



FEATURE: HIGH-NET-WORTH FAMILIES & FAMILY OFFICES

By **Don Kozusko** & **Miles C. Padgett**

Coordinating Risk Management

Can wealthy families do more?

Centuries ago, the future rested in the hands of the gods, and only oracles and priests were able to interpret what man was allowed to see. Then, as Renaissance thinkers began to identify and measure cause, effect and probability, society relied less on fate and faith and more on knowledge and prediction.¹ Today, we confront the future with the power of technology, reducing risk and gaining insight through predictive mathematics and, to a lesser extent, qualitative judgment. It's not just next week's weather report; it's election polls, petroleum demand and the discreet 10-year revenue effect of a specific Tax Code change. Google even created a system based on cold math and two million data points to predict the future performance of job candidates.

From the broad perspective of a wealthy family, however, what stands out today isn't how much attention is paid to risk management, but how little. Aside from managing investments and business operations, efforts to manage risk are generally sporadic, even for family offices and family businesses that manage very large stores of wealth. In reaching this conclusion, we admit to relying on anecdotes and personal observations, yet the lack of more complete and objective data itself reinforces our conclusion that a broad range of risks aren't being systematically managed. If more was being done, it would be visible.²

Interface Risk

The most challenging gap involves what we call "interface risk." Interface risk arises "outside" of the assets them-

selves, at the intersection of ownership, management, regulation, taxes and family. Here are four scenarios that illustrate interface risk, which we've drawn from a composite of our own clients' experiences and public records.

- 1. Neglected beneficiary.** The trustees of a 100-year trust have broad discretion to sprinkle distributions among the grantor's descendants. The trustees keep no records of any kind, except for tax returns and custodian statements, because no one has ever asked for an accounting; all the living beneficiaries, except one estranged grandchild, have always had substantial other resources and never expected distributions from this trust. That grandchild, Harry, has drifted away and no one cares to give him information on the trust, since the family considers him to be antagonistic, lazy, irresponsible and unlikely to ever deserve a distribution. What's the unmanaged risk at this point? Fifteen years later, a woman contacts the trustees in her capacity as the mother of Harry's teenage child, and, on her child's behalf, she seeks redress against the trustees for neglecting her child as a beneficiary. The trustees believe they exercised reasonable diligence, but have no records to show attention to their duties apart from occasional investment decisions.
- 2. Daughter's premature death.** At a father's death, the family farm continues in trust for his 25-year-old daughter, Katie, until she reaches age 35. What's the unmanaged risk at this point? Over the next decade, Katie works hard to run the farm to emulate her father's success, but the operation is under financial stress when Katie dies in a farm accident just a month short of age 35 and outright distribution to her. The ownership continues in trust for her infant child, but the child's surviving



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guardian, Katie's recently divorced husband, seizes the opportunity to sue the two trustees, including his former mother-in-law, for damages due to the poor financial returns attributable to the holding of the family farm. He's hoping to squeeze out a settlement and force the sale of the farm so he can claim a large guardianship management fee. Katie had released the trustees each year from any such liability, but that doesn't necessarily bind her infant child as successor beneficiary, and the guardian claims that the losses, including the investment returns that could have been achieved elsewhere, must be calculated for the entire 10-year term of the trust.

- 3. Troublesome charitable bequest.** A widow with no children leaves her entire estate, including a large share of an underdeveloped real estate parcel, to a favorite local charity launched years ago, but still primarily funded by her family office. What's the unmanaged risk at this point? While the widow's estate is winding up, the real estate parcel spikes in value when it becomes a critical link in a potentially very profitable long-term redevelopment plan. The family office wants to control the redevelopment, but must first buy out the charity (with borrowed funds backed by personal guarantees) to meet state regulatory standards and must navigate through the evolving tax rules for charities. Once the charity is cashed out, it appears that the charity can't have its funds managed as a client of the family office (unless the family office registers as an investment advisor with the Securities and Exchange Commission or restructures the charity's endowment), because the charity doesn't qualify as a family client under the single family office exemption.³ As a result, the family office is not only being forced to take on more leverage in its redevelopment plan, but also will lose the ability to add the buy-out proceeds to the assets it manages.
- 4. Founder's team.** Fifteen years ago, a successful entrepreneur died and left part of her business holdings in trust to provide for her grandchildren and named two

