Home and the World

Tools of the Trade: Keeping Your Wealth Intact for Multiple Generations

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Preserving Wealth, Reducing Risk and Avoiding Lawsuits. Sounds like every high net worth individual/family's dream. It is actually the title to a panel discussion jointly presented by Moses & Singer LLP and Family Office Metrics in the law firm's offices inside the Chrysler Building in Midtown Manhattan on November 13.

Jon Carroll, president and CEO of New York-based Family Office Metrics moderated the discussion, which at the bottom line was about the critical importance of planning to avoid missteps that could lead to the detriment of the family. Among the main topics were asset protection, regulatory changes and litigation pertaining to small businesses, like the family office.

Gideon Rothschild, partner at Moses & Singer LLP and chair of the Trusts & Estates and Asset Protection practices in New York firstly underscored the importance for conversations involving estate and tax planning to include asset protection. Why? He pointed out the fraudulent transfer statute. What it means is if you make transfers to protect your assets from the reach of existing "or even reasonably foreseeable creditors," it's basically too late. "In fact, according to New York law, once you are named as a defendant, any transfers you make are deemed fraudulent," said Rothschild. "And what that simply means is the creditor can reach it from wherever you've transferred it."

Rothschild raised the issue of how to protect the wealth generated by estate tax through succeeding generations. Divorce, litigation matters, real estate deals going under - he again stresses the importance of incorporating the different strategies that can be applied. Offering an example of real estate gone bad, Rothschild describes, "Clients came to me [somewhere between 2008 and 2010]. They were real estate developers whose project had gone under and they wanted to protect it from the banks coming after them on their mortgage loans. At that point, it's too late folks," he said.

Common Mistakes

The most common mistakes he sees among clients deal with documents that pass wealth onto the next generation. According to Rothschild, there isn't enough attention paid to the mandatory distribution at certain ages that is usually stipulated in such a document. Clients often approach him asking: when should I distribute my inheritance to my children? "The typical response most lawyers give is: 'when do you think your kids are mature enough to receive it?'" he said. Rothschild pointed out that even a child at age 45 is not immune to many problems, like lawsuits or divorce, that diminish net worth.

His solution is to not express mandatory distribution of income or principal unless it's a marital trust (required by the tax code). "Leave it at the discretion of the trustees," he stressed.

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Rothschild gave an example of a client who was the sole heir to a $20 million co-op on Fifth Avenue that his uncle left for him after he passed away. He and two of his friends were developing some condominiums in New York City that happened to go under. The three signed personal guarantees of $25 million, but his friends had nothing outside of other real estate that was under water. Rothschild's client was now inheriting $20 million from his uncle and there was no way to protect it. "The uncle had died already. Had the uncle been a client of mine, his will would have said to leave it in a trust for the nephew for his lifetime and the bank wouldn't have gotten a dime. But because it was just left outright, there was absolutely nothing the nephew could do to protect those assets. We live in a litigious world, we just don't know what the risks are going to be going forward."

Rothschild called for the need to educate clients and encourage them to keep these trusts in perpetuity.

Growing Trend of Private Trust Companies

Part of the discussion turned to private trust companies - a growing trend. These are dedicated trust companies whose regulations permit only family members who are related by blood or marriage to use their services. Now why would a family office need a private trust company? "You have a choice," said Rothschild. "You can go to the JP Morgans of the world and you can have them as a trustee. But one of the attractions for private trust companies is that many families have their wealth concentrated in very few assets. It might be a closely held business that's worth several billion dollars and they want to pass the shares of that business onto the future generations in trusts." Rothschild pointed out that many of the institutional trust companies don't want to hold concentrations of assets like real estate. He explained that they have an obligation, especially under New York law and the Prudent Investment Act, to diversify.

So one major reason for family offices to form private trust companies is to be able to retain the concentration of assets in their family businesses.

There are other reasons, such as cost efficiency, the ability to manage the investments, favorable state laws and taxation. "If you have a New York client creating a trust, he dies and you have a New York trustee, your trust is subject to New York City income tax," said Rothschild. "You move that trust company to Nevada or South Dakota, assuming it's being administered in South Dakota or Nevada and not in New York, then you can avoid New York State income tax." Now you can do the same things if you were going to an institutional trust company as well.

