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Trusts & Estates newsletter

Spring 2004

LETTER FROM THE EDITOR

Welcome to the third issue of the Rodi Pollock Trusts and Estates Newsletter! In this issue, Tom Curtiss writes about some planning opportunities for our most mature clients and Jack Pettker discusses some key issues for family business owners to consider when planning for continued management of their companies.

Beginning with the Fall edition, we will convert the Newsletter from Trusts and Estates to a full firm Newsletter, which will include articles from each of our practice groups. We also invite you to check out our new and improved website at www.rodipollock.com.

Jean Beasley

THE PERILS OF AGING IN THE TWENTY-FIRST CENTURY

by Thomas Curtiss, Jr.

Americans are living longer all the time. Not everyone who enjoys this new longevity, however, retains the capacity to manage or control his or her affairs.

Everyone needs to plan for the possibility of mental or physical incapacity at some point in later life. This article will consider some estate planning techniques and other actions available to protect the elderly client from such infirmities. The list is not exhaustive.

A CASE STUDY

A client of ours was elderly and in ill health, suffering from diabetes, heart disease and Alzheimer's. She had long lived alone in her townhouse with only her cat as companion. She socialized with a circle of old friends, and she had three brothers, all of whom lived in the east.

The client had recently contracted for a 24-hour caregiver, who had in a very brief period of time insinuated herself into the client's affections. The caregiver had persuaded the client to make sizable gifts to her and her family and had even convinced the client to sell her townhouse and purchase a condominium unit, putting the caregiver on title.

This kind of financial abuse occurs with disturbing frequency. Fortunately, however, many options are available to protect people from such predators. Happily, several of these options protected our client from her "caregiver."

THE OVERREACHING CAREGIVER

Home care has become an explosive growth industry in California. The individual caregiver who spends weeks at a time addressing the most intimate needs of a physically or mentally incapacitated person is inevitably presented with a golden opportunity to take over in some manner all aspects of his or her client's life.

The caregiver can isolate the client from long time friends and family, creating a psychological dependence by the client on the caregiver. The caregiver insinuates him/herself and his/her family into the client's physical and emotional life and manipulates the client's sense of dependence and affection to extract gifts: "My son needs an operation." "My daughter is pregnant."

The employment contract between the client and agency will normally forbid gifts to a caregiver, but enforcing that prohibition is difficult. Such conduct by the caregiver constitutes

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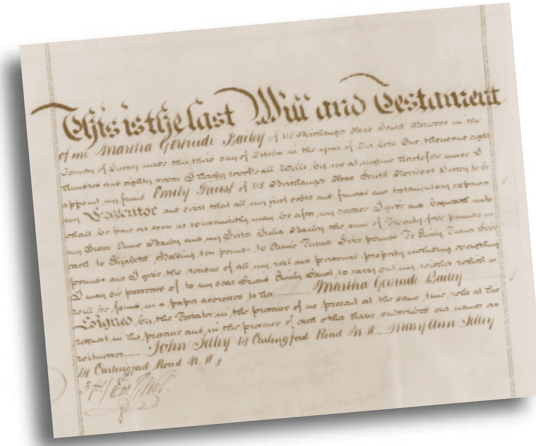

This is the last Will and Testament

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SUCCESSION PLANNING FOR THE FAMILY BUSINESS

by John D. Pettker

A family business is a relatively stable organization while its founder is alive and in control. During that time, threats to the business generally come from external sources, such as competition or regulation, rather than from internal dissent among family members. The founder's authority is seldom challenged, and he or she is generally able to control the roles of other family members within the business. Upon the death of the founder, however, disagreements among family members over management, strategy and different levels of benefits enjoyed by each person can jeopardize the very existence of the company.

Few family businesses survive from one generation to the next. Only 30% survive to the second generation and only 12% to the third. Although the impact of estate taxes can be a factor, in our experience the biggest threat to survival of the family business is rooted in either the failure to provide for the succession of strong leadership or the inability of the founder's heirs to share management control and equity ownership.

CHOOSING A SUCCESSOR

Passing the leadership torch to the next generation may force the founder to face difficult choices as to succession. The choice may be simple when the founder has only one heir who is interested in the business, already actively involved in its management, and a capable business leader. The choice is much more difficult when the founder has several heirs — adult and minor, active and inactive in the business and with varied business and non-business skills.

Sharing management authority, although sometimes successful among co-founders, is rarely successful among members of the generations that follow. The optimal managerial situation exists when there is a good, strong organization supporting one good, strong leader. In order to prosper, a business needs prompt, capable, consistent decision-making, and in the context of the family-owned business, one person can do that best.

