By **Thomas J. Handler** & **Judith Pearson**

Family Enterprise Risk Management

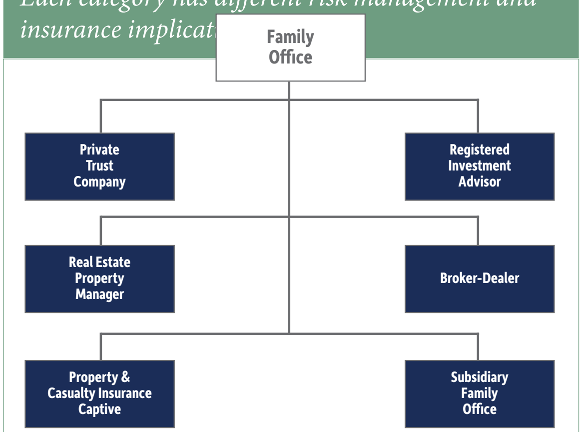
Directors and officers liability and professional liability insurance

Ultra-high-net-worth (UHNW) individuals, private businesses and family offices don't always appreciate the significance of risk management. Risk management for family offices and other family businesses involves the process of identifying, assessing and controlling threats to a family's capital and assets. These risks can come from various sources, such as financial markets, legal liabilities, accidents, natural disasters, government agencies and even within the family itself. The primary goal is to protect the family's wealth and ensure its long-term sustainability. While it's critical to evaluate all areas of risk management, we'll focus on risk from a legal structure and insurance perspective to understand how these different areas of risk management are intertwined.

The families with whom we work tend to fall into several categories depending on how and when the wealth was created and how the wealth is being transferred. Transferring wealth involves a complex strategic process designed to ensure that assets, experience and family values are passed down through generations. Many multi-generational families have thoughtfully created complex structures that outline not only how wealth transfers but also goals for next generation management and governance. In that case, there may be a standalone family office structure that facilitates the successful transition. The transition period from first generation to second may not have a formal family office structure and often uses employee and administrative services of a family operating company. This de facto family office exists without a separate legal entity and is thus considered an embedded family office. It's essentially operating within a family operating company as a separate division. Newer structures may include a private trust company (PTC), registered investment advisor, real estate property manager or subsidiary family office.[1] See "Complex Family Office Structure," this page.

Complex Family Office Structure

Each category has different risk management and insurance implications



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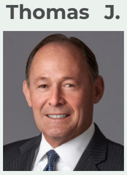

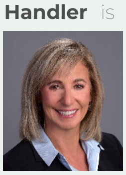

Each structure is attendant with different risk management and insurance implications that are often misunderstood. To address these implications,

we must first understand the relevant insurance policies.

Types of Insurance

Directors and officers (D&O) liability insurance[2] provides financial protection to the directors and officers of family businesses from claims made against them while performing their duties. The primary purpose of D&O insurance is to safeguard directors and officers from personal financial loss in the event that they're sued for alleged wrongful acts committed in their capacity as company executives. It provides coverage for legal defense costs, settlements and judgments that may arise from claims related to breaches of fiduciary duty. These policies can and should be highly customized. They're structured with three key insuring clauses:

- Side A coverage: Protects the personal assets of directors and officers when the family business can't indemnify them, usually due to legal or financial reasons.
- Side B coverage: Reimburses the family business when it indemnifies its directors and officers, meaning the family business first pays the defense costs, settlements or judgments on behalf of its directors and officers.
- Side C coverage: Also known as "entity coverage," extends protection to the family business itself for claims made against it, for most kinds of lawsuits unless excluded, brought against the family business for alleged wrongdoing. While the entity is commonly named along with the individuals, this coverage may be critical for regulatory exposures especially for UHNW families because we expect the evolving structures to be tested.

Coverage commonly known as "errors and omissions" (E&O) insurance[3] protects management and employees for mistakes made in carrying out their professional duties. For family offices and businesses, these professional duties can include management and protection of assets as well as handling regulatory requirements and providing services in other fiduciary roles.

