who are seeking financing for professional ventures*

- *Trustee + Other Beneficiaries serve as Mentors for the individual seeking guidance for a new potential venture*
    - *Trustee has final decision / Family serves as Advisory Committee*
  - *Intangible assets are generally income tax free for South Dakota state income tax purposes; Life Insurance contract growth and death benefit are free of Federal and State income tax.*
- *Separated beneficial interests between family members in-the-business and outside-of-the-business is critically important to set expectations and avoid over-reaching into the family business by non-involved family members*
- *Provided Opportunities for Family Members + In-Laws to have opportunity to serve the beneficiaries of Trust A as Stewards of the enterprise; they must earn the privilege of serving in such capacity + participating in the phantom stock plan and beneficial interest. They earn privileges ... no inherent rights*
- *Made sure that Trust B beneficiaries have legacy benefits of “tailwind” support*
  - *Discretionary*
  - *No stated financial benefits at given ages / years*
- *Conducted Family Meetings ... to display Bob & Ellen’s expectations of family members, and (thematically) what they can expect as family members and as family business participants.*
- *Conducted family business management meetings ... to announce the enactment of a Management Incentive Plan for non-family management and the Phantom Stock Plan for family management.*
  - *Both plans provide quantitative formulas for participation in EBITDA and enterprise value*
  - *Concurrent announcement of the plans provides non-family management and next generation family business leadership with commonality of business interest and promote mentoring by non-family management towards next generation family.*



*This is a brief Summary of some of the WHATS taken by a thoughtful, deliberate family like Bob and Ellen to support strong family relations and highly functional business protocols. These are some of the demonstrable steps enabling top performing family business owners to be among the 12% whom are successful in developing sustainable family businesses ... and sustainable families.*

*We hope that this e-book provides you with clarity of to establish clear WHY's and just some of the WHAT's towards a sustainable business and the satisfaction of a highly functional, loving family.*



*Phil*

*Philip J. Toffel Jr., JD, Managing Partner*