Generational resilience through the integration of governance into structure

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Architects of large family enterprises may be tempted by the simplicity and clarity of focusing exclusively on tax efficiency, but at what cost?

Recognised areas of global uncertainty, such as political and social unrest, stock market volatility, global pandemics, and an ageing population erode stability and create challenging environments for the general public, but large enterprises may be particularly susceptible. It is frequently suggested that a family's resilience in the face of adversity is one of the key predictors for their long-term enterprise success.[1] Large global family enterprises and the professionals who oversee them are well-advised to employ creative planning and management tools to create and maximise the characteristics of nimble decision-making and flexibility – and ultimately resilience – which provide the best chance of success during tumultuous times.

In this article, we advocate for the incorporation of resiliency planning into family systems, concurring with other recent scholarship on resiliency as a goal of family governance work. We will expand this further, by mapping family resiliency to a technical application, including components of a legal advisory framework and against recent cases where this has proved relevant.

Today's challenges and the importance of proper structuring

One of the central roles of family planning is risk management. At no time has this been more apparent, and more critical, than in 2020, given the litany of global challenges which have arisen during a short period. A steady hand in the face of such challenges is one of the hallmarks of effective risk management. Ultimately, resilience is the way that families will be best equipped to weather the current storm.

Scholars have long observed that many wealthy families establish and then lose their wealth within three generations, absent well thought-out planning. While typically losses of wealth are thought of as negative, if wealth decline is planned then it doesn't have to be. For some families of significant wealth, the ultimate legacy is a large charitable endeavour, not wealthy generations of heirs. Such a view has, in recent years, been made more public via Bill Gates and Warren Buffet's "The Giving Pledge".[2] Still, the classic example of a family losing wealth remains – a family growing in members but stagnant or depleting in its resources, combined with a prevailing sense of entitlement among the future generations.3 As subsequent generations continue to hold onto the lavish lifestyle of their ancestors, the pot must get further divided, until it dwindles. The problem is compounded when future generations do not have the same enthusiasm or interest in taking an active role in the family wealth, through participation in operating businesses, board membership or roles within the family structure. In the classic example, by the end of the third generation, the wealth is gone.

Among scholars and advisers who focus on this dynamic, the agreed-upon 'insurance' for high-net-worth families seeking to preserve their wealth and achieve their goals across generations is by demonstrating urgency to address this paradigm, and a commitment to developing a well thought-out family governance structure and system.[4] Just as important as the structures themselves are the actors and family members who play a critical role in preserving wealth and managing risk. They steer the ship and are integral in perpetuating the values and vision of the family and making sure that the stated objectives are maintained (or adjusted as needed). And at the heart of the capability of these actors is resilience. Resilience trumps the fear of uncertainty and can lead to protection from an unstable framework and economic loss in turbulent times.[5]

However, the broad ideas of resilience and family governance are not in themselves enough for families to protect their wealth and achieve their goals. Families need to actively cultivate resilience by folding it into the fabric of the family system, including their legal structures. Within these structures, tax efficiency and investment returns are very important, but the success of a family will depend on its ability to cohesively govern itself within the structure. Below are our suggestions for integration of family governance into legal structures.

Recognising the triggers: instability and unpredictability

Although it is impossible to predict what challenges a family may face over time, certain events test a family's bonds. These triggers are moments that shock the system, are often emotional, and take family members' focus away from the continuity of the system and their individual, day-to-day roles. It is crucial to identify these potential inflection points, and build in mechanisms to help deal with them when or if they arise.

Some triggers may be easily identifiable by technical family advisers, as a result of their training in tax planning or investment management. However, many triggers involve interpersonal relationships and family dynamics and require an understanding of the various actors and larger social landscape in which they operate. Triggers may be internal to the family members or might be external, coming from the surrounding environment. Internal triggers include births, deaths, illness, incapacity, divorce and retirement. These triggers impact the family system itself – the size and members of participants and/or their ability to fulfil a given role. Whether through the addition of new family members (marriage, births) or subtraction of others (death, divorce), the definition of 'family' itself is changed in some way. External triggers include geopolitical events, market volatility resulting in dramatic declines in capital, political or social unrest, and natural disasters. Both types of triggers put strains on the structure and are key drivers in why families need a solid governance with resilient people at the helm. Leaders of family enterprises are wise to be aware of triggers and to have a risk management plan for addressing them in advance.