Evaluating the Risks

The differences between D&O insurance and E&O insurance for family offices, PTCs[4] and family businesses can be confusing due to subtle, often little understood differences. These differences lie in management decisions and the impact on stakeholders, as opposed to the services that are provided to clients and beneficiaries.

By combining these concepts, we can achieve a better understanding of how to evaluate and insure the respective risks.

Making sure the underwriters understand the structure of the current family enterprises is key to adequately structuring the necessary policies.

Standalone family offices. These can get quite complicated and should consider a full suite of management liability insurance policies depending on the number of employees and the services provided. The management of the family office is generally charged with making decisions like a private company board, such as balancing risk versus return, investment options available to the family, reviewing investment policy statements and corresponding investments and oversight of the investment team. The management team may review changes to tax and estate laws to ensure the related plans are the most efficient and up to date. The team may place insurance policies on behalf of the family. The property and casualty insurance market has never been so challenging requiring heightened evaluation of the liability limits, exclusions and deductibles versus premium charges. If the family office chooses to absorb more risk, it then needs to ensure there's available capital to deploy in the event of a loss. Making sure the underwriters understand the structure of the current family enterprises is key to adequately structuring the necessary policies.

Embedded family office. A family office that's integrated into the structure of a larger organization,

such as a business owned by the family with no separate legal entity is known as an embedded family office. The two operations may share services such as accounting, investment, distribution and legal services for family members.[5]

The potential advantages of an embedded structure over a standalone structure include having centralized services and the resulting cost efficiency. However, there can also be complicating factors to consider:

- Lack of clear boundaries: Along with blurring the lines between family business operations and personal family affairs, there may be challenges in delineating which assets and liabilities belong to the business and which belong to the family. This lack of boundaries could potentially expose family assets to business-related risks or challenges if there's a sale or bankruptcy of the operating entity.
- Conflicts of interest: Because an embedded family office is closely tied to the family's business operations, there could be conflicts of interest, particularly involving investment decisions or transactions that may benefit one part of the family or its holdings over another.
- Regulatory and compliance risks: Depending on the jurisdiction and the specific activities of the embedded family office, regulatory requirements may come into play. Tax and accounting compliance is also more complicated and attended by a greater chance for error. Failure to meet these compliance requirements can lead to financial penalties and legal consequences.
- Operational risks: The close intertwining of family and business operations can lead to operational inefficiencies, errors or oversights that might not occur in a more distinct separation of entities.
- Reputation risks: If the family business becomes embroiled in any public scandal or controversy, having an embedded family office might mean that the family's private affairs are also dragged into the limelight.
- Privacy concerns: The more integrated the family office is with business activities, the greater the number of individuals who might have access to private family information. This integration could raise concerns about the privacy of the family's financial and personal data.
- Legal disputes: If disputes arise within the family or with external entities, embedded family offices might become more easily entangled in legal battles.
- Lack of independence: A family office that's embedded might not have the same level of independence in terms of decision making. This situation could be problematic if the family needs to take actions that aren't in the best interests of the business (or vice versa). Additionally, there could be adverse tax consequences if the Internal Revenue Service perceives the family has too much control over the assets that have been placed in irrevocable trusts.[6]
- Succession and governance issues: With family and business matters intertwined, it's more challenging to set clear governance structures and succession plans, which could lead to disputes and disruptions down the line.

If a claim arises that involves both the family office and the family business, a combined policy could create conflicts in terms of defense strategies or indemnification.

Insurance Considerations

When deciding on the best insurance converage, consider these limitations and exclusions:

- Sharing policies between the family office and operating company might result in coverage limitations, such as the insured versus insured exclusion. Management or employees of the operating company have a fiduciary duty to corporate stakeholders while trustees have

a fiduciary duty to beneficiaries. If multiple individuals are acting in multiple capacities and are in conflict, litigation may ensue, and if there are cross claims, the insured versus insured exclusion may eliminate coverage.

