The *Process* of Trusting

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"THE VERY RICH are different from you and me," F. Scott Fitzgerald began one of his stories. "Yes," Ernest Hemingway famously rejoined, "they have more money." They also have more money managers, trustees, and advisors. For great wealth always entails the delegation of responsibilities and authority. Death forces the ultimate delegation. And every estate plan represents a set of decisions about what should be entrusted to whom, for what purpose.

Our work with multi-generational families with substantial wealth gives us a developmental perspective on what happens when owners either entrust *too much* or *too little* control to successors or outsiders. This article describes some patterns we've observed—and their consequences. Among the lessons, which advisors should convey to first-generation owners and their immediate successors, three are paramount:

1. Certain responsibilities of ownership can never be successfully delegated to others.
2. Baton passing takes time. More important than creating structures for future generations is to establish a process that accommodates change.
3. If wealth creators place too little trust in their descendants to make wise decisions together, subsequent generations may end up trusting others too much and delegating responsibilities they should retain.

About 18,000 families in the U.S. (27,000 globally) have assets greater than $30 million, according to the 2002 Merrill Lynch Cap Gemini World Wealth Report. Each of those families faces unique challenges that accompany the preservation and transfer of that wealth. Owners must make life-altering decisions for their living heirs and future descendants, as great wealth usually benefits at least three generations**.** Whomever the owners decide to bring into their trusted circle of advisors will significantly impact the outcome over the next 100 years. A successful outcome greatly depends on defining the proper levels of trust and establishing checks and balances for the process of trusting.

> *The most important gift to future generations is to create a process that can accommodate change.*

Not trusting enough

Few wealth creators are able to cover all their own financial and legal bases, let alone foresee the diverse needs of a growing number of owners and beneficiaries. However, many have difficulty delegating responsibility and decision-making to others.

Some simply don't trust their offspring to make good decisions, even as adults—not only about managing the wealth but also about such questions as who to include in the family council or what kind of schools children should attend. They may try to rule from the grave through their legal documents.

A justification we hear from wealth creators is that they already learned lessons the hard way. They don't see the need for the next generation to learn the same way, by having to correct their own mistakes.

Trusting too much

Along with the benefits of a dedicated team to manage one's financial affairs, delegating control or partial authority brings inherent risks. The challenge lies in having enough experience to recognize qualified counselors and financial advisors who have exceptional judgment and are trust-worthy.

The most disastrous examples of delegating too much responsibility occur when the person in question turns out to be dishonest, and proper checks and balances have not been designed to

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uncover irregularities. Every year, examples surface in the family office industry: Who's watching the watch-dog? What conflicts of interest exist between individuals with responsibility, and the family's interests?

The selection of qualified managers on the basis of character can lead to too much trust in their skill. For example, owners bring along a trusted business CFO to manage their wealth, with neither an informed audit of the requisite skills and experience nor a competitive search among possibly better qualified candidates.

Conversely, delegation can be based too much on technical skills and not enough on personal qualities. Even when owners search widely and pay what the market demands for the best advisors, they sometimes neglect to evaluate how well those individuals will work with the rest of the family.

Often, if a founder trusts the next generation too little, successors delegate too much to advisors or a single family member.

Another critical case of too much trusting occurs when one owner in the next generation has a desire or willingness to be entrusted with responsibility, despite an insufficient endorsement by the family. Siblings who are not stepping up and getting involved in the financial process at this time will often feel differently, down the road—leading to accusations of unfairness, and destructive feuds.

The biggest problem with unwarranted confidence early in the process is that the consequences may not be reversible. An owner's first reaction to sudden liquidity is a knee jerk response of "putting the money to work quickly." Yet, when we ask owners five years later what they wish they had known about managing family wealth, they consistently say "I wish I had taken more time to understand my options better. I made uninformed decisions that cost me money later." For example, they created irrevocable trusts, or they invested in asset strategies that cannot be unwound without triggering taxable events.

Cannot be delegated

Most professional advisors agree there are some responsibilities owners cannot delegate to outsiders, such as deciding how much and how long the assets will be held collectively for the benefit of future generations, or how involved family members will be in managing the wealth process. Even when an owner thinks he has the answers, he cannot dictate those answers to his descendants.

- Times change (economic realities, human priorities, and legal options change).
- Succeeding generations will have different needs and desires.
- Marriages will both dilute and enrich the heritage, culturally as well as genetically.
- The owner cannot be sure which members of the next generation or two will possess the talents, interests, and education necessary to lead or even participate in stewarding family wealth.
- Furthermore, the owner may clearly see advantages for the wealth in keeping it tied together, but if it doesn't turn out to be advantageous *for the future owners*, shortsightedness and conflicts among them will undermine the mission of stewardship.

Recurring theme

At a recent Learning Academy organized by Family Office Exchange, a fourth generation inheritor spoke movingly about how her family had failed to manage the process, allowing a negligent trustee to dissipate the family assets. This illustrates a recurring theme: *too little* trust in the next generation by the founder often leads the successors to delegate *too much* to an outside professional or a single family member.

