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Integrating Family Governance Into an Existing Estate-Planning Infrastructure

Linking form with function

Given the increasing popularity of family governance as a topic in wealth planning, there's no shortage of articles reviewing its components and formal definition. Of course, the concept of family governance sounds appealing and aspirational, but practitioners understandably need to consider its practical implementation. With trusts already established, how can family governance take effect and not conflict with the rules and protocols already prescribed by the trust instruments?

This question has arisen more frequently in the context of family leadership succession. The past year and ongoing response to the pandemic have caused many of our clients to consider the prospect of mortality in a more tangible way than ever before. Coupled with this concern lies a heightened interest in preparing their next generation to steward and, just as importantly, work productively with each other as a family in using and growing the family's resources. What they effectively seek is a system of family governance to harness both family values and capital productively across generations. However, a universal challenge lies in creating such a system when the client has already established an estate-planning infrastructure of trusts and other entities.

Here's a common fact pattern: A grantor establishes various trusts for optimal tax and legal planning (for example, generation-skipping transfer (GST) tax-exempt and non-exempt trusts, grantor retained annuity trusts, charitable lead trusts and foundations of which the grantor and spouse serve as the sole current trustees). Several of these trusts in turn own interests in various limited liability companies (LLCs) that own specific assets or asset classes. The grantor appoints a trusted individual, of roughly the same age, to serve as trustee for these trusts. Fast-forward to when the beneficiaries have long since entered adulthood, with little or no contact with the non-family trustee. Then add an overlay of current events—due to the pandemic, the grantor contracted and recovered from COVID-19 and now feels more concerned and motivated to ensure that their family can collectively handle, in their absence, the resources provided for the family's benefit.

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A Distilled Definition

The term "family governance" can be overwhelming. To some, it implies complicated procedures, documents and obligations. But at its core, family governance simply reflects a family's process of communicating and proactively navigating its future. A simple concept, but not readily practiced. Ideally, a system of family governance will preserve a family's wealth and uphold its values over a long period while also enabling the family to evolve to meet new challenges.

Without an accepted protocol for decision making—about the business, the family and shared responsibilities—family members can fall prey to their emotions. As estate planners well know, generational conflict, sibling rivalries and other tensions all too often lead to disputes and division. Family governance offsets these tendencies by facilitating communication, collaboration and long-term planning. Its procedures needn't—indeed, shouldn't—be unduly complex and can be tailored to each family's requirements, taking into account a family's culture, history and unique values. In addition, family governance provides a framework for protecting and cultivating a family's rich reserves of human, intellectual and social capital. Material wealth, though crucial to a family's survival, isn't the only wealth that can pass on to descendants. Talents, personal

Trusts vs. Family Governance Systems

How they compare

	Trusts	Family Governance
Originator	A single individual or married couple (the trust creator or grantor) creates a trust and defines its terms.	A family regularly convenes to make decisions in accordance with agreed-on core values.
Enforceability	A trust document imposes a legally enforceable obligation on the trustee.	A family constitution generally isn't a legally binding agreement. It's a set of voluntary guidelines.
Timing	Trusts are often established to maximize the tax advantages of placing assets irrevocably into trust before they substantially appreciate. As a result, the ideal timing for trust creation may be long before the intended beneficiaries reach adulthood and before family governance has been established. Grantors/settlors may have no opportunity to work with beneficiaries when creating a trust.	Family governance systems emerge when wealth creators and their family members collaborate on and agree to a process for self-governance.

— www.brhauser.com/articles/trusts_international_family_governancechapterintrustsinprimejurisdcitions.pdf.

connections and intellectual passions are essential parts of a family's legacy. Family governance isn't a panacea for internal and external challenges to family wealth. It does, however, provide an ongoing mechanism for families to raise concerns, share ideas and take proactive measures.

Trusts vs. Family Governance

Clients often assume that a trust, or another formal entity such as a family business or foundation, will create the structure and opportunities for the next generation to emerge as mature leaders. While trusts and other entities serve important tax and legal purposes, they alone don't ensure the unity or well-being of a family across generations.