Changes in global tax compliance and reporting obligations for families is another potential trigger. For example, in June 2020, the US Internal Revenue Service (the IRS) announced the re-formation of the Global High-Net-Worth squad, formed to take a holistic approach in addressing high-net-worth taxpayers and to look at the complete financial picture of high-net-worth individuals and the enterprises they control.6 IRS Commissioner Chuck Rettig once referred to audits by the Global High-Net- Worth squad as being "audits from hell", and the reviews will include interests in US and foreign partnerships, trusts, subchapter S corporations, C corporations, private foundations, and gifts between family members.[7] Increased regulatory scrutiny demands cohesive and well-functioning governance, where the participants are adhering strictly to the purposes, structure and formalities of the system. As any practitioner who has navigated an IRS audit can attest, the process can be trying for even the most organised of taxpayers. A solid and organised governance structure with intelligent and capable people can help mitigate this risk.

When dealing with triggers, it is often the perception of a risk that increases the stress response.[8] Humans, whether individually or as groups, are not typically at our best when faced with a decision to fight or flight.[9] Without proper training and structure, family members may push for quick and simple solutions, or may act reflexively and impulsively. Decisions made in a moment of stress frequently fail to account for the long-term problems or risks that erode economic fortunes.

A better plan is to prepare when times are not urgent, and equip family members and other relevant actors with the tools and skills to handle triggers effectively. Under calm circumstances and with level heads, a family is best-positioned to build a system for decision making which can be practised over time, and then utilised when triggers appear.

The solution: family governance integration

Family advisers have a variety of tools at their disposal to maximise wealth and provide for efficient transfer across generations. But while traditional advice may prevent some triggering events from taking root or delay the impact of others, it may not adequately prepare a family and its members for dealing with unexpected or inevitable triggers. This is when resilience is required.

Fortunately, the process for developing effective governance can be easily mapped against resilience by applying the three component parts of resilience: shared beliefs, organisation and communication. Professionals can assist in this by counselling families through these decisions based on professional experience, and drawing on known family fortunes that have been squandered. In quick summary:

Beliefs

The first step to forming an effective governance structure is for a family to turn inward and consider its mostly closely held beliefs and values. Helping family members to articulate family values is critical, as it binds individuals together and is the test against which future actions are considered. It is also the bedrock upon which a family will rely when a crisis hits, giving it the resilience it needs.

Organisation

While unpredictable triggers lead to uncertainty, proactive organisation enables efficient and effective decision making. For family enterprises, this involves developing systems for clear management. Which individuals should be involved in key decisions? Do the relevant persons include those with both formal and informal roles within an operating business? How does a group convene, vote and effectuate its decisions? Who receives material benefits, and what benefits should they reasonably expect? A tax-efficient structure that does not contemplate these issues will inevitably lead to problems, and a family mired in bureaucracy will succumb to inaction during a crisis.

Communication

Finally, family resilience demands clear communication with a spirit of collaboration. Family member roles may differ, and indeed in a complex enterprise the level of participation is likely to be varied.[10] But the importance of feeling included and informed cannot be overstated. Failing to communicate with key parties – even those who lack current authority, but whose future interests are nonetheless at stake – is the surest path to family discord, and ultimately to potential litigation.Communication should not wait until a structure is in crisis mode. If possible, it should occur all throughout the planning and operation phases of the structure.

Importantly, the goals, process and organisation are the prelude to the structure. These three elements, and their codification through a family governance deliverable such as a family constitution, may be viewed as sitting 'above' trust structures in the organisational chart of a family system. Taken together, they transcend all individuals, operating businesses or other holdings, even tax and legal planning, and provide both stability as well as flexibility.

Design and implementation

Once the family have established their goals, and have a clear articulation of their desired organisation and communication channels, they can then move on to designing and developing the structure. During this phase the estate plan is formulated, including more precise details of the overall structure, its benefits and implications, and the documents to memorialise it.While legal and tax advisers are frequently in the driver's seat, this should remain a collaborative process between counsel and the family.