The founder may be ready and able to choose a successor to lead the business; if so, he or she should proceed to do so and, to the extent possible, invest the chosen successor with full management authority. This may be accomplished during the founder's lifetime or through his or her estate plan. Where balancing equities among the founder's heirs requires a division of equity ownership among them, the founder may transfer the elements of management control to his or her chosen successor(s) and divide the equity of the business among his or her heirs using an estate plan that separates management control from equity ownership.

MANAGEMENT CONTROL VS. EQUITY OWNERSHIP

In planning for the succession of a family business, it is important to recognize the distinction between management control and equity ownership of the business. "Management control" of the business is the ultimate authority to make management decisions; "equity ownership" is the right to receive income and ownership of the assets of the business. Often management control powers parallel equity ownership rights, but this is not always the case.

Attempts to preserve the business in the same integrated, organizational structure built by the founder, with succeeding family members sharing management and ownership, are probably doomed to fail. Examples abound of division and sale of many family businesses after the death of the founder because of disagreements as to management direction and authority between members of succeeding generations. Furthermore, the events preceding such failures are predictable and unfortunate — management of the business is disrupted, family relationships are bruised or even destroyed, and substantial legal costs may be incurred. Accordingly, it may be advisable to separate these two components.

> ***Developing a sound plan to assure capable future leadership and motivated heirs is the key to successful family business succession planning.***

The divisibility of these components allows the owner of the business, where necessary, to retain or transfer management control separately from the transfer of equity ownership of the business. This may be necessary in order to preserve the vitality of the business through strong leadership. Separation of management control from equity ownership may be accomplished through use of a combination of voting and nonvoting stock of a corporation, in the management provisions within a general or limited partnership agreement or in the operating agreement of a limited liability company.

USING AN ESTATE PLAN TO TRANSFER THE BUSINESS

The founder can also transfer equity ownership of the business through his or her estate plan. If the founder has more than one heir, it is relatively simple to provide a structure for equal division of the equity ownership of the business among those heirs. In the long run, however, maintenance of

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elder economic abuse, however, and the legal consequences in California are well settled, both civil and criminal.

Our client was fortunate enough to have friends who observed her situation and contacted her brothers and attorney. One of them also filed an elder abuse complaint with the Los Angeles County Sheriff's Department, and her out of state family members came to California to visit her.

The Protection of a Revocable Living Trust

If an individual (the "Settlor") has established a living trust and then develops debilitating problems that prevent him or her from managing daily trust affairs, a trusted friend or family member can suggest that the Settlor either resign as Trustee or add another person for convenience to serve with him or her as Trustee. The goal is to ensure continuing management of the trust.

The Settlor's long time attorney is often the logical person to suggest this solution, and in doing so will not have violated any ethical duty of loyalty. Because the attorney represents the Settlor and not the other family members, however, if the Settlor refuses to resign, the attorney cannot ethically take any action contrary to the Settlor's wishes. The family must then seek such other remedies as may be available to them.

It is common practice for trust instruments to define the incapacity of a Trustee for purposes of empowering a successor to assume the trusteeship. One common procedure is for the Settlor's physician to confirm in writing that the Settlor is incapacitated, thus avoiding a Court determination. This procedure has historically worked well, as medical professionals have cooperated with family members in order to protect their incapacitated patients.

Recent federal and California legislation has, however, seriously restricted physicians from disclosing their patients' records or venturing opinions derived from those records. The federal Health Insurance Portability Act of 1996 ("HIPAA") and the California Confidentiality of Medical Information Act ("CMIA"), with their prohibitions and civil and criminal penalties, leave doctors, as well as attorneys and Courts supervising Conservatorship proceedings, in a very uncomfortable legal limbo.

> ***Because the attorney represents the Settlor and not the other family members, however, if the Settlor refuses to resign, the attorney cannot ethically take any action contrary to the Settlor's wishes.***

These restrictions could materially impede efforts by family and friends to protect an elder from financial disarray and sweet-talking charlatans. One solution may be to have the individual preauthorize the release of such information. We believe that logical person is the designated agent under a power of attorney for health care (discussed further below).

Our client had established and funded her living trust ten years before her incapacitation, naming her three brothers as beneficiaries and successor Trustees. We were able to persuade our client to resign "temporarily" as Trustee, while in the hospital, allowing her brother to manage the trust and protect the assets from the caregiver. As a result, we avoided the impediments of HIPAA and CMIA.

Powers of Attorney for Assets and Health Care

An individual (the "principal") can also, in the absence of a trust, execute a power of attorney for assets, which confers upon a trusted family member or friend (the "agent") the right to act on his or her behalf. Such a power can be effective over all of the principal's assets or be tailored to meet limited needs, such as negotiating a bank account.

A general power of attorney can usually avoid the immediate necessity of a Conservatorship, but the principal retains the right to act on his or her own behalf. He or she may therefore still be subject to designing individuals regardless of whether he or she still has the actual legal capacity to act.