- If one entity faces a significant claim, it could exhaust the policy limits, leaving the other entity fully exposed.
- The definition of "wrongful act" may not be expanded to cover the services provided by the embedded family office to family members.
- In some cases, such as trustee services, the person is serving individually and not as an employee, which may create capacity issues.
- Clarity and simplification: There might be disputes or ambiguities about which entity's activities led to a claim and how the insurance coverage applies.
- Conflicts of interest: If a claim arises that involves both the family office and the family business, a combined policy could create conflicts in terms of defense strategies or indemnification.
- Future flexibility: If there's ever a consideration to spin off the family office as a separate entity, having separate policies can make the transition smoother and ensure there aren't runoff issues or prior acts exclusions.
- Claims history and renewals: If one of the entities has a significantly adverse claims history, it might impact the renewal terms or premiums for a combined policy, potentially penalizing the other entity.
- Market cycles: Insurance markets don't cycle at the same time and are driven more by market segments today. Therefore, changing markets will affect coverage grants and pricing differently, creating challenges in leveraging market conditions.

In sum, families are often far better off by establishing a separate legally organized family office to avoid these many problematic issues and compliance problems. The popularity of PTCs operating in conjunction with family offices is increasing, because PTCs offer privacy to families, more flexibility, greater control and potential cost savings when compared to a corporate trustee.

A PTC[7] is a formally organized entity established to act as a trustee for only one family and its branches to administer family trusts. PTC regulations ensure that the establishment and operation of PTCs are conducted in a manner that protects the interests of beneficiaries, promotes transparency and maintains the integrity of the trust industry. Because a PTC is a separate business structure, individuals serve on the board as managers of the enterprise and may serve on various committees.

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Mandatory Insurance

In addition to risk management techniques, risk transfer opportunities may be mandatory. State regulatory requirements vary significantly, so it's important to review state regulations for mandatory versus recommended insurance.

The relevant insurance policies often referenced are:

- D&O liability insurance, which covers management of a breach of fiduciary duty for operational decisions such as regulatory obligations.
- Errors and omissions insurance, which are mostly applicable to negligence and providing trust administration.
- Fidelity bonds, which protect PTCs against losses caused by employee theft or dishonesty.
- Surety bonds, which replace the need for depositing regulatory capital in an approved bank account.
- Cyber liability insurance, which protects families in the event of a bad actor, potentially covering costs of prospective lawsuits, data breach response, forensic investigations, ransomware payments and social engineering.

Purpose Trusts

More recent structures such as family holding companies, series family advancement funds and purpose trusts[8] are increasingly being used to own everything from personal property, family compounds and PTCs to stock in private companies. Generally, a purpose trust is established to effect a specific purpose. Unlike traditional trusts, which operate to benefit identifiable individuals or entities, purpose trusts exist to fulfill a particular goal without the necessity of identifiable beneficiaries. The trustees of a purpose trust take on the responsibility and personal liability of the trust in the same way as any trustee. They must understand the trust document in terms of purpose, powers and duties as they manage the trust's assets. The role of trust protector (sometimes referred to as the "enforcer") has been used to focus responsibility for monitoring the trustees' actions and confirming they align with the trust's objectives. If they don't align, the trust protector typically has the right to remove or replace the trustee.

In the past, many jurisdictions deemed purpose trusts without identifiable beneficiaries as invalid because there was no one to enforce the terms of the trust. Many jurisdictions, however, have now changed their laws to allow for certain types of purpose trusts, especially for charitable purposes.[9]

State laws vary regarding purpose trusts. Currently Delaware, South Dakota and Alaska have enacted provisions recognizing purpose trusts.[10] Wyoming and Nevada also have favorable laws, with Wyoming allowing purpose trusts to own PTCs.[11] Other states are closely watching trends in wealth transfer vehicles; it's feasible that additional states will incorporate provisions to recognize non-charitable purpose trusts in the near future.