Even when a wealth creator has good advisors and is wise enough to establish goals and guidelines for managing the family wealth, the challenge lies in developing a process for reaching family agreement—for example, to

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start a family office or a foundation, reallocate assets after the sale of a business, or administer family trusts. Dele-gating control or partial authority to others is not a natural instinct for any business owner. Staying in control, or involved in the process, has paid off well over the owner's lifetime. As risk-takers with capital, entrepreneurs trust their own instincts. Yet personality studies show that their primary concern is to *minimize* risk. Thus they often guard control and have difficulty trusting even their best employees, let alone their children. And perhaps because they know so well the narrow margin between success and defeat, they distrust their children's ability to make successes of themselves.

Business owners work hard to preserve their success, using complex structures their children don't understand and don't want to manage. What happens when the wealth passes from the founder to the second generation? Most sibling groups are more risk averse than their parents were, having been taught to avoid risk and preserve the assets they were so fortunate to inherit. It's about "not blowing it on my watch," as opposed to "building a legacy" for future generations. Therefore, they seek to restructure any complex or highly-leveraged positions they may have inherited. Second generation siblings often inherit concentrated stock positions, and for the first time must address—together—complex financial, tax and legal issues they have little or no experience with, such as the risk/reward tradeoffs surrounding an undiversified asset.

The next step is almost inevitable. The structures are so complicated that the inheritors have to find sophisticated advisors and delegate major aspects of financial oversight to others. They don't feel comfortable being in charge of such complex ownership and management arrangements, and they don't have the business experience or the appetite to manage the risks built into the structures.

Inherited wealth can be particularly challenging for second and third generations, who have had no appropriate role models for collective ownership. Having watched a strong and controlling founder operate tirelessly for 30 to 40 years, most children and grandchildren strive for more balance in their lives. Expanded opportunities for enjoying life can make it difficult for inheritors to focus on the work of "managing the process of managing the wealth." And the financial services industry makes it difficult for owners to learn what they need to know about the process, as most firms still view client education only as a marketing tool rather than a part of their core business.

The widespread image of "trust babies" who shun the responsibility and hard work required to continue growing their wealth is unfair to many inheritors, who do inherit the work ethic and a sense of responsibility but cannot be expected to have the skills their parent or grandparent acquired over decades. And the job they inherit is, in some ways, more difficult than the one the founder was doing. In most families, they will have to make decisions as a group; they don't have the luxury of being able to dictate, and to ignore roads not taken.

Most successors are more risk-averse than their parents, having been taught to preserve inherited wealth.

When we work with families whose younger generations don't want to get involved in governance matters as long as the wealth creators are still in charge, we visit the future with them by describing other family histories. We contrast those where the structures have failed and/or the family legacy itself has been lost due to conflicts over trust and distrust, with other families that successfully passed stewardship through several generations. The latter only occurred because both the generation in charge and their successors were willing to do the hard work of hashing out administrative issues, redefining their mission, and designing

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new structures to serve the broadening and diversifying family.

An example

John Dough built a small, inherited business into a diversified family enterprise that exceeded $500 million, after estate taxes. His widow is in her 70s, wants no part of her children's decision-making process, but is distressed by their conflicts with one another. There are four of them: two older daughters and two sons.

About a third of the family wealth is in direct private equity, which was the father's main interest for the last 20 years of his life. This includes controlling interest in six operating companies in three different industries, as well as minority interests in six others. There is a management team, which sits on the boards of eight of the companies along with one or more of the four second-generation owners. The family members are uncomfortable with their ownership responsibilities, as three of them readily admit. Only one of the four is interested in this work, and believes himself to be getting up to speed. Unfortunately, his siblings don't trust his business judgment, nor one another's. (They do, however, care about one another, which only adds to their difficulties.)

The two older sisters and the younger brother have decided they want to cash out of these businesses within three years. John, Jr., 38, can stay in private equities if he chooses to do so, but not with their money. All of this has been discussed with their senior advisor, Dad's old attorney, but not with management. How can they tell management they want at least three fourths, if not all those assets, spruced up for sale—without precipitating the management team's departure?

The lesson here is that Dad delegated *both* too much and too little. He gave his children more responsibility than they were prepared to handle, but too little choice in the matter. He should have been advised to bring them into the bigger picture of the family enterprise long before he departed, understanding their skills and their weaknesses, and restructuring the ownership and governance around their capabilities.

The Doughs illustrate nicely how much more planning and work was needed, as a family, before the founder passed from the scene.

However, even if he were alive and involved today, the work they would have to do would be slower and more deliberate than any of the four 35-to-45-year-old Doughs might wish.

The question of whom to trust is inseparable from how much trust to place, and in what areas of responsibility.

And certainly more time-consuming than the founder might tolerate.

Baton passing takes time

The decision to entrust responsibility to someone is not a binary decision, to delegate or not to delegate. The question *in whom* to place trust is inseparable from *how much* trust to place, and *in what areas* of responsibility.