As shown in "Trusts vs. Family Governance Systems," this page, trusts and other estate-planning vehicles emerge from legally binding documents, with terms often determined by the wealth generators, with guidance from counsel for optimal tax results. Family governance systems, by contrast, reflect a voluntary agreement among family members to act according to certain values and principles. These agreements, often reflected through family constitutions or charters, while not legally binding, still represent a solemn covenant among family members to communicate and deliberate among themselves about the family's current direction and long-term prospects.

Governance Opportunities

While it's easy for clients to view estate planning as a "set it and forget it" exercise, many opportunities exist throughout the life cycle of a trust to cultivate a system of communication and future planning.

Express reasons. Even for trusts established long ago, grantors have the opportunity to express their reasons for transferring their wealth in the first place. Memorializing their intent on paper, whether through a letter of wishes to guide trustees, a statement of values or an ethical will, remains a valuable exercise for distilling intent and the purpose of the family's resources. The exercise itself, as opposed to the end document, remains critical for putting the grantors' intents into their own words and, therefore, wouldn't be served by just copying standardized phrases, although clients do seek actual examples. The process of clarifying one's intent in writing also serves a dual role of creating an inner script to guide current verbal communication with their beneficiaries on the "why" of providing resources, as opposed to the "how much" and "when." Examples of values that inform the purpose of a family's wealth include:

- **Fulfillment:** "We believe that people are happier when they're productive and doing something that is meaningful to them (for example, through work or raising a family, etc.). For this reason, we want to support the education of our descendants, to realizing their vocational fulfillment, with no restriction on topic, major or level of education. We want to clarify this purpose to our children soon, to enable them to proactively map out their career-forming years." Given the different interests of each beneficiary (for example, a 4-year private college vs. 2-year trade certification), this principle rationalized the variation of education costs underwritten, reflecting fairness and consistency in realizing the value of individual fulfillment, despite unequal dollar amounts spent per individual and family branch, with different numbers of descendants.

> Trustees have the opportunity and arguably the responsibility not just to protect the trust's assets but also to prepare the beneficiaries to use them productively, by providing, among other things, both education and mentorship.

- **Entrepreneurship:** "We recognize the value of entrepreneurship as an engine of economic growth and opportunity for others. The ability to take initiative and generate new solutions remains critical to catalyzing the growth of successful businesses, industries and communities. For this reason, we especially seek to foster and channel the entrepreneurial spirit of all our family members." Similarly, although each request for capital varied by amount and sector, the protocol of vetting these proposals remained consistent, thereby reflecting fairness and consistency in approach, despite unequal dollar amounts distributed.
- **Security:** "To foster a peace of mind for our descendants, we want to provide for any gap in medical expense coverage and the ability to live with their spouse and children in a safe neighborhood, regardless of the vocational path chosen." The principle of providing a baseline of fiscal and physical security justified a supplement to a schoolteacher's salary towards this end and none to a hedge fund manager.
- **Well-being:** "We prioritize the mental, emotional and physical health of our family and support the open discussion, treatment, prevention and rehabilitation of any illness or substance abuse disorder borne by a descendant or spouse, and don't seek to be punitive but rather supportive of those struggling with health challenges."

Trustees. They have the opportunity and arguably the responsibility not just to protect the trust's assets but also to prepare the beneficiaries to use them productively, by providing, among other things, both education and mentorship. In the example provided at the outset, the trusted peer of the grantor may enhance the positive impact of the trust by communicating with the beneficiaries regularly (when authorized to do so) and to welcome questions and understand their current needs and aspirations.