If a purpose trust is used to own a private company or manage other assets, trustees and trust protectors might be inclined to think they can use their D&O policy to insure the purpose trust. However, because there's no corporate structure behind this financial vehicle, the D&O insuring agreements don't apply. Moreover, the individuals serving as trustees aren't working in their capacities as directors, officers or employees of an insured entity. By contrast, a trustee liability policy is structured to provide insurance for wrongful acts committed by trustees.

Team Approach

There isn't one structure superior to the others; the choice depends on the family's situation, goals and objectives. To safeguard family businesses, family offices and PTCs from growing spheres of liability exposure, the professional advisory team needs to do an enormous amount of work. That team should include not only counsel but also accounting and insurance (life and property and casualty) professionals. The key to effectively assisting families and their family enterprises is to fully understand the opportunities and structures and to continually evaluate the advanced planning design from a risk management and liability insurance perspective.

Endnotes

1. *See,* Thomas J. Handler, "21st Century Family Office Structures," Family Office Ass'n (2017), *www.handlerthayer.com/wp-content/uploads/2021/09/21st-Century-Family-Office-Structures.pdf.*
2. Jason Metz, "Directors And Officers (D&O) Insurance For Small Business," *Forbes Advisor* (Dec. 21, 2023), *www.forbes.com/advisor/business-insurance/directors-and-officers-insurance/.*
3. Jason Metz, "E&O Insurance: Coverage & Costs," *Forbes Advisor* (Dec. 21, 2023), *www.forbes.com/advisor/business-insurance/errors-and-omissions/.*
4. *See generally,* Christopher C. Weeg, "The Private Trust Company: A DIY for the Über Wealthy," *Real Prop. Tr. & Est. L.J.,* (Spring 2017), at p. 122.
5. *See,* Thomas J. Handler, "Establishing Virtual Family Offices," *Trusts & Estates* (2014), *www.handlerthayer.com/wp-content/uploads/2020/04/2014_Establishing_-VFO_March.pdf* (discussing the use of virtual family offices to avoid compliance problems).
6. *See generally, Estate of Powell v. Commissioner,* 148 T.C. 392 (2017) (wherein the Internal Revenue Service argued there was no non-tax business purpose behind the transactions); *see also Estate of Strangi v. Comm'r,* T.C. Memo. 2003-145, *aff'd,* 417 F.3d 468 (5th Cir. 2005) (the U.S. Court of Appeals for the Fifth Circuit ruled that the decedent retained control of the assets in the family limited partnership during his life).
7. Weeg, *supra* note 4; *see also,* Judith Pearson, "Why are Private Trust Companies Becoming More Popular?" Woodruff Sawyer (March 20, 2023), *https://woodruffsawyer.com/private-client/private-trust-companies-more-popular/.*
8. *See,* Judith Pearson, "What is a Purpose Trust?" Woodruff Sawyer (Oct. 23, 2023), *https://woodruffsawyer.com/private-client/what-is-a-purpose-trust/; see also* Richard C Ausness, "Non-Charitable Purpose Trusts: Past, Present, and Future," *Real Prop. Tr. & Est. L.J.,* (Fall 2016),

at p. 322 (for a general discussion and overview of the concept of purpose trusts).

9. *See, e.g.,* S.D. Codified Laws Section 55-9-1 (2004); Del. Code Ann. tit. 12, Section 3541 (West 2017); Wyo. Stat. Ann. Section 41-10-406.
10. *See, e.g.,* Del. Code Ann. tit. 12, Section 3556 (West 2008); S.D. Codified Laws Section 55-1-20 (2018); S.D. Codified Laws Section 55-1-21 (2018); Alaska Stat. Section 13.12.907.
11. *See, e.g.,* Wyo. Stat. Ann. Section 4-10-406; Wyo. Stat. Ann. Section 4-10-410; Nev. Rev. Stat. Section 163.006 (2017); Nev. Rev. Stat. Section 163.5505 (2017).