A useful analogy is the trust we place in a total stranger every time we get into a taxicab in a foreign city. We don't sit back and close our eyes. We observe what direction he heads off in, whether he seems to know the best route. If we don't have a common language, we are much more likely to insist that he stop while we phone for directions. We may get out and flag down another taxi. On the other hand, when a driver impresses us with his knowledge of the city, driving skill, and reliable service, we take his card and call him personally the next time.

So it is with the responsibilities of ownership. The taxi is moving to an unknown destination, and the new drivers of that taxi

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need to be tested with manageable doses of responsibility, educated further, and empowered gradually. Therefore, what the estate plan establishes should be understood to be as much process as structure. The process must accommodate the development of leadership in the next generation, just as it must accommodate the beneficiaries' changing needs and circumstances.

To make the taxi an apt metaphor for family wealth, it will have to be transformed into a stretch limo and eventually a bus, because the passengers are reproducing. And it isn't headed to any existing address. It is going into outer space, the unexplored future. Nor can it stop to refuel or to turn the wheel over to a fresh driver. Leadership has to be passed while the taxi/bus/spaceship is moving.

Families tend to avoid conflict by arriving prematurely at a consensus. Trust is granted instead of being earned.

In the Dough family, there is no reason the passengers should trust any of their number to climb in front and take the wheel. They needed to learn to drive on country roads before they moved up to New York City traffic—let alone Paris or Tokyo.

It is clear that the grantors (delegators of responsibility) are as much a part of the process as the trustees and beneficiaries. In the second generation, the trustees and governing council of a family are a critical part of the process of succession to the third generation, and so on.

Family harmony can be a trap

We don't know what the outcome will be in the Dough family. We can make a prediction based on a considerable number of other families who are further along in the process.

So soon after inheriting, while family feeling is strong, and there is still more cash than their lifestyles can absorb, and their mother is still alive, they probably will not go to the mat over the disposition of those private equity holdings. They will do what most families do in the early stages of a major conflict: back off. They may entrust owner decisions to the management group, which can be very dangerous. Or they may empower John, to nurture his self-image as a businessman in the footsteps of his father. They don't mean to set him up for failure; they are simply in denial, or half in denial, about what they intuitively know: It is too big a job for him.

Look at the trap they have fallen into. Dad, convinced that these private equity investments and the management structure he created were a wonderful bequest to his children, didn't delegate sufficient responsibility to them 10 years earlier. Now they are in the position of delegating too much to one of them. We see this often, an inexperienced owner feeling obligated to follow in the father's footsteps.

Families tend to avoid conflict by arriving prematurely at a consensus, usually a decision to divvy up the responsibilities, and/or to delegate them to the family member who most wants them. Trust, in other words, not having been earned, is granted in order to avoid seeming unsupportive and to avoid tense relations.

This gets confounded by another psychological phenomenon. When people intuitively sense that they are in over their heads but are not sure what's wrong, one response is to deny the complexity, to feel greater certitude or false confidence, suppressing their own doubts and plunging ahead into the darkness.

The family will not address the problem, and may not even seek consultation about it, until their own conflict about it gets worse—more painful and more destructive to their family, either in terms of financial loss or in terms of blaming John and pointing fingers at each other. Perhaps all of the above.

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A premature consensus often will fail to create two things that are most necessary for consensus to succeed:

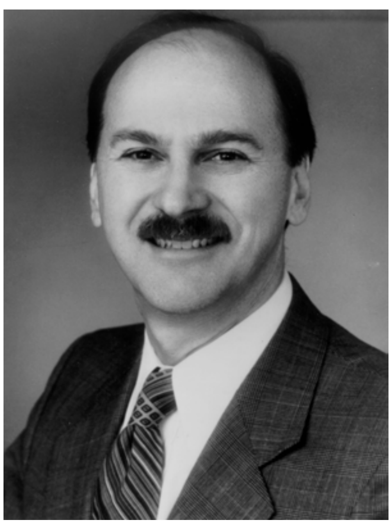
- a process for continuous reassessment of how well the trustees and advisors are fulfilling their roles and–within the choices open to them—how satisfied the stakeholders are.
- exit strategies that don't threaten to break up the family.

We virtually insist with our clients that every joint endeavor they enter into, whether it be a holding company, family office, private trust company or business partnership, be voluntary in the sense that no individual dissenting partner is trapped in the relationship. One can voluntarily go along with the majority, but no one should be compelled to participate either by the legal structures or by family pressure. The feeling that "You can pull out if you want to, *but if you do you're breaking up our family*" is surely not a viable exit strategy. Such compulsion would be sure to dissolve their family bonds, without which their financial partnerships are eventually doomed.

Avoid leadership void

Each owner has to define an appropriate level of delegation based on personal intelligence, skills, contacts, ability to judge others, and desired levels of involvement. Owners who want to retire from the process must recognize that they are relinquishing their ability to control the outcome to a significant extent. They accept a beneficial interest in the process, and must become very adept at evaluating performance, measuring success and making changes if the process isn't working.

The players in the family enterprise change as time passes. Leaders pass the baton, some more gradually than others, new generations come of age, and new spouses are integrated into (and sometimes out of) the family. Families with a leadership void in younger generations, due to lack of preparation and training, are particularly vulnerable to the issues of delegation.



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