Beneficiaries. They have the responsibility of understanding the terms of the trust instrument, the fiduciary function of the trustee, the implications of the distribution and investment of assets on the trust corpus and on any other beneficiaries, as well as gaining fundamental financial and investment literacy to handle constructively the resources they receive.[1]

Interaction of Parties

These examples illustrate how these parties may interact to effect the family's governance process:

Example 1: Grantor still alive and in control of underlying business. Patriarch has transferred company shares to both a revocable trust (through which assets will flow into distinct continuing trusts on his death) and directed trusts for his descendants, with his son to serve as the investment advisor and the institutional trustee to serve as fiduciary in charge of distribution decisions. As the investment advisor,

the son has developed a track record in overseeing the growth of the trust's liquid investment assets. Patriarch continues to control the operating business as chairman of the company board, and while Patriarch had no plans to sell the company during his lifetime, he's identified his son to ultimately decide after Patriarch's death on any potential sale of the shares held by the family trusts. While the daughter as beneficiary has no other formal role with these trusts, she regularly meets with her parents and brother to discuss the status of the company, along with the trust's other holdings, and plans for the ongoing education of the grandchildren, who need to become, in time, stakeholders informed about the scope and nature of the family's wealth.

Example 2: Grantor still alive, with control now vested in adult children. Having conveyed shares of the family business to his descendants through a directed trust, Patriarch was able to move significant growth out of his estate before the sale of the business several years later. Having retired and devoting his time to various charitable causes, Patriarch's two sons now manage the family office entity owned by the directed trustee. The sons are responsible for overseeing the investment and growth of the proceeds from the sale of the company. Both sons and the parents formed a family council to clarify the long-term purpose of the family's resources and to identify and cultivate talent among the grandchildren in leading the family in the future. To begin this process, the family established a modest donor-advised fund to encourage collective decision making and giving, in alignment with the family's values.

Example 3: Grantor no longer alive, beneficiaries active in stewarding trust assets. A trust owns a holding company that in turn owns a wide array of interests in both investments and operating businesses, having sold out of the family's core legacy business years ago. All four of Patriarch's daughters serve as co-trustees, with the ability for each to designate her own successor. As beneficiaries, they're entitled to distributions based on an ascertainable standard and hold a limited testamentary power of appointment. When the trust makes a distribution, each branch decides independently how to use its portion of it, within the terms prescribed by the trust instrument. The family council consists of the four trustees and their designated successors, in addition to a G3 family member serving as the family office head: nine members in total. The inclusion of secondary members ensures that there will be descendants both experienced and qualified to succeed the daughters on the family council. Each year, the holding company's board of directors presents a 12-month strategy to the family council to approve. This yearly vote enables both the company's management and family owners to communicate and align on the high level direction of the family enterprise. The family's strong culture of entrepreneurship and self-sufficiency, inherited from the grandfather, anchors the family's overall focus on sustainable wealth.

> A family assembly helps increase transparency, foster communication and thereby mitigate potential conflict.

Levels of Family Engagement

There are differing levels of family governance participation, all optional, in keeping with the basic premise of family governance as voluntary.

The family assembly. Whether or not explicitly described as such, a baseline level of family governance participation exists through a family assembly. Also called a "family forum," a family assembly often refers to a gathering of all family members, including spouses and children, typically involving recreational activities and/or an annual reunion. At a family assembly, members may receive high level family business updates and learn of general topics geared to educate the family at large, for example, basic estate and/or financial planning. Because some family members are likely to be more involved than others in the management of the family enterprise, a family assembly helps increase transparency, foster communication and thereby mitigate potential conflict. Meeting at least annually not only keeps multiple generations and

branches connected but also allows the family assembly to feature updates on the personal and professional accomplishments of family members, as well as any family philanthropic initiatives. Sample family assembly or retreat agendas may include:

- Review of family history and key lessons
- High level review of the state of the family business(es), enterprise
- Education sessions on financial, estate, investment, entrepreneurship and cybersecurity planning, as well as personal and parental development, led by guest speakers
- Group recreational activities, field trips and volunteering
- Family philanthropy updates and calls for ideas/volunteers

The family council. In terms of more actively managing the family's communication, wealth stewardship and long-term planning, a subset of family members, often referred to as (or effectively functioning as) the "family council," consists of family members who prioritize the long-term sustainability of the family's wealth.

As a family grows, it may wish to formalize the role of the family council through a family constitution.