An Advance Health Care Directive (the current statutory title for a power of attorney for health care) confers upon the designated agent the authority to make health care decisions on behalf of an incapacitated principal. If the power is effective immediately, we believe that the agent can act to release medical information in compliance with HIPAA and CMIA.

At the time, our client had no Advance Health Care Directive. Her caregiver had therefore suggested naming the caregiver's daughter and son-in-law (whom the client hardly knew). Fortunately, we were able to persuade her that her brother was the more logical choice. She instead named him as her health care agent.

The Conservatorship Petition

If an individual refuses to acknowledge his or her incapacity, friends or family can apply to the Probate Court for a Conservatorship. The appointed Conservator of the estate manages the financial affairs of the Conservatee; the Conservator of the person assumes responsibility for his or her health care, living conditions, etc. Often, the same individual serves in both capacities.

Conservators must report to the Court periodically on their activities. Also, the Conservator's fees and those of the Conservator's attorneys are

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this ownership arrangement can breed dissension among family members if only one of them has been chosen to lead the business.

The chosen leader may consider the non-managing equity owners as largely irrelevant to his or her management of the business or, at the very least, may undervalue the contribution of their equity ownership. The leader may also view his or her management skills as the key to the success of the business and compensate himself or herself well, while making little provision for a return on the investment of the non-managers.

The non-managing equity owners, on the other hand, may be economically frustrated by the leader's actions. They may realize and even accept that they have little or no role as managers, but they may feel abused because they receive little or no return on their equity investment. They may feel that they are providing the leader, in effect, with an interest-free loan of their capital investment in the business.

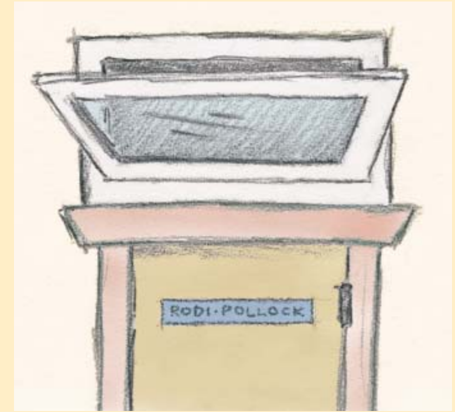
The above dilemma is the crux of the business succession problem. Several solutions are, however, available to the family business owner:

The founder can leave the business to the new leader and leave other assets of equivalent value to his or her other heirs. The purchase of sufficient life insurance can help to accomplish this purpose.

If, as is often the case, the family business constitutes the most significant asset in the founder's estate and such a division is impossible, we recommend that the founder create a plan under which the non-managing heirs' interests will be bought out by the chosen leader or redeemed by the business as soon as possible. This approach not only allows the new leader to run the business as he or she sees fit without encountering any family or business acrimony with non-manager owners, but can also provide very real benefits to the founder's other heirs. They will become financially independent of the new leader and are thereby encouraged to become independent leaders themselves, responsible for their own destinies and with the financial resources to accomplish their own life goals.

Developing a sound plan to assure capable future leadership and motivated heirs is the key to successful family business succession planning. By doing such planning during his or her lifetime, the founder can protect the future viability of the business entity.

A Peek Through the Transom at Rodi Pollock



Property Tax Law

Our firm is a general practice firm, and we offer many other specialties in addition to Trusts and Estates. For example, we pride ourselves as being one of the premier property tax law firms in California. For over 30 years, we have successfully represented national and multi-national corporations, California-based businesses and individual property owners statewide in all aspects of real and personal property assessment and tax refund controversies, many arising out of California's unique property tax system under Proposition 13.

We represent our clients in litigated and non-litigated assessment and refund controversies from the initial administrative proceedings before state and local boards of equalization through appellate litigation. We have been designated as the Southern California member of American Property Tax Counsel, the national affiliation of premier law firms specializing in property tax matters. We are therefore ideally positioned to assist our clients with multi-state or even national property portfolios.

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subject to prior approval by the Court. Still, Conservatorships are costly and often painful Court proceedings and should always be a last resort. Fortunately, our client's willingness to step down as Trustee avoided this distasteful alternative.

The System Worked

Because of these efforts by our client's family, friends, attorney and public agencies, our client was protected: her brother assumed the trusteeship, effectively protecting the client's estate from the overreaching caregiver; the Sheriff's Department began an investigation that sent the caregiver into hiding, and, finally, her brother as health care agent was able to instruct the hospital not to allow the caregiver access to the client. Without caring family and friends and the pre-existing trust structure, the outcome might have been sadly different.

Instead, during the last year of her life, this client's person and estate were well managed and secure. We should all have her good fortune in having such a solid network of protectors!