Before drafting, advisers charged with setting up or managing a system should:

- take the time to understand the symmetry between the family's personal goals and business goals;
- explain various governance structure options to the family (family entities, trust companies, family offices, etc);
- consider the family's own closely held beliefs and long-term goals;
- include various roles in the structure, in keeping with the family's own identified way of organising themselves;
- build in opportunities and channels for family communication; and
- help the family identify any service providers that will be needed to implement and maintain the structure.

Finally, jurisdiction can be a very important question at this stage with wide-ranging considerations and implications for resiliency. At the highest level, determining foreign or domestic status is critical, but from there the options quickly multiply. Both US states and many countries globally offer compelling and persuasive tax regimes, governance flexibility, privacy and protection of property rights. But others, particularly the older, larger and more structured jurisdictions, are more restrictive. While considering the most important factors to a particular family, convenience should also not be overlooked.Many a family office has struggled to recruit top talent due to their physical location; virtual offices in major hubs may be a sufficient work-around, but add additional complexity and overheads.

Once these considerations have been navigated with care, and appropriate jurisdictions identified, only then does one turn to the legal documents. The legal implementation should be reserved to the end of the process. In other words – measure twice, cut once.

Looking closely at the legal documents

For a resilient system able to withstand a crisis, legal documents are as important as the codification of the family governance plan. Extending the family governance work into the legal documents takes some effort and creativity, but the resulting system is most likely to address a family's own values, organisation and communication – and therefore provide the greatest chance of resilience.

While a traditional estate planner may focus primarily on a client's last will and testament, there are other crucial documents that should and often do form part of the plan.

Trusts

In many US family governance structures rooted in estate planning, trust agreements are often the central documents. This is true for many other common law jurisdictions across the globe. A trust, in essence, is an agreement whereby a settlor (the person currently holding wealth) makes an arrangement with a trustee (a competent, experienced, party suitable to oversee wealth) to manage wealth (whether assets or property) for a set group of beneficiaries (often, but not always, descendants of the settlor and charities).

Trusts are ideal documents for family governance. At a high level, the trust instrument clearly defines roles and provides clarity around expectations. This includes setting forth the fiduciaries and beneficiaries. Trusts also clearly define the terms by which future power holders or beneficiaries step into their roles – potentially mentioning specifically the triggering events about which a family is likely to be concerned, such as the death or incapacity of an older generation. While the trust does not prevent the trigger from happening, it does provide clarity and structure so that the individual actors can proceed in an orderly and organised way.

Other estate planning documents

For individuals, basic estate plans include financial powers of attorney and healthcare directives setting forth wishes in the event of incapacity. Both documents have significant implications for family dynamics, and care should be taken when counselling a client about who to name in such roles. This is particularly the case for a financial power of attorney – unless restrained by the power of attorney instrument, the attorney-in-fact can typically freely make decisions that the individual himself can make, including wiring money into or out of bank accounts, and selling or acquiring property. While tradition might prescribe that an oldest child or male heir be given authority, this may not always be the best choice for a family with multiple children, particularly where distrust is an issue. Even worse is when the person to be named suffers from addiction or other issues. Therefore, there is value in considering these decisions carefully, appointing individuals who are well-equipped to be good stewards, and ideally build flexibility to make adjustments as needed.

Partnerships

Many families consolidate wealth in a family holding vehicle; in many cases, this is in the form of a limited partnership. The governing document of a partnership agreement establishes general partner and limited partner roles; each of these roles include specific responsibilities and benefits which should be considered (in addition to the traditional tax reasons for doing so). For example, in the case of a cohort of siblings, are each equally well-suited to participate in such an arrangement? Will one or more not honour the formalities? This can lead to undesirable results in the future. The partnership agreement may also contain various withdrawal and transferability restrictions, as well as guidelines and procedures for managing the partnership, which can be helpful in providing flexibility in the future as circumstances surrounding the assets held in the partnership or the participants change. But careful attention should be paid to who holds a particular power, and how the legal drafting may actually create unintended imbalances of power among related people.

