Gauging and reducing risks to the family business

Assessing risk is more difficult than deciding 'how much' to take. Be aware that there are two different types.

CALIFORNIA RESTAURANT Owner Frank DiMarco (a pseudonym) considered risk management an activity only for big nationwide companies. His strategy involved reading the *Wall Street Journal* and following trends that affected his restaurants. When his daughter approached him about investing in a production company that had pre-sold a film to a premium cable channel and was seeking early financing, he looked at the numbers, saw the company had a completion bond in place and considered it a safe way to dip a toe in the entertainment industry. More than a toe, really; the producer was looking for $3 million to cover up-front costs, but it was an amount the family could raise. All the risks seemed to be covered, so Frank wired the funds.

Karen Lynne (another pseudonym) had lost her husband in a boating accident. Married as a teenager, she'd helped "her Kenny" and his brother build a handyman business from their garage on Long Island into a successful tri-state operation. After Ken's death, the brother bought out her interest at a fair price. For a woman who had never written a check or looked at a bank statement before her husband passed away, she felt she'd learned fast and there was enough to take care of her and their three children. A friend from the neighborhood was making big money in Washington, D.C., real estate, and Karen's brother-in-law was sure they could do the same. He'd found two homes in a hot town for tear-downs, hired his own appraiser to verify the price and was ready to build six houses in their place. It was a natural extension of their business. Karen thought of all the extras the kids would like, took a deep breath and moved half her capital into the deal.

How did these two stories end? Frank's producer took the money he had received from a half-dozen "early investors" and headed for the Caribbean. His resume had been exaggerated, and the completion bond protected only the buyers of the film. The DiMarcos' retirement was indefinitely postponed.

The property Karen's brother-in-law bought was in a hot town—but in its worst school district. The comparables for the appraisal were to the south, and their property was two blocks north of the dividing line. After tearing down the existing houses, the Lynnes couldn't get financing to build because of the location. They're thinking of suing the appraiser, but now Karen is learning computer skills to make herself employable.

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Risk assessment and risk management are critical to a family business. Determining an appropriate level of risk to take is extremely difficult. Take too little and you fall behind; take too much and again you fall behind. But gauging risk is more difficult than deciding "how much" to take. The difficulty exists because we never have enough information to assess fully the actual risk. Those who bet it all on a single stock like eBay, or Wal-Mart, became wealthy specifically because they took "too much" risk. These distortions, or "outliers" as the statisticians would call them, create hope for the proverbial grand slam and make risk assessment more difficult.

Classifying risk

There are two general categories of risk.

Specific risk can be diversified away. Specific risk is what people talk about when they discuss their investments. Volumes have been written on it, and money managers prosper by identifying that perfect mix of investments, far beyond the tradition of just stocks (foreign and domestic) and bonds, to reduce specific risk in their clients' portfolios.

Managing specific risk is the linchpin of modern portfolio management and receives a disproportionate amount of attention from investors and investment managers. Specific risk is not, however, the only type of risk that a family business should consider. Systematic risk can, and often does, play a more dramatic role in altering a family business.

Systematic risk cannot be diversi-

fied away. Reducing systematic risk is difficult, and the techniques for reducing that risk are far less precise than the techniques used to reduce specific risk.

Reducing systematic risk is difficult, in part, because systematic risk is broad in scope while techniques to reduce it are situation-specific. Activities identified as "good" business practices or "healthy" lifestyles often come from accepted techniques for reducing systematic risk.

Managing systematic risk

Because managing systematic risk involves identifying the risk, and the likelihood and consequences of possible outcomes, the decision-making process for relatively straightforward decisions becomes complicated.

Jn the family business, common techniques for reducing systematic risk include:

- Acquiring risk-reducing information.
- Isolating risk using legal structures.
- Using contractual techniques.
- Initiating processes that reduce risk.

Each has its limits, but families can reduce the risks in any particular situation by drawing from one or more of them.

