Inner City Housing, Family Business Succession Planning Success Story: A Case Study

By Edward Rosenfeld

Ed Rosenfeld addresses family business planning issues suggesting critical team members that will help to move this planning forward. Family business is a unique planning specialty, which brings specialized training and experience to the planning process.

Introduction

A key to successful transitioning of family-owned business is a collaborative relationship among the attorney, accountant, financial planner and other key advisors. In some cases it is helpful to have one of the key advisors trained as a family business consultant or to bring a family business consultant in when goals are not clearly defined, there is conflict or the fear of it, or unexplained inertia. The family business consultant understands, through training and experience, the complexities inherent in a family-owned business. The consultant brings special skills in the process of change, which is crucial to succession planning. My experience is in family business consulting and financial planning. Depending upon which professional is leading the planning team, my role in the transaction varies.

Background

Jack Sr. founded his real estate business almost by accident to provide a space for the driving school that he started to put himself through college. He bought his first building to house the school while he juggled his time and became the first in his family to graduate from college. A classic Horatio Alger success story, the real estate business has now grown to 400 units owned in three limited partnerships and managed by an in-house management company. The company specializes in inner-city rental housing in Newark, NJ. Jack's hands-on approach, eye for value and commitment to providing well-run and maintained for profit low-income housing has enabled his business to both prosper and provide affordable housing to a community in need that most real-estate entrepreneurs avoid.

Jack, at age 51, came to us for succession planning consulting both because he wanted to transition the business over a seven to nine-year period to his two sons Jack Jr., age 30, Arthur, age 24 and possibly his daughter who was just entering law school. At the same time he wanted to simultaneously unwind his business interests with his two brothers.

Over the years Jack brought his two brothers, Andy and Johnny, into the business. While Jack owns 100 percent of one limited partnership, he is equal partners with Andy in a second and one third partners with both brothers in the third limited partnership. The business had grown quite profitable, although growth had stalled. There was conflict among the brothers that led to tax inefficient liquidation of some of the properties and unless solutions were found, the divestments would continue inefficiently.

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Jack and his children also expressed a desire to maintain a welcoming attitude and structure not only for their sister, but for their cousins to become involved in the business.

The Engagement

Step 1: Clarify the Family's Principles, Values and Vision and Produce Statements That Articulate Them

Principles and Values. According to Steven Covey, in The 7 Habits of Highly Effective Families, principals are like true north, they never change no matter how the compass is positioned. Values are like the direction of travel, which unlike true north, can change. Values are flexible and are derived from principles, but can change and are influenced by social and cultural systems.

What are principles?

- The laws or regulations that govern us
- The foundation of who we are
- The beginning or source of what we have become
- Beliefs from which values are derived

What are values?

- Values are standards that are important to a feeling of well-being
- They evolve from our basic principles and help us determine what is worthwhile
- They guide our behavior and decisions

By starting with principles and the values that flow from them we were able to determine that Jack and his sons shared a common foundation that led to an articulation of vision.

Vision. Through a series of facilitated meetings we developed a vision statement for each son, 24-year-old Arthur and 30-year-old Jack Jr. Initially they each wanted independence from each other and independence from their father. They did not want to reproduce the conflict that was driving their father and their uncles apart. Ultimately, they each wrote lengthy vision statements that included each of them having an independent business of their own that is real estate related and would allow them to follow their own unique abilities and collaborate with each other while maintaining independence through having no formal partnership. Jack Jr. decided to open his own management firm and Arthur decided to become a licensed commercial real estate broker.

We also decided that up to $500,000 in equity would be gifted to each brother to purchase rental buildings that each would own independently of each other but for an interim period in partnership with their father in an LLC structure. This would help them establish credit and credibility and also to leverage the gift into substantial real estate assets. Neither felt uncomfortable partnering with their father in the end, once they realized that they shared common principles and values. Jack Sr. felt that the process enabled him to realize his three major goals:

1. To begin his sons on the path to success in their personal and professional lives.
2. To contribute to the emotional and physical well-being of his family.
3. To successfully pass on a legacy, both monetary and in family principles and values.

Step 2: Structure the Transfer of Assets to the Next Generation in a Tax-Efficient Manner Consistent With Developing a Workable Business Structure

This process included determining what is fair in business compensation and sharing of assets. Working with the estates and trusts attorney and accountant, we made choices on tax efficiently structured gifts for the working sons, while providing for equal treatment of their sister Katherine when she graduates from law school. Irrevocable life insurance trusts were set up for Jack Sr. and spouse and for Jack Jr., who had just married and also signed a prenuptial agreement prior to the marriage. Each son was also provided with a temporary income subsidy that will allow them to pursue their entrepreneurial goals.

One roadblock we encountered was that the attorney was brought in independently and had his own ideas about who should be the planning quarterback. It is key to establish in advance how the professionals are to share responsibility. The result in this case is that the design and implementation of the estate plan took longer than necessary.

Step 3: Coordinate With the Other Advisors to Design the Unwinding of the Limited Partnerships

When we began, the tension among the uncles was very high. While we did not work directly with Arthur Sr.'s brothers, the process, in providing momentum to the entire planning process made his brothers comfortable that being mired in inertia would not continue and they began showing renewed patience with the unwinding and even have entertained continuing some level of partnership for the long-term. This will play out over time as market conditions and potential tax changes are factored into their decision-making.

Step 4: Set Business Goals That Integrate With the Clients' Personal Lives and Develop a Strategic Business Plan

While we did not develop a formal strategic plan, each participant clarified their thinking and the direction in which they would take the business and they have begun purchasing properties in the names of the sons, individually with their father. As time goes on the client anticipates requiring further consulting as the complexity of the businesses grows and they take steps to retire from the business or change their day to day role within the business.

Conclusion

Creating a safe environment for managing conflict and change is essential for successful transitions. In change is opportunity. Advisors must be proactive in encouraging and guiding change by creating a safe environment for conflict that overcomes inertia and devises a process for planning change. The addition of a family business consultant to the team can help expedite planning. The family business consultant may have a dual role on the team but the important contribution is the experience in family business issues and moving the business and the family forward. As in any planning engagement the professionals should focus on establishing a smooth, collaborative relationship with the family members, key members of the business and the expert planning team.

Retirement planning is part of succession planning in the family-owned business and it is never too early to begin.