Rothschild added that there is a cautionary note here: the Internal Revenue Service came out with a notice in 2008 that still leaves an open question (or many) as to how much involvement family members can have in investment and distribution decisions of a trust if they are members of a private trust company. "Based on this notice, you need to have a wall between the family members making investment decisions and other members, employees perhaps, of the trust company who are making distribution decisions. And you would have a distribution committee, so you've got to be careful with the regulations, with the rules - there are some tax traps there," explained Rothschild.

But having a private trust company can be very useful, he added. It also allows you to accumulate the investable assets so you can qualify to invest in certain hedge funds and private equity funds where there might be minimums that individual investors might not be able to meet.

Carroll noted that a lot of Family Office Metrics clients have formed private trust companies because they were serving as individual trustees and they have personal liability for whatever happens to that trust. "So the private trust company is the way to institutionalize away from individual liability," he said.

Private Placements

New York's Allan Grauberd, partner and chair of Moses & Singer's Securities and Capital Markets practice group later took over the conversation to talk about capital deployment in "private placement," which has gained a lot

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of attention in the past three years. It's like a privately-offered security, though Grauberd was quick to point out that that definition doesn't work very well anymore because the most popular exemption for private placements, Rule 506 of regulation D, has been undergoing a major revision.

"So for years, 506 was the exemption of choice for private placements. The reason it was the exemption of choice is because it gave you the status of covered securities through the Securities Act, which basically meant that an issuer offering securities under the rule 506 could avoid having to comply with any state blue sky registration," said Grauberd.

In other words, as long as you comply with the federal exemption, you can avoid any need to check out any of the 50 states where you are going to be offering your securities. That means you wouldn't need to be concerned if the states would look differently upon that offering. Grauberd said rule 506 offerings constitute 93% of all private placements in the US.

In 2012, the Securities and Exchange Commission passed the JOBS Act. This created a new rule, 506(c) that allows an issuer to publicly offer rule 506 securities. "In the past, you would have to have a pre-existing relationship, a network, a relationship either between the issuer and the investor, the issuer's placement agent in the investment. Now you are going to be able to advertise rule 506(c) offerings on the Internet, on any kind of broadcast media, on social media, however you want to do it. The only restriction is that only accredited investors are allowed to purchase," said Grauberd.

The difference between the old rule 506, which is still going to be in effect, and the new rule 506, he said, is that if the issuer is going to publicly advertise its rule 506 offering, they are going to have to take reasonable steps to get independent verification that the investors are accredited.

So what does that mean for family offices? "If you are going to participate in a rule 506(c) offering as opposed to the old rule 506 where you would just check the box and say 'we are accredited' based on your $5 million assets or because your equity owners are accredited, now you are going to have to provide the proof," said Grauberd.

That proof could take many forms, like financial statements or information provided by your accountant. It's the "bona fides" that count.

Grauberd went on to emphasize the second half of the SEC rulemaking, which passed the bad actor disqualifications. "Basically they said that any issuer who wants to use either the new version or the existing version of rule 506, which is the non-public version, is disqualified from using 506 if any of their directors, officers or 20% or greater shareholders are 'bad actors'," said Grauberd. Bad actors is "a slug of different events" - everything from fraudulent, deceptive conduct, person subject to SEC cease and desist orders, expulsions of suspensions - essentially securities and financial crimes.

Carroll pointed out that the whole concept of the "bad actor" is to prevent unintended consequences for an investor, such as a family office.

"The whole purpose of them putting this criteria into play is to keep rule 506 as a very advantageous exemption from being used by fraudsters," said Grauberd. "So there is a protective rule for the 'taketh away' part that the SEC gave when it made the 506 solicitation rules."

Risks Related to Capital in the Family Office

The latter part of the talk focused on the risks related to capital in the family office, which can be quantified as small businesses (with fewer than 20 employees).

Kimberly Klein, litigation partner at the firm based in New York, led the topic of discussion. She noted that she has clients who call regularly about various employment issues and others clients who will only call when a situation tends to reach a boiling point - when litigation, or the threat of it, has commenced.

