

International family governance: integration with family trusts

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This chapter is an innovative proposal about ways in which family governance could be integrated with family trusts.¹ The author always had a strong trust background² as a private-client lawyer, and later developed a focus on family governance (as the key to building cohesive families and avoiding family fights over wealth transfers).³ This chapter contains ideas about how family governance could now be integrated with family trusts.

1. Importance of family governance

The term ‘family governance’ refers to the way in which a family makes decisions as a family. Key questions range from the initial and often delicate question of “who is in the family” for these purposes, to the question of “how are these decisions enforced?”

I am now a firm believer that good family governance is more valuable than good trust documents. My test criterion for ‘valuable’ is whether something will enable a family to avoid the bitter fights that result in the disintegration of the wealth and of the family itself.

My point of view is a result of a learning process over a 30-year period of working with wealthy families in many countries. It was certainly not my view at the beginning of my career. I began my career as a traditional trusts and estates lawyer for wealthy clients. I would advise the patriarch and then I would draft trust documents to carry out his wishes. Our focus was on writing clear and tightly drafted conditions in the trust agreement.

I eventually realised that bitter family fights can and do take place no matter how carefully the trust document is drafted. I became intrigued by a growing field of family system professionals (largely from a psychology or business background⁴) who were working on ways to keep harmony among family members. As I now say to groups of lawyers: “If the most carefully drafted trust documents can end up in court if the family members want to fight... why don’t we all pay more attention to helping families learn to avoid those fights?”

1 Many of these ideas are likely to appear in forthcoming articles by the author, perhaps even in a book.
2 See, for example, her chapter in this book on trusts in the United States.
3 See her book *International Family Governance: A Guide for Families and their Advisors*, Mesatop Press, October 2009.
4 James E Hughes, Jr is a notable exception, having begun as a partner at the Coudert law firm and then devoting his counselling efforts to the family governance field. His first book, *Family Wealth: Keeping it in the Family*, is often regarded as the seminal book in the field.

Now, I encourage families to begin with family governance. The implementing documents can follow after the family has completed its work on its internal policies and governance. After the family has agreed upon its goals for the future, the choice of associated legal documents becomes much easier. One former banker summarised this approach succinctly: “Process first, then product.”

I asked to have this chapter included in the 2010 edition of *Trusts in Prime Jurisdictions* with the hope that trust advisors around the world will read about family governance, and will think about how those successful concepts could be integrated into trust documents.

This chapter will address four primary topics: family governance, traditional trusts, the gap between them, and a proposed model of integration.

2. Key elements of family governance

We begin with an executive summary of family governance.⁵ Although every family is unique in the development of its own governance system, and families in different cultures will have their own differences, there are several common elements, which include those set out next.

2.1 Family councils

A family council (perhaps with a different name) is the chosen smaller group to act on behalf of the larger family. The family council is given authority to make certain decisions and to communicate them to the larger family. Some major decisions might need ratification by the larger family. Vacancies in the family council may be filled by the remaining members or by the larger family. In many ways they have a role that is similar to boards of companies.

An effective family council will have regular, formal meetings, often on a quarterly basis. There are written agendas and decisions will be recorded in writing after the meeting.

2.2 Purpose

The purpose of family governance is to support the continuing (multi-generational) well-being of the larger family. The family council is created for this purpose and has the responsibility of acting on behalf of the larger group. The larger group participates in the formation of the family governance system, which is required in order for the system to be truly adopted by all of the members of the larger family.

2.3 Written document – the family constitution

Most families around the globe who are engaged in family governance work to create a written document that will contain the key elements of their family governance system.⁶ Often called a ‘family constitution’, it is also sometimes called a ‘protocol’ or a ‘code of conduct’.

5 See generally, Barbara R Hauser, “Family Governance: Who, What and How?” in the *Journal of Wealth Management*, Fall 2002.

6 For a template of a family constitution, see Barbara R Hauser, “International Family Governance: A Proposal for ‘Two-tier’ Family Constitution”, *STEP Journal*, June 2010.

The family constitution might include a summary of the history of the family and the reasons that the family has decided to write a constitution.⁷ It will describe the range of issues that are to be decided by the rules in the constitution, and which issues will remain personal. The constitution is where the family council will be formed. The document will include the method of voting by the family council and by the larger family. The voting procedures will also address the position of spouses, and the voting ages for children. It may also address whether various family branches need proportionate representation.

Family constitutions are extremely flexible documents. Sometimes they are long enough to resemble a rule-book to cover every possible situation. Other times they are very short, and just establish the procedure by which the rules will be made. If they create a family council, for example, they may delegate all decision-making discretion to the council.

It is often said that a family constitution is not a binding document, but that might be changing. I am aware of at least one family that has obtained the equivalent of a private court ruling that their constitution would be enforced. If the family controls a business that generates income, it is also possible for penalty provisions in the constitution to include a reduction in dividend payments.

The final point in putting together a written constitution is addressing the need for future flexibility. I always recommend that some provision be included to allow a procedure for amendments.

2.4 Administration

To carry out its purpose, the family council will often create sub-groups. These can include investment committees, budget projection committees, education committees, and committees to prepare written family histories.

2.5 Distribution of benefits

The family council, acting in its role to benefit the larger family, may be charged with responsibility for the decisions relating to the distribution of dividends from family companies. The council may be entitled to a position on the company boards, to represent the interests of the entire family.

The council may create a family venture fund to support entrepreneurial projects presented by individual family members. This would allow a family member to make a formal funding proposal to the family venture fund. The family committee would have to approve of the business plan and would normally monitor the success or failure of the funded project.

It may create a philanthropic committee to make contributions to various charities selected by the family. Family members could make formal proposals to contribute funds to an existing charity, or to create a new charity. There might be requirements that the charities are consistent with the stated values of the family.

In some cases, the council might provide an emergency fund for special needs by

7 For example, the beginning of the Preamble to the US Constitution could apply to families: "We the people, in order to form a more perfect union, to establish justice, insure domestic tranquility..."

family members. The family member could present a request for special funding (such as for a catastrophic illness) which could be approved by the council.

Realising that the skills and competencies of the younger family members are crucial to the continuing success of the family, the council may create a family educational fund to ensure that every family member receives the highest possible education. In some cases the family will form its additional learning academy, to be sure that the subjects that are important to the family will be included, and will be taught in a consistent manner to the entire family.

If these core functions sound familiar, that was deliberate – they have been written to mirror the core elements of a family trust.

3. Elements of family trusts

The core elements of family trusts can be broken into very similar categories, as set out next.

3.1 The trustees

The trustees are those persons chosen by the settlor to act for the benefit of the larger family (the beneficiaries). The settlor may direct the manner in which vacancies are filled, or may give that function to the current trustees. Their legal responsibility is to be fiduciaries for present and future beneficiaries. Although the trustees have the legal control over the trust assets, they are under strict fiduciary rules to manage those assets for the larger family, and not for their personal benefit.

3.2 Purpose

The purpose of a family trust is for the trustees to manage (and distribute) the trust assets for the continuing (multi-generational) well-being of the larger family (of beneficiaries). The entire trust fund is dedicated to this purpose. Courts will enforce compliance with the purpose of the trust.

3.3 Written document – the family trust

In the trust field, there is a nearly universal requirement that there be a written document. The settlor will create the document, which is referred to as a trust agreement (United States practice) or a trust deed or settlement (English practice). The written document can be very long (US practice could include as many as 150 pages) or very short (some offshore jurisdictions have standard trust deeds that are only two pages long). In the longer documents, the settlor has tried to address every possible situation. In the shorter documents, the trustees are given complete discretion (including the discretion to add or remove beneficiaries).

Whether or not the trust document can be amended is a serious issue. Generally speaking the trust document, which is written at the direction of the settlor, cannot be changed. The settlor generally requires that their wishes will be carried out. In some jurisdictions a practice has developed of using a 'letter of wishes' by the settlor, who then retains some ongoing sense of having an ability to change the terms of the document if he has changed his mind since the document was originally written, even though as a matter of law the letter of wishes is not a legally binding document.

In the United States there is also a heavy use of trusts that can be amended directly by the settlor at any time and for any reason. These trusts are primarily written in order to avoid a probate proceeding. Even these trusts provide that upon the death of the settlor the terms of the document cannot be changed.

Recently (as referred to in many of the chapters of this publication) there are procedures that will allow someone besides the settlor to make changes in the terms of the trust document. One example is the position of a protector, who is often given the right to make changes in a variety of areas.

The above comments relate to the trust practices in England and the United States, where the lawyer or solicitor is actively involved in tailored drafting to suit the wishes of the client. In parts of Asia and some offshore jurisdictions, the use of trusts is more confined to a bank-generated form document.⁸

3.4 Administration

To carry out its purpose, the trust may include sub-groups. These can include investment committees, budget projection committees, charitable committees and so on. Modern trust law is permitting an increasing amount of delegation of the administrative functions.

3.5 Distribution of benefits

Traditionally the trustees are directed to distribute assets of the trust to the beneficiaries at the times and for the reasons that are stated in the trust document. In the longer trust documents the reasons for distributions could be listed in some detail. Examples would be allowing (or directing) distributions for “health, education, support and maintenance” (a standard taken from the tax provisions in the Internal Revenue Code of the United States) or to purchase a home, or to start a business. They are also often authorised to make loans to beneficiaries.

The trustees, acting in their role to benefit the larger family (in accordance with the terms of the trust agreement), may (although these are admittedly not very common provisions, at least yet) create a family venture fund to support entrepreneurial projects presented by individual family members. They may create a philanthropic committee to make contributions to various charities selected by the family. They may create a family educational fund to ensure that every family member receives the highest possible education. Some trusts contain funds to pay for family reunions.

Most likely, though, the trustees will simply make outright distributions of trust funds as directed by the written directions in the trust document.

4. The key differences between family governance systems and family trusts

Before moving on to the positive proposals for the integration of family governance with family trusts, it is helpful to point out some of the key differences between family governance (as described in section 2 above) and family trusts (as described in

8 This caution was added by Christian Stewart, based in Hong Kong, a former banker who founded Family Legacy Asia (HK) Ltd to focus on family governance approaches.

section 3 above). *In the author's opinion, these differences are the root causes of litigation by beneficiaries against their trustees.*

Some of the key differences between family governance systems and family trusts are as follows:

- The single biggest difference between family governance systems and family trusts is the matter of who creates them. The successful family governance system is one that is created by the larger family, including all of those who will be affected by it. The family trust is created by one individual senior (and wealthier) family member, usually with no input from any other family member (including any of the beneficiaries).⁹
- There is little (or no) input from the family members (beneficiaries) on the ongoing operation of the trust administration and investment decisions.
- There is little (or no) input from the family members (beneficiaries) on the distributions of the trust assets. When, why and to whom distributions are made are terms that the settlor would have included in the trust document. The terms might be very specific (as in the longer documents) or might be given to the trustees in their broad discretion. The beneficiaries would rarely have been given any control over the distribution decisions.
- No changes are allowed by the family members (beneficiaries) in the terms of the trust document, which must be followed as it was written and in accordance with the original intent of the settlor (disregarding the English use of letters of wishes, which are intended only for the use of the settlor anyway).
- The family members (beneficiaries) usually do not have any right to determine who will act as successor trustees.

5. Proposed integration of family governance with family trusts

The field of family governance is increasingly being recognised as the critical success factor in maintaining family harmony and wealth from one generation to another. The use of trust documents to control the passage of wealth from one generation to another continues to increase globally (even in countries that have not had the concept of a trust in their domestic law). Yet there is a serious gap between these two very different tools.

I am convinced that finding ways to integrate family governance concepts into family trusts would create better trusts as well as more competent and fulfilled family members (beneficiaries), and would help families to avoid much harmful trust litigation. The question of how these can be integrated has been on my mind for several years. My initial thought was that a copy of the family constitution could be attached as an exhibit to a trust agreement. This would allow the trustees to have a sense of the family. But there would not be any real impact on the administration of the trust, and the exhibit would not be a legally binding document.

Recently I have been thinking of ways in which the important and effective

9 See Barbara R Hauser, "Appreciating Beneficiaries" in *Trusts & Estates*, June 2007, for an argument to include the beneficiary in the planning process.

family governance concepts can be integrated into the actual trust document. This chapter is the initial attempt to persuade trust advisors and drafters (and settlors also) to consider including some innovative provisions in trust documents. Some examples follow.

If we consider the list of differences between family governance concepts and traditional trust concepts, I would argue that the common element of the differences between family trusts and family governance systems is the element of control.

In country governance terms, the typical family trust is a governance system of a dictator (albeit usually of the benevolent type) with no participation allowed ('taxation without representation?'). Successful family governance systems, on the other hand, succeed because they are based on the initial and ongoing participation by all of the affected members of the family ('taxation with representation'). Without a means of active participation in the governing system (or trust agreement) that impacts their individual lives, family members (beneficiaries) either develop a passive, dependent role – or there is rebellion (and litigation).

Here then are some proposals as to how successful family governance concepts can be integrated into family trusts.

5.1 **The trustees**

The trustees could be chosen by a representative committee of the entire group of beneficiaries (such as a family council, if they have one). That same group could remove and replace the trustees. They could also name one (or more) of themselves to serve as a co-trustee or as a liaison between the trustees and the larger family group. The family could form its own trustee advisory committee, to hold regular meetings with the trustees.

5.2 **Purpose**

The purpose of a family trust could still be to manage (and distribute) the trust assets for the continuing (multi-generational) well-being of the larger family (of beneficiaries). But the control over the management and distribution would be shared with the larger family (of beneficiaries), all of whom would be expected to exercise a fiduciary type of responsibility on behalf of the larger family (including future generations).

In other words, instead of saying that the purpose is to carry out the wishes of the settlor, the written purpose could be to provide for the general well-being of the multigenerational family based on their input from time to time. As in the Preamble to the US Constitution, this purpose would be "to promote the general welfare" of the family.

5.3 **Written document – the family trust**

Instead of leaving the selection of the terms of the trust to the settlor and his lawyer, the beneficiaries could be included in the planning. The process, for example, could include the participation of representatives of all of the intended beneficiaries in the formation of the trust document.

There could be formal family meetings to discuss the selection of suitable trust

provisions. There could be a requirement that there would be official family approval of any final trust document.

5.4 Administration

To carry out its purpose, the trust (written with the input of the beneficiaries) may include sub-groups. These can include investment committees, budget projection committees and so on. Those groups could be constituted by the family council or by other members of the family. The more groups, the more opportunity there is for the family to feel involved in the trust administration. This would alleviate the common complaint of beneficiaries that they lack information about the trust administration.

5.5 Distribution of benefits

In addition to the traditional distribution of income and principal, the trust agreement could authorise a number of creative family-based uses of the trust funds.

For example, the trust agreement could provide that the family council, acting in its role to benefit the larger family, would have the power to create a family venture fund to support entrepreneurial projects presented by individual family members.

The family council could also create a philanthropic committee to make contributions to various charities selected by the family.

The family council could create a family educational fund to ensure that every family member receives the highest possible education. The funding for these ongoing funds would be provided by the trust assets, upon approval of the trustees. The trust agreement would authorise the trustees to make such decisions, for the ongoing multi-generational benefit of the larger family.

5.6 Dispute resolution

If a beneficiary is dissatisfied, for example with the amount of a distribution or with the investment policy of the trustees, the traditional process that is followed is for the beneficiary to make claims in court. In this new integrated model, though, dispute-resolution provisions could be included in the document. For example, the trustees could meet with the family council to determine the reasons for the dissatisfaction. The trust document could provide that a determination by the family council would be final.¹⁰

6. Conclusion

This proposed integration would be a radical change, but it can be done. I will close with a poignant example of how that change can occur.

I met with a patriarch who had included some particular provisions in his trust documents that would impose his views on his children's access to funds for a significant period of time. I suggested that he review those terms with his children

¹⁰ This section was added at the urging of Alon Kaplan and raises intriguing questions about whether the beneficiary could be denied redress to the court system. It is different from an *ad terrorem* or 'no contest' clause because the contest would be considered just by an internal family council instead of the public judiciary system. Indeed, it could be seen as a form of binding arbitration.

(all of whom are adults). At first he was adamantly against the idea. He said that how his wealth would be administered was his personal decision to make, and it was a private matter.

Later I was invited to his home to meet with the whole family. To my amazement, after social talk the patriarch said "So, Barbara, go ahead and tell them about the plan." I did so, with a careful eye on the patriarch. His own contribution, from time to time, was to explain his caring motives to them. They in turn expressed their appreciation. At the end of the discussion he said to his children, "You know, I feel happy that we can talk about this."

This illustrates how a process of family governance might begin. It is likely now that the trust plan for the future will be redesigned with the input and cooperation of the adult children. This will be an integrated trust, and as such is likely to benefit the family for many generations and without disruptive conflict.¹¹

In sum, my argument is that the integration of successful family governance principles into family trusts would remove the root causes of conflict (and ensuing trust litigation) within families and would instead strengthen the intended positive benefits of family trusts. Family trusts that integrate family governance principles should provide positive support for the family for many generations of beneficiaries.

11 While thinking about integrating family governance into trust agreements, I ended up writing another article suggesting that all of the succession planning be handled in a family governance model.

