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Deal With Inflections Before They Become Afflictions

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An advisor to family offices sets out a range of considerations that these organizations should address, and how to curb the danger that families fall prey to "echo chamber" effects.

The following article comes from Xylogenesis | Family Office Advisory, and is written by its founder and lead, Richard J Wolkowitz. He delves into how governance can help mitigate problems such as "groupthink" of the kind that can lead families astray around investments and other topics. The editors are pleased to share these insights. The usual editorial disclaimers apply. Email tom.burroughes@wealthbriefing.com if you wish to enter the conversation.

Single family offices can often become impenetrable fortresses, impervious to change and challenge. The guards, gatekeepers and moat surrounding the castle can be deep with many layers. This tendency toward isolation and self-sufficiency can become self-serving and potentially self-destructive, and a hindrance to preventing families from evolving, adapting, and achieving durable harmony and financial prosperity.

Paradoxically, those on the inside closest to the family (internally and externally) and the day-to-day operations can fall victim to "group think" or conflicts of interest. Lacking the objectivity, independence, and perspective to identify the blind spots, risks, and opportunities often translates to the family leadership acting upon sub-optimal advice and counsel.

Fundamentally, governance proves to be the antidote to this conundrum. Families relying on external, independent non-family members to provide a degree of oversight and wisdom often makes the difference between families who are stuck, reactive, and paralyzed and those who are forward-thinking, proactive, and resilient.

Family transition or conflict oftentimes provides a robust stress test of a family's governance. "Nothing is so painful to the human mind as a great and sudden change," said Mary Shelley in Frankenstein. This is especially apropos in the lives of families with significant wealth. She might have added that the same goes for long-anticipated changes, since they are fundamentally unsettling.

Considerations

Add to this the complexity are all of the normal considerations for a healthy family office:

-- managing the growth of the family members and households reliant on the family office;
-- managing the growth / decline in the families operating business(es);
-- managing wealth/investment portfolios;
-- managing growth, profitability, and distribution expectations;
-- managing risk levels;
-- managing capital allocation;

-- managing liquidity;
-- managing diversification;
-- managing technology;
-- managing personnel (family and non-family);
-- managing philanthropy;
-- managing family brand or reputation; and
-- etc.

Adding to this meshwork of complexity is the implication of a rising new generation, some of whom do not feel as though they want to be part of the family unit but want to go about creating and blazing their own path without the pressure or judgment of making compromises with loved ones or as part of a collective.

These are just some the circumstances that can make the single family office and, therefore, the family enterprise "wobbly" and vulnerable.

It takes a constant planning effort to engage, frame, and decide what makes most sense for the family. Single family offices are not always well-positioned to manage certain questions about the future of a family even though they are closest to it and the answers directly affect them.

This is where governance really shines and the importance of the composition of those in governance positions is amplified. Never underestimate the value that external, independent non-family members can bring, whether formally on the board or simply as a trusted, "sounding board" to the family.

Let us examine several scenarios.

Suddenly, a not so valuable operating business?

One of the first problematic scenarios that can destabilize the family office relates to the operating business(es). Imagine the implications of a self-inflicted wound on the "golden goose" that generates much of a family's security and wealth, while they have not yet realized the value or distributed much of the cash flow to date.

What if there is little in the way of diversification in the source of security and wealth for the family? What if too much of the value of the business is at risk? What if growth decelerates? What if acute disruptions, such as regulatory changes, new competition in the marketplace, or innovative technologies have been underestimated? What if there is too much customer concentration? Is the ownership team, board, and management team skilled to adapt, pivot, and manage through the next phase?

All these factors can create great tension and open the family up to a syndrome of "tunnel vision." This is one important reason why it is so important to include external, independent non-family members in the governance structure who have the capacity to artfully challenge the status quo and maneuver within the family system dynamic. Without this perspective, the situation can lead to greater tension, other missed opportunities, risk factors, and misalignment between generations, exposing the family health-wealth value.

The balance between reinvesting and distributing?

Capital allocation decisions in the business can be overwhelming for families, and it is critical to have a decision-making framework that integrates all considerations including the need to preserve appropriate cash reserves and fund growth, both organic and inorganic. This may require reinvestment in the business and sometimes acquiring other businesses. These factors influence the quantum that should be distributed to shareholders. Increasingly, families also deploy family capital directly back into their businesses along the capital structure as part of their strategy to build incremental wealth, promote wealth transfer, and execute tax optimization. Aside from the issues surrounding illiquid wealth, there are fundamental questions around decision-making, risk management, and accountability.

These decisions require not only strong financial skills but also sound business judgment and acumen, which should be part of any thoughtful adaptive governance structure. A "North Star" of external, independent trusted advisors can provide timely and robust guidance for families to consider their options and protect their health-wealth value.