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Her best advice when it comes to the myriad of issues that pertain to employment, such as pregnant employees, federal wage-an-hour laws, meal and break hours, and overtime, is to provide an employee handbook that documents all policies and procedures and then to apply those policies and procedures rigorously across the board.

Klein said she is litigating a couple of cases at the moment involving smaller employers who are being sued by former employees for various discrimination claims. "And the first thing the plaintiff's lawyer said to me [with one case] was 'well, your client doesn't have a handbook and doesn't have an anti-discrimination policy. And there is no reporting structure for my client to have reported the alleged discrimination,'" she said.

Klein impressed upon the point that this can be taken care of with a handbook and a zero-tolerance anti-discrimination policy, a practice that should be the norm in today's environment. "It's a place where your employees will understand what conduct is expected of them and what is the discipline for [non-compliance]," said Klein. She further emphasizes the critical nature of the document and the need for it to be updated, modified, and supplemented on a yearly basis in accordance with the current environment.

There are other best practices related to policy that are paramount to running a successful family office. One of these best practices is the non-disclosure agreement (NDA). This, said Klein, defines your confidential information, helps your employees understand how to use that confidential information, how not to use it, and your remedy in case of breach, misappropriation or misinformation. "Today we all know it's easy for information to walk out the door," noted Klein. "You not only have email and Internet, but you've got Cloud and DropBox.com, and ways to download that information. There are remedies that we can put into these agreements."

She also pointed out that the NDA can be used in lieu of the traditional employment agreement. Employment agreements tend to be reserved for top-level employees. For the rest, the NDA can be used to put certain protections in place such as non-disparagement clauses, at-will relationships, and restrictive covenants, if any of those apply to your business.

Another document that protects your information is a waiver of expectation of privacy, which basically goes hand in hand with the NDA. It informs your employees that "we're going to let you use our systems, servers, Internet, email, voicemail. But you, as the employee, need to understand we can monitor your use at any time," said Klein.

She stressed that each of these are considered standalone documents and the employee should sign them individually for them to be enforceable. "It is adequate consideration to have employment and continue to have employment for these documents to be enforceable," she said. "And a waiver of expectation of privacy becomes a critical document when you suspect that an employee is using your information improperly or accessing your information without authorization."

The last best practice document is an arbitration agreement, of which Klein impressed she is a big proponent. "I think that employers are a little too quick to take out the checkbook when they are threatened with a discrimination action or a wage-an-hour action," she said, pointing to two reasons in particular. The first is a concern around confidentiality and the second around the cost of litigation. Klein believes arbitration addresses these issues well. "If you have someone who really knows what they are doing and understands the process, you can really streamline [the drafting of it]," she said. 'There's no reason for a drawn-out discovery process when you are the employer and you have all of the information in your arsenal. You have access to your workforce, to personnel files - to basically all the information you need to get to a hearing. It's really the plaintiff who benefits from a drawn-out discovery process."

Klein also provided best practices for terminating an employee. For a smaller business, this is a very touchy area as you tend to know your employee better, know

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their family - or perhaps they are family, she highlighted. Typically when they terminate, employers want to give severance to help with the transition period. Klein emphasized that whenever you do that, it is important to get a severance and release agreement.

She proffered an example of a case she is litigating at the moment that emphasizes this point. Her client is a very small employer with only four employees. At the end of last year they needed to eliminate the position of a long-time employee - she had been with the company for about five years. The relationship had always been good with this employee, said Klein, so there was no expectation that there were any issues that would cause her to want to sue. The employer paid her six months of severance but they neglected to obtain a severance and release agreement. "The employee has taken this six months of severance and recently commenced an action against the employer who is just shocked because they didn't see it coming," said Klein.

She emphasized that a client should not hesitate to pick up the phone and have that brief conversation. "It doesn't mean that every phone call has to cost you thousands of dollars," Klein underscored. "It could just be bouncing something off in a 15-minute conversation. But we are going to get you in good shape. We are going to make sure you are handling that termination correctly or whatever that need is. You have to have someone walk you through this process so you can do it right. And if you do, it's really going to minimize any risk of litigation."

The main takeaway for all of this? Plan before you act. Oh, and don't let things get to the boiling point.

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