long-time business partners as trustees and her lawyer as protector. She wanted to encourage entrepreneurship among the beneficiaries, but their interests and talents vary widely, and only a few have followed that path, including joining in the management of some of the trust's businesses. What's the unmanaged risk at this point? One of the trustees has moved his personal residence to a state that might impose an

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income tax on the trust. The second trustee is slowing down physically and mentally at age 80. The trust protector has the power to replace these trustees, but the family hasn't been able to agree on a qualified younger individual who's willing to assume the risk of personal liability as trustee. Moreover, both existing trustees prefer to continue serving and have begun to question the capability of the protector who seems to be distracted by personal financial stress and health issues. More fundamentally, the trustees have succeeded in active businesses all their lives and can't imagine selling off the businesses and investing in the volatile public markets, apart from a small bond allocation. Meanwhile, those beneficiaries not involved in the businesses are confused as to the true purpose of the trust and frustrated by their own inability to understand business and by the trustees' lack of attention to the beneficiaries. The beneficiaries see



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conflict among their lives and the life cycles of the trust, its holdings and its trustees.

These examples are representative of the tendency for wealthy families to dedicate little systematic attention or resources to risks that arise at the intersection of ownership, management, family, regulation and taxes. We surmise that these risks are often neglected, because the families and their advisors believe that interface risks aren't predictable or amenable to more proactive systematic management.

We challenge that assumption. Of course, the events that transpired in each of the above scenarios

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aren't common experiences, and thus, the disappointing results may appear unlikely in hindsight. However, the results weren't beyond anticipation, as one of many possible (perhaps materially possible) future outcomes, because the underlying causes were readily identifiable in advance. Indeed, the resulting complications, personal stress and potential financial loss could have been substantially reduced if the risks had been identified and managed over the course of time. Moreover, many of the same steps that could have avoided the negative results in the scenarios above would have also increased the likelihood of a more positive outcome. Like risk management for portfolios, it's not necessary to predict exactly the course of future events. Instead, we need proactive practices to manage risks to increase the likelihood of better, more productive outcomes.

Getting Started

If prior planning can provide more successful risk management, how can we timely implement that planning process in a typical setting without a prohibitively

burdensome analysis and an unrealistic expenditure of time, effort and money? Here are some common sense possibilities to consider:

1. Understand why we fail to manage future risk.

As in many other obstacles or life challenges, the first step is to admit there's a problem and then to understand why. There's a considerable body of knowledge about our inability to manage the risk in future events. We tend to have optimism bias, suffer decision fatigue, have difficulty comprehending the interaction of multiple influences over time, not want to project ahead if that leads to examining the disappointments of the past and be human in so many other ways.⁴ Learn about and combat these tendencies.

2. **KIS2S.** This isn't a typo. It's not an instruction to "keep it simple, stupid." It's a suggestion to "keep it simple to start." Start with things you already know are neglected and with future risks you already appreciate and understand. A comprehensive list of all the things that could possibly be considered is overwhelming and usually beyond the reach of a family that doesn't have considerable time and resources to devote to this work (at least initially).⁵

3. **Think 10 years ahead.** Given our tendencies and KIS2S, think first about the next 10 years, rather than the next five generations.

- Start by thinking about the family. Think through how information, perspectives, expectations and experiences are shared by family members and what impact that will have over time. Don't start by projecting the asset base.
- Picture where the family will be 10 years from now, and then think about how it will get there. Imagine a different picture after the same 10 years, consider why the different result and seek the thoughts of others.
- Consider trends in demographics and culture that will lead to broad changes in the family as it grows and in regulation and the economy. Consider the impact on marriages, education, taxes and personal goals. What risks and opportunities are linked to the forces of family, demographics and culture?



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- Avoid the tendency to dwell on all the risks that occupy the grand scale of the future. During the last 125 years (five generations), the U.S. economy and the role of family and children have changed dramatically.⁶ Don't become trapped by trying to imagine the changes that will take place during the next five generations. Those changes aren't knowable today.⁷ If you're skeptical, just think of the volume, depth and pace of change since 1945 (a mere three generations).


4. Identify and prioritize. After developing that understanding and perspective, look at the family and the asset structure, and then consider how risks interact at the level of family ownership, management, business, investments, regulation and taxes.

- Identify priority risks. Look in those areas of highest probability of risk and of highest impact on the outcome. For example, certain businesses or estate plans naturally have a higher risk of major regulatory challenges or changes.

- In this process, don't overlook "people risk." A family that's homogeneous (and, thus, inclined to think alike) can more readily collaborate, but also may suffer from group think, unwilling to challenge accepted wisdom and unprepared for disagreements when they arise. A family that's heterogeneous (varying greatly in education, empathy, outlook, values, energy and understanding) will find it more difficult to communicate and share goals and methods, but may be more attuned to various possible outcomes.

- Respond to each priority risk by managing it, staffing it or hedging it. Periodically expand and refresh the analysis and the response. For larger issues, prepare for the time when the issue is ripe for resolution. Everyone has limited resources, so stop doing what's less important and free up resources. An actively managed, complex investment strategy or tax plan may satisfy a need to achieve measurable results, but consider simplification, streamlining and outsourcing to devote more attention to interface risk or other neglected larger issues.

5. Manage complexity by managing collaboration. One-stop shopping no longer works anywhere (if

it ever did), much less in working with advisors. The world is too complex. Nurture collaboration and effective communication among your advisors. Avoid advisors who think of themselves as gatekeepers and quarterbacks, rather than filters, proposers and leaders. Identifying and managing interface risk requires true collaboration among expert advisors in different fields. 

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Endnotes

1. Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* (1996).
2. We're not suggesting that broader risk management is unknown, but that it's comparatively rare. Family Office Exchange (FOX) has recently published its third report on risk management, "Building A Financial Enterprise Plan to Deal With Future Uncertainty," Family Office Exchange (2012). It contains a comprehensive description on p. 24 of risks on multiple levels that a wealthy family should consider. The handful of illustrative risk studies described in the report involve very large family offices. While FOX also makes reference to over 100 other family offices that have undertaken risk management efforts of this kind to some degree, that number compares with several thousand family offices in the United States alone, as well as additional numbers of wealthy families (such as those in a family business) that don't self-identify as having a family office. In contrast, risk management is applied almost universally in investing or business operations.
3. See rule governing exclusion from Investment Advisers Act registration for single family offices, contained at 17 CFR 275.202(a)(11)(G)-1 and, specifically, 17 CFR 275.202(a)(11)(G)-1(d)(4)(v).
4. For example, see Dietrich Dörner, *The Logic of Failure: Recognizing and Avoiding Error in Complex Situations*, p. 198 (1996); Tali Sharot, *The Optimism Bias: A Tour of the Irrationally Positive Brain* (2011); Robert A. Burton, *On Being Certain: Believing You Are Right Even When You Are Not* (2008); Daniel Kahneman, *Thinking, Fast and Slow* (2011).
5. *Supra* note 2.
6. John Steele Gordon, *An Empire of Wealth: The Epic History of American Economic Power* (2004); Steven Mintz, *Huck's Raft: History of Childhood in America* (2004).
7. For example, a futuristic version of a trustee is described in Avi. Z. Kestenbaum, Mary P. O'Reilly, Danielle M. Weiner, "The Virtual Clone Trustee," *Trusts & Estates* (September 2012) at p. 24. Such possibilities are in line with scholarly assessments of the virtual reality future. See Jim Blascovich and Jeremy Bailenson, *Infinite Reality* (2011).