Family limited partnerships offer opportunities for integrating management collaboration and family values. Determining who will participate in a partnership should not be a foregone conclusion.It is an opportunity to make important decisions fostering family involvement. While some families do not require structured engagement, such as when a family is merely pooling portfolio investments managed by an external adviser, this is not the case when a family limited partnership is concerned; engagement here is highly valuable.

For example, consider a hypothetical family limited partnership which has six limited partners and one general partner who has sufficient income generated from outside the family. The general partner may not be focused on managing the assets within the partnership, and instead may retain an investment adviser with limited vetting, and may charge that adviser with managing the assets with limited oversight. These situations occur, and the results can be significant, particularly where the chosen delegate lacks appropriate experience and skill.

Alternatively, if this same family established a family office, and undertake to hire employees, vetting of skills and experience become folded into the process. A chief executive officer can be hired and compensated accordingly, and such families are often able to retain top talent from hedge funds and investment banking. This formality and infrastructure can be helpful to a family to maintain its wealth.

Holding companies and limited liability companies (LLCs)

In the United States, the LLC is used almost interchangeably with the limited partnership. But they are not identical. An LLC operating agreement functions similarly to a partnership agreement, establishing whether the entity is managed by managers or members, and it will dictate roles and responsibilities. In the United States, a default classification LLC will be taxed identically to a partnership, unless it has only a single member. The LLC operating agreement can be drafted to graft in the committees and positions that mirror either a partnership or a corporation. Again, as above, consideration should be paid to who is appointed to these roles and the family dynamics which exist today and are anticipated in the future.

Especially outside of the United States, families often find value in using holding companies, however, there are compelling reasons to incorporate a family holding company (of sorts) in certain US situations as well. A holding company is typically established as a corporation (or an LLC that elects to be characterised as a corporation), or in the European tradition, a société anonyme, but could be a private limited company as well. Shareholders of these types of holding companies will memorialise their governance with a corporation's bylaws, which function similar to the LLC agreement but may include additional roles such as boards and officers, and may include various restrictions on transferability of shares, among other parameters of operations not otherwise dictated by state statute. While some families may benefit from these additional roles, which can bolster organisation, facilitate communication and enhance feelings of fairness, not every family needs this level of detail, and for some the additional complexity may be undesirable.

Other operating business documents

While traditionally families make decisions around the dining room table (or a family meeting that occurs over a holiday), roles, responsibilities and decision- making authority in those situations are subjected to the natural governance of the loudest family members. For entities with employees, such as private trust companies and family offices, the ongoing demands of running a complex network requires clarity of organisation and communication. For these entities, the list of important and relevant legal documents can be quite long: employment agreements, training manuals, employment road maps, internship programmes, independent contractor agreements, commercial lease agreements, and contracts for dealing with third-party vendors.[11] The nature and character of these documents evolves as the structure continues, and often the library grows over time. Resiliency here may hinge more on organisation than the other two factors, due to the sheer volume of the information and documents involved, but these documents can also be tools for communication and articulation of values.

Legal documents related to the structure of such entities are ideal for incorporation of family governance. In the corporate and business context, these documents offer an opportunity to define various positions and explain the entity's approach to these positions. For example, the purpose clause of key documents can be a cornerstone provision. In developing a purpose clause, a family essentially reiterates the products of their family governance work: the goals and objectives, values, desire for communication, and family organisation. Functionally, the question may be, "why is a legal entity being established, and what objectives should future decision makers keep in mind?" but underscoring the response is the work done by a family to articulate its own purpose. Ideally a purpose clause strikes a balance between allowing for flexibility, while also providing meaningful guidance to future participants. Depending on the context, it may make sense to have broader statements in certain documents which govern investments or other holdings which will change over time, with more refined objectives outlined in testamentary letters of wishes, which are nonbinding.

Where employees are concerned, key legal documents often serve to bring employees into the system in a clear and organised fashion, and provide new employees with an understanding of the expectations of their role. A thoughtful employee handbook may include the family's values, so they are known to all who work there. These statements of values are often a point of pride for a family, and employees may also feel an affinity for the mission of the family. The employee handbook can also offer guidance to those active in the operation on how they should act and react in different situations. In particular, the employee handbook should include directions for how to resolve conflicts within the appropriate hierarchy, thereby potentially eliminating threats to the system before they arise.