What if family members need cash or larger distributions but there is no mechanism?

If there is no mechanism to enable conversations around liquidity to shareholders/owners, family members may be reluctant to raise the issue for the sake of family unity. Some might eschew the topic for fear of facing questions or being judged about the purpose or need for the liquidity; but ignoring this topic or not having open communication about it eventually leads to conflict and fractured family dynamics.

There can also be inherent conflicts of interest for family employees driven by compensation plans that require certain levels of profitability/growth targets which would preclude distributions. Again, experienced external, independent advisors can shed light on how and when to raise these issues and how to find a proper balance amongst the stakeholders.

Chronicle of a death not foretold.

An unexpected death can throw succession plans in disarray. In this scenario, the benefit of external, independent advisors with thoughtful, adaptive governance principles usually provides the support needed to help the family navigate the reality of dealing with the aftermath in a focused, professional manner while being sensitive to the family's shocking new reality. If the death involves the beneficial owner(s), their spouse/partner, or even one of the children who was being groomed to take over, what happens on the "day after" the tragic news and emotions run high? External, independent advisors can be remarkably effective and helpful in this circumstance to prevent a personal tragedy from becoming an existential threat to the other overall family and its enterprise.

Children and their own destiny?

Rising generations are a source of pride, but they can also drift apart. What if members of the second or third or fourth…generation do not want to continue as part of the family collective? How many households can the single family office realistically serve and support? In practice, single family offices often struggle when dealing with the range and scale of problems emanating from the number of people and households of a multigenerational family.

Can the single family office be repurposed to manage the assets and outsource other services, such as accounting and individual tax preparations, to an accounting firm or well-equipped multi-family office? Should the next generation build their own single family office? Should this single family office merge with another single family office to capture subject matter expertise, share expenses, and support scale?

Planning for succession due to leadership change or retirement?

It is critical to plan for leadership "off ramps" and "on ramps" for the time when the leadership and other human capital components of a single family office consider retirement. Imagine the dynamics and complexities of G2/G3/G4/G5…asserting and inserting influence with certain households feeling disenfranchised or de-prioritized in favor of others? What about the concurrent and parallel needs to plan for the same retirement of internal family office executives/employees and other outside trusted advisors? In these moments, inherent conflicts arise, self-interested parties sometimes prevail, and the unity of the family and health of the enterprise are at risk.

Having thoughtful, adaptive governance and access to an external, independent sounding board to undertake a review of strategic options is the best course of action. As discussed previously, some of the options that family offices can consider are:

-- the family firm maintains the same model and elevates / recruits new individuals; or
-- the family considers recentering the single family office, or changing its business model to a more narrow focus; or
-- the family considers an outsource model to a multi-family office or hybrid family office or virtual family office?

All these scenarios are windows into the life of multi-generational wealth creators, owners, and operators. Transitions and change are admittedly very difficult. Thoughtful, adaptive governance - combined with external, independent advisors - mitigates both the risks and the tensions and allows for a methodical process driven by reason, acknowledging family dynamics and emotions, so that a high-performing family and its enterprise do not fall prey to unnecessary conflict. Shortcomings imperil legacy. In extreme conditions, family conflict can culminate in the courtroom when it should have been handled in the boardroom.

Single family offices are multidimensional and ever evolving. Just as the watchmaker looks at the hundreds of mechanical parts, each piece needs to be carefully constructed and nurtured. External, independent advisors can offer that invaluable, broader perspective and insight, possessing the ability to see and raise the issues to bring calm and mitigate conflict when no one else can or will.

About the author

Richard J Wolkowitz is Founder of Xylogenesis | Family Office Advisory and serves as a family advisor with 25-plus years of first-hand, inner working experience of multiple family offices (of all types). Hiss background is in law, business, independent board of director service, management, operations, financial services, and professional service firm leadership with a focus on serving multigenerational families and their full business and life continuum of needs. Wolkowitz began his legal career in The White House, and then joined an AM 100 law firm where he was an equity partner, Chair of the firm's hiring committee, and practiced international and domestic M&A and business transactions, serving as outside general counsel and consigliere to public, PE/VC-backed, and family enterprises.

Wolkowitz then joined his own family's third-generation enterprise before managing two different single-family offices as non-family leader. Prior to founding Xylogenesis | Family Office Advisory, Rich managed a global family business consulting firm. He now consults for family offices, whether existing or in concept, supporting the family and their family office staff, and team of multidisciplinary trusted advisors. He graduated from the Georgetown University Law Center (LL M, International Transactions and Comparative Law with distinction), Gonzaga University School of Law (JD, cum laude and editor of The Law Review), and University of Illinois – Champaign-Urbana (BS, Agriculture Economics with honors) and resides in a suburb of St. Louis, Missouri.