A family council may initially emerge organically from a subgroup consisting of the wealth generator and adult children inclined to work together in stewarding the family's wealth. As family council membership can itself cause family drama, a key intangible criterion of eligibility should involve a family member's available bandwidth of time and, most importantly, a mindset to serve and benefit the family at large beyond their individual interests. One family has expressed this attribute as "a willingness to hand assets and income to the next generation." This quality also remains critical for family council members to gain both credibility and trust among their relatives.

To distinguish entity governance from family governance, the bylaws of a family's business, or underlying agreements of an LLC, will specify the voting protocol of shareholders or members and may dictate a majority vote to act in most cases and potentially a super-majority voting threshold for more consequential matters. Because family members serve as the ultimate stakeholders in such decisions, the family council serves as a useful forum for discussing any action or decision items in advance. For instance, before one multi-generational family decided to effect the sale of its core legacy business, the family council deliberated and had candid discussions with the family at large to gauge family sentiment and ultimately reach a unanimous support to sell, thereafter applying the proceeds to a wide array of direct investments in other operating businesses and investment pools.

As a family grows, it may wish to formalize the role of the family council through a family constitution, which typically describes the qualifications for serving on the family council, such as the threshold age and any other basic requirements, such as minimum educational attainments or a history of involvement in the family business. It also usually spells out the family council's role, which may encompass:

- Serving as a communication channel between the family and the corporate board of the family's businesses, to ensure alignment of business needs with the family's values and long-term mission.
- Clarifying the roles and responsibilities of family members as shareholders, wealth inheritors, employees or active family members in the business, family office or foundation.
- Planning educational opportunities to prepare younger family members for these respective roles.

Integrating Trust and Governance

In general, domestic trusts, LLCs, foundations and other family entities remain subject to their underlying agreements and a panoply of federal and state laws. They typically exist separately from a family council, which serves as a voluntary governing body. In such cases, how do family entities and councils work together?

As reflected in the examples above, a family council may consist of family members who serve as

trustees, co-trustees or investment committee advisors to family trusts, LLCs or the family foundation. In addition, it may include trust beneficiaries who have taken an interest in the stewardship of family wealth. The family council could require equal representation among branches.

Integrating existing trusts into a family's governance process may take one of two paths:

1. A family may be using a corporate trustee for its administrative support, fiduciary expertise and insights into succession planning, as well as jurisdictional and other institutional benefits. In such a case, the family council may provide high level oversight by having certain members in their capacity as trust beneficiaries exert the power to remove and replace the corporate trustee, pursuant to the terms of the trust instrument. That is, rather than burden the family with granular oversight over trust assets, they may outsource this function and oversee it.
2. Alternatively, having family members serve effectively as trustees requires a much greater foundation and culture of family cooperation, informed by its history and reiterated by its culture. It takes a significant investment of energy and a recommitment from each generation to work collaboratively. If family members do serve as trustees, co-trustees or beneficiaries, and remain committed to preserving and growing the family's balance sheet, they may also potentially serve on the family council, which exists as a voluntary committee existing separately from all the family's entities.

Including family trustees and engaged beneficiaries on the family council may enhance family governance in several ways. The family council serves as a forum for reviewing the state of the family's overall balance sheet, including those assets held in trust, and aligning the family's objectives with the strategies effected through all the family's entities. The council provides a training ground for beneficiaries to steward family assets, especially if they'll ultimately serve as an investment advisor to a directed trust. In addition, council meetings serve as a forum for constructive debate before emotions and conflicts relating to family assets escalate. (See "Family Council Membership," p. 68.) A family council roster may include:

- **G1 (grantor and spouse)**, to set the family culture and values as a framework for guiding the family in any collective decision making and in the conduct of family members towards each other.
- **G2 (adult children and trust beneficiaries)**, to carry the family's culture and values and lead the family's internal communication and planning of the family's use and investment of its resources.
- **G3 (younger adult grandchildren and trust beneficiaries)**, to learn from council discussions and innovate the family's approach as needed to adapt to an ever-changing landscape.

Once they understand the grantor's intent, beneficiaries may become better positioned to join the family's council.