Training and educational programmes may sound rudimentary, but offer valuable benefits for employees and family members alike, in terms of fostering communication and bolstering the resilience of the system. Family training programmes might incorporate how to be good stewards of the family wealth, communications over succession, management training, and oversight over operating businesses and investments, and the family philanthropy. Who participates in such a meeting, how it is run, and the frequency with which it occurs are all variables to be determined by the family, but including key employees in some sessions is not unusual. Ultimately, active engagement will allow family members and their advisers to anticipate actions, expectations and the realities of operating a family enterprise.[12] Inviting rising generations into the enterprise creates opportunities for them and for the best and brightest within the family to feel they are an integral part of the family ecosystem. This can, in turn, have both educational and practical benefits in terms of building resilience.

The importance of following the formalities

One of the principal tenets of any family governance structure is that the key actors must follow the rules that are established. If a system is to be resilient, risk must be managed, and orderly operation is a must. Not only is this essential for operational reasons, but also for tax reasons, depending on the applicable jurisdiction. Failure to follow the rules as established can lead to disaster.

In *Lender Management, LLC v Commissioner*,[13] a court analysed a family's centralised control and management structure. The question at hand was whether a tax deduction was permissible under the US Internal Revenue Code (the US Code). Under the US Code, a deduction is allowed for all expenses paid or incurred in carrying on a trade or business,[14] but sporadic activities such as a hobby do not qualify.[15] The rule requires that "the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit".

For the Lender family, oversight and management of the family's investment strategy had been executed through Lender Management LLC (Lender Management), an LLC formed under the laws of the state of Connecticut. It operated as a fund manager and had been in continuous operation for 25 years. Lender Management elected to be treated as a partnership for US income tax purposes and it provided direct management services to three LLCs (each family investment consolidation vehicles). The overall structure was created as part of a reorganisation, the goal of which was to accommodate greater diversification of the managed investments and more flexible asset allocation at the individual investor level. Lender Management's managers ran the operation in an extremely professional fashion, and they spent significant time exploring hedge fund and private equity opportunities, closely monitoring the holdings, and meeting with family members to discuss their financial needs and investment risk tolerances.

Lender Management offers a good illustration of the professional attributes reflected in a carefully constructed structure that serves the family's robust investment strategy. In this case, we see that clearly defined roles and responsibilities including meetings, reporting and a formalised professional approach solidifies family member positions on both the management side of a family enterprise as well as those benefiting from being purely passive investors. In Lender Management, the professional arrangement mirrored, to a large degree, that which is used in a private equity or venture capital context, where a general partner promises to manage assets according to a strict investment strategy and attracts limited partners with a similar objective to the investment programme. Investors, including family members who may be passive investors, are attracted to a strategy that is operated consistently and predictably to meet their cash-flow needs. Without clearly identifying the cash-flow needs and memorialising it in a binding legal arrangement, limited partners would not have confidence in such an investment. Such predictability and stability fosters resilience, and these formalities were noted by the tax court's analysis.

Another example of high-quality management and structuring, when presented with a legal challenge, is the case *Estate of Barbara M Purdue v Commissioner*.[16] In *Purdue*, the court held in favour of a viable family partnership, and the corresponding tax planning that had been achieved in its formation, when both family engagement and a significant non-tax purpose were evidenced. As part of an intentional and well-planned consolidation, an older generation member before her death contributed assets including marketable securities and a building within a single-family partnership that was managed by a single adviser. The older generation member received interest in an LLC that was proportional to the property. Additionally, the decedent had retained sufficient assets outside the LLC that could pay for her living expenses, and she did not commingle her funds with the funds of the LLC. While the IRS had argued that the entity was formed and funded primarily for transfer tax savings, the court found that the consolidation of assets for management and control purposes was a significant non-tax reason to form and fund the LLC. This was true even though partnership assets were ultimately needed for estate expenses.

