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Preventing and avoiding costly conflicts

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FAMILIES AND FAMILY OFFICES

This paper, as originally published in the August 2018 issue of Trust & Estates, focuses on successful families that should plan for the future for their business, which helps to maximize the family's wealth and objectives and also provides helpful tips for successful family offices to avoid costly conflicts.

Preparing for changes helps to maximize the family's wealth and objectives

Family office (FO) goals, structures, leadership and challenges are as complex and distinct as the families themselves. Although each FO approach and structure is unique, all FOs must address the