1. Acquiring risk-reducing information. Decision making without enough information increases systematic risk. Much of the systematic risk we face exists because we simply don't know all the facts. Business negotiations often go awry because the parties each draw from very different information sources and reach very different conclusions regarding the risks inherent in the transaction.

Hiring or partnering with industry-specific expertise is one method to obtain risk-reducing information. A seller or builder of real estate, for example, often knows the local market much better than the buyer. Engaging a buyer's broker levels the playing field with information about the local market and increases the likelihood of a successful transaction. While a mild to moderate disparity might result in one party getting a "better" deal, industry-specific expertise will spot a large disparity in information and often prevent a bad investment. A family's investment in real estate construction, franchising, or restaurants, for example, will be much safer if a lender familiar with the industry is financing part of the project. Paying for industry-specific expertise is money well spent.

2. *Using legal structures to isolate risk.* This technique works because a shareholder in a corporation and a limited partner in a partnership are liable for the obligations of the entity only to the extent of their investment in the entity.

The technique has become more efficient since the IRS agreed that taxpayers can form a single-owner entity, typically a limited liability company, that is respected for state law purposes and yet disregarded for federal tax purposes. Using this structure, families can conduct activities while containing liabilities, assuming the entity is formed and operated properly. The new entity must legally come into existence and then be operated in a way that respects that entity's separate existence. The requirements for proper formation are clear but families sometimes lose the liability protection because they don't operate the entity in a way that bolsters its separate existence. Common failures include:

- Inadequate capitalization of the entity.
- Commingling of funds.
- Not respecting "corporate" formalities.
- Not maintaining separate bank accounts for the company.
- Not maintaining separate and accurate books and financial records.
- Not having agreements (leases, contracts, etc.) made, and checks signed, in the company name by an authorized company executive.

Avoiding these common failures will help isolate liabilities in the newly formed entity.

3. Using contracts to mitigate risks. Contracts formalize terms and also allocate risks—sometimes unanticipated risks—between the parties. The risk allocation element of a contract simply allocates costs and benefits of the particular relationship. Families and their lawyers can use common contractual provisions to shift risk to the other party with little or no cost to the family. Risk-shifting provisions usually come in three flavors: seller favorable, buyer favorable and middle-of-the-road. An agreement between two sophisticated parties generally ends up near the middle of the road, but at times one party will gain a risk-allocation advantage because the other side doesn't appreciate the importance of these provisions.

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Indemnity and limitation-of-liability provisions both allocate risk. An agreement to indemnify is one party's promise to make the other party whole if that party suffers a loss. A lirnitation-of-liability provision limits a party's liability to the other party.

The initial bias in indemnity and limitation-of-liability provisions is easy to detect because these provisions are typically drafted as "one-way," with the benefits flowing to just one party, or "two-way"/recip-

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rocal, with the benefits flowing to either party depending on the circumstances.

4. Initiating processes to reduce the overall risk profile. Managing systematic risk often evolves into prudent business practices. Cash management techniques, human resource practices and decision-making processes have developed over years of trial and error and refinement.

Entrepreneurs often bristle at the thought of initiating procedures to govern functional areas, particularly the hiring and firing of employees. As organizations grow, however, processes take on a larger risk management component because the entrepreneur is less involved in day-to-day decisions. Growth necessitates delegation of authority, and established processes ensure that authority is exercised reliably.

A multitude of techniques

Family businesses must consider both specific risk and systematic risk as they chart their path for the future. The good news is that entire industries exist to help families in that endeavor, offering literally thousands of different techniques. The bad news is that many techniques are specific to a narrow universe of risks with limited application in other areas. Additionally, techniques are scattered throughout different disciplines, making it difficult to identify the available alternatives. Despite the difficulties in managing systematic risk, families that attempt to do so increase the probability of a better result when it conies to both the growth and survival of the family business.

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