The court opinion in *Purdue* also provides a reference for similarly situated families. The court described at length the professional management of the family partnership including the maintenance of its own accounts in the use of its own funds for partnership business. Meetings were held which had written agendas, minutes and summaries. The family members knew their role and responsibilities and respected them in a professional and diligent manner. All of these facts were important factors in the court's opinion, and adherence to the structure led directly to the taxpayer's success. Additionally, *Purdue* is an important lesson on how honouring the legal structure actually served to provide stability in the face of a legal challenge, and therefore rendered the family structure and its members more resilient.

However, not every example of family entity planning has been positive. In *Estate of Howard V Moore v Commissioner*,[17] a taxpayer transferred his farm shortly before death to a family limited partnership. The stated rationale for forming the entity was that the family could hold and maintain productive use of the actively managed farm and real estate. Five days after the transfer, the family limited partnership sold the farm. Throughout the process, the decedent maintained a high level of control over the entity, and no members of the taxpayer's family expressed interest in managing the taxpayer's assets. Unsurprisingly, the tax court found against the taxpayer. The court noted that the sale of the farm had been contemplated before the family partnership had been formed, and then proceeded immediately after the partnership was in place. While the maintenance of the farm and its operational activities could be a good and supportable reason for a family to consolidate family assets into a family partnership, the subsequent sale and continuing control by the decedent shattered the business purpose to a point it could not be reconstructed. Without any other non- tax reason for the transfer, the transfer was invalidated and the court brought the value of the farm back into the taxpayer's estate for the purpose of taxing it.

Conclusion

While the considerations and factors facing individual families vary widely, long-term resiliency is a goal for most. Crises are unpredictable, but families will be best positioned to weather the storm through proactive thoughtful incorporation of resiliency factors via family governance. A good model for achieving governance is applying the three components of resilience – shared beliefs, organisation and communication – to a given situation and then formalising the system via an appropriate structure. This should, in turn, be incorporated into legal documents and legal frameworks.

By integrating family governance into structures and including resiliency factors into legal documents, the entire system becomes more resilient – able to withstand changes to internal family dynamics, endure external pressures such as pandemics and recessions, and even overcome legal challenges. This work requires time and effort, but the risks involved with not doing so are grave. Particularly in today's environment, family resiliency is needed more than ever.

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Footnotes

[1] See, eg, James Grubman, Strangers in Paradise: How Families Adapt to Wealth Across Generations, Family Wealth Consulting, 2013.
[2] The Giving Pledge, "A commitment to philanthropy", givingpledge.org/.
[3] Roy O Williams, and Vic Preisser, Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values, Robert D Reed Publishers, 2015.
[4] HSBC Private Banking's annual Essence of Enterprise Report, 2017.
[5] For more on the topic of family resilience and its role in a crisis, see "Family resilience: strengths forged through adversity" in F Walsh, Normal Family Processes: Growing Diversity and Complexity, Guilford Press, 2012, pp329–427.
[6] www.irs.gov/businesses/large-business-and-international-lbi- division; https://www.irs.gov/irm/part4/irm_04-052-001.
[7] www.forbes.com/sites/jasonbfreeman/2020/06/21/the-irs-intends- to-audit-more-high-wealth-

taxpayers/#291e010c596e.

[8] See, eg, Tagiuri and Davis, "Three Circle Model", Harvard Business School, 1978.

[9] F Walsh, Normal Family Processes: Growing Diversity and Complexity, Guilford Press, 2012, pp399–412.

[10] Tagiuri and Davis, Harvard Business School, 1978.

[11] See, eg, "Structure and Integration: The Architecture of Succession", by N Todd Angkatavanich and William J Kambas, FFI Practitioner, 27 August 2013, https://ffipractitioner.org/structure- and-integration-the-architecture-of-succession/.

[12] See "Engaged Ownership: A Guide for Owners of Family Businesses" by Amelia Renkert-Thomas, https://www.engagedownership.com/engaged-ownership-book.

[13] Lender Management, LLC, et al v Commissioner, TC Memo 2017- 246.

[14] IRC Section 162(a).

[15] Commissioner v Groetzinger, 480 US 23, 35 (1987).

[16] Estate of Barbara M Purdue v Commissioner, TC Memo 2015-249.

[17] Estate of Howard V Moore v Commissioner, TC Memo 2020-40.