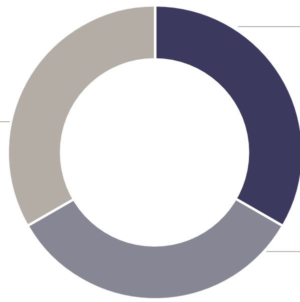
PTC Considerations

A private trust company (PTC) is an entity formed and authorized under state law to act as a fiduciary for a single family. Depending on applicable state law, a PTC may exist as an LLC or a corporation. The centerpiece of the governance structure lies in the board of directors, which remains responsible for the overall management of a PTC, including the formation of internal committees, including a distribution committee and investment committee. With careful structuring by counsel, family members may serve on the board of directors and the investment committee.[2] Primary benefits of this structure include opportunities for family members to participate in the governance structure of the PTC.

As with any family governance framework, the efficacy of a PTC entails common elements, for example: (1) a properly structured and operated board of directors and internal committees, with systematic monitoring of any conflicts of interest; (2) the presence of independent individuals when necessary; (3) the inclusion and ongoing education of family members whenever possible; (4) open lines of communication among the various levels of governance and

Family Council Membership

The roster can include multiple generations



G1

Wealth creator and spouse

G2

The family council may potentially include G2 family members with the following roles:

For trusts
—Co-trustees (participating only in investment decisions)

For family business, investment and/or philanthropy entities
—Senior management or board members
—Investment committee members

G3

The family council may potentially include G3 family members with the following roles:

For trusts
—Engaged trust beneficiaries

For family business, investment and/or philanthropy entities
—Senior management or board members
—Investment committee members

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family members; and (5) a strong commitment to the PTC by current and future family generations.[3]

Wealth Visibility and Disclosure

Regardless of trust structures used, beneficiaries can't be expected to responsibly use and oversee assets they're not aware of. While silent or quiet trusts may have their place, limiting disclosure in general may not reconcile with the spirit of transparency, communication and empowerment so critical to effective family governance.

"Money silence" reflects a natural and understandable fear of disincentivizing beneficiaries, but its long-term costs can be acute. Grantors often liken the sensation of disclosing information about a family trust to jumping off a cliff. However, we don't propose exposing the full balance sheet as the very first step. Three questions have helped clients define their long-term aspirations for their family:

- What would success look like for your family in 10 and in 20 years?
- How do you want your family to use and not use its wealth?
- What personal values do you want to pass on to your children and grandchildren?

Communicating answers to these questions sooner rather than later helps beneficiaries understand on a high level what goals and aspirations the family will and won't underwrite.

To assuage one client's anxiety over trust disclosure, we asked him to answer the following questions:

- What behaviors, attributes and skill sets do I want my children to exhibit, now and in the future?
- What concerns, if any, do I have about each child's ability to manage resources independently?
- What financial, investment and philanthropic topics do I want each child to understand and learn more about?

The answers to these questions help set an education roadmap to prepare beneficiaries for greater participation in the monitoring and productive use of trust assets. Once they understand the grantor's intent, beneficiaries may become better positioned to join the family's council in the stewardship of the family's overall balance sheet.

Charting a Path Forward

Trusts and trustees are usually charged with a gatekeeping role, to protect beneficiaries from their own unfettered access to trust assets for practical, tax and legal reasons. However, families whose wealth and values endure succeed in optimizing the family's collective resources by supplementing trusts with the creation and inculcation of core principles informed by the grantor and maintained through an active communication and education loop that encourages wealth stewardship. In this way, family descendants, in partnership with a proactive trustee, can manage family assets for the entire family's long-term benefit, even if they had no hand in establishing these vehicles.

Endnotes

1. Hartley Goldstone, James E. Hughes and Keith Whitaker, *Family Trusts: A Guide for Beneficiaries, Trustees, Trust Protectors, and Trust Creators* (2015).
2. Jim Weller, "Key Questions to Ask Before Forming a Private Trust Company," *Estate Planning Newsletter #2844* (Dec. 10, 2020), *www.leimbergservices.com*.
3. Jim Weller, "Examining the Governance Structure of a Private Trust Company," *Estate Planning Newsletter #2834* (Nov. 3, 2020), *www.leimbergservices.com*.

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