STONEHAGE FLEMING

KNOW HOW BULLETIN

MANAGING THE BIGGEST RISK TO FAMILY WEALTH – THE KEY ROLE OF ADVISERS IN SUCCESSION PLANNING

The role of properly structured succession planning in reducing the risks to family wealth is beyond dispute. Yet this most important of all risk management tools is too often overlooked, both by the families themselves and their advisers.

It is a well known fact that most family fortunes fail to survive more than three generations. Less well known is that the prime cause of wealth destruction is a breakdown of communication within the family, which often results from failure to plan adequately for passing on the wealth from one generation to the next.

In the current economic environment there is a great deal of focus on the management of risk and, in particular, the potential vulnerability of the family business or the investment portfolio to a further banking crisis and a collapse in market confidence. Increasingly sophisticated risk management tools are promoted by wealth managers and private banks for this purpose.

In the longer term, the biggest risk of all is a failure within the family itself which, at its mildest, results in a loss of direction and leadership and, at its worst, can result in a full scale family war as different family members fight each other for the assets, the legacy or the family leadership. By the third or fourth generation the chances are very high that those who inherit were brought up in luxury with little concept of the work ethic on which the family fortune was founded.

Succession planning is therefore the most important tool of long-term risk management. It does not guarantee the preservation of wealth through the generations, but it can and does improve the chances that the wealth will survive, in an environment which enables family members to flourish as individuals, as part of the family unit and as members of society.

Why is it, therefore, that whilst so much time and resource is commonly allocated to other, less important risk management tools, far too little attention is given to the most important tool of all – succession planning?

THE CONSEQUENCES OF FAILURE TO PLAN

The consequences of failure to plan are well known, and far too numerous to list. Perhaps the most obvious are disputes between siblings on the death of the founder or disputes between those who are involved in the family business and those who want it sold. There is also jockeying for position within the business and disagreement about its strategic direction, some perhaps preferring to stick to the core activity, whilst others advocate a more risky expansion and diversification strategy, involving substantial leverage.

There may be family members who want to use family wealth to invest in new ventures, following in the entrepreneurial footsteps of the founder, whilst others have no interest in business and prefer the wealth to be independently managed by professional managers. All this can have an impact not only on the business and the family wealth, but on the family itself, as the key protagonists try to lobby other family members for support. Sadly, in most instances, those who advocate the greatest risks have the loudest and most persuasive voices.

In addition to business strategy, there is the simple issue of management competence and the danger that the next generation does not have the talent to run a large business, either as managers or as owners.

All of these risks and many more, are greatly magnified by the lack of a clear framework for making decisions and a clear set of objectives which have been originated by the founder and renewed by successive generations.

The potential for damaging divisions and perhaps catastrophic wealth destruction is so obvious that it is hard to understand why an exceptionally able and talented human being, who has spent a lifetime putting together a large fortune, would ignore many of the basic principles of handing it down to the next generation. Yet many otherwise brilliant men and women do just that.

REASONS FOR FAILURE TO PLAN

Some say that the biggest obstacle to succession planning is the typical entrepreneur's belief in his or her own immortality, or to put it the other way round, a reluctance to face up to his own death or incapacity.

In truth, the answer is more complex, in that there are many hard decisions to be made, some of them straight business decisions, others highly overlaid with emotional considerations. Some may create a division between father and son, between brother and sister, or even between husband and wife and even when it is all done, the outcome can never be guaranteed.

Many entrepreneurs have observed that it is harder to pass on your wealth than to make it in the first place, but perhaps this is precisely the argument for some sort of formalised process. Such a process takes at least some of the emotion out of decisions, which otherwise have the potential to cause resentment and division. Pre-determined criteria will help provide an objective measure, to avoid the perception that one family member has been favoured over another.

KEY ELEMENTS OF SUCCESSION PLANNING AND FAMILY GOVERNANCE

The drawing up of a succession plan is clearly, in the first instance, the prerogative of the founder of the wealth, or subsequent family leadership. However, it is argued by most experts that it should generally be done with some degree of consultation among those principally affected. Those involved need to have a say and the opportunity to work together with other family members in defining a common set of values, objectives and governance framework. This can be a substantial task.

There are three main elements of succession planning:

Defining the purpose of the wealth

Much can be achieved by trying to answer the simple question ‘what is it all for?’ Is the wealth simply to provide for the living standards of subsequent generations? If so, how do you ensure it contributes to enhanced quality of life, when there is so much evidence that inheritance without responsibility can be damaging?

For some families, much of the wealth is tied up in particular assets such as a family business, a landed estate or an art collection, which the founder wishes to be maintained intact. If so, this must be made clear, to avoid future disputes. It should also be specified whether and in what circumstances the wealth should be used to encourage entrepreneurial or other creative activities of family members or to be used for philanthropic purposes. Whatever the specific purposes, the founder will surely wish to leave a legacy which encourages a positive work ethic in subsequent generations to reduce the prospect of wealth being squandered and lives ruined in the process.

Dividing the wealth

The next question is how the wealth is to be divided between different family members. Fairness and equality are easy words to use, but it is not so easy to define what they mean in practice. It could be argued that the wealth should be divided equally between members of the next generation. Alternatively, that a greater share is allocated to those with responsibility for carrying forward the family business or other assets. The responsibilities of family leaders have to be specified and mechanisms put in place to protect the interests of others. Some families have a ‘pot’ of money to finance family members with exceptional talents or business ideas, or those with special needs or suffering hardship. Without a guiding philosophy every decision has the potential to cause a rift.

Making decisions

The processes by which decisions are made is critical to the future wellbeing of the family.

For many wealthy families, their assets are held through a variety of ‘vehicles’, being primarily companies and trusts, each with their own objectives, their own boards of directors or trustees and their own governing instruments. However, most families have seen the benefit of some kind of family constitution, which defines the overall objectives and decision making processes for the family as a whole.

Communications will usually include family meetings (the whole family and consultative only) and the family council (representative body with some decision making powers). Where there is a family business making up a substantial part of the assets, the relationship between the family and the business will be critical, as will the rules which govern the highly sensitive area of family members working in the business.

ROLE OF THE ADVISER OR TRUSTEE

The above is just a selection of the many issues which need to be considered by a wealthy individual or family, to which should be added all the usual tax and legal issues affecting a family with complex assets, especially those distributed across a number of legal jurisdictions.

As mentioned earlier, many wealth creators postpone consideration of all these matters, often until it is too late. Equally their advisers are at fault for failing to put the issue firmly on the table in a manner which provokes a positive response. After all there are so many arguments in favour of a properly structured succession planning exercise, that it should surely be routine for all advisers?

CONCLUSIONS

It has been demonstrated beyond reasonable doubt that in the vast majority of cases an effective succession planning exercise brings considerable benefits to a wealthy family. The question is when to start such an exercise and the biggest challenge is to agree the format and get the process started.

The scope of the exercise and the extent of involvement of family members will depend on the wishes of the wealth creator, or the current family leadership. Although it is generally regarded as advisable to involve the next generation in a consultative exercise, there may on occasions be reasons for not doing so. Equally, the founder may wish to lay down some principles from the outset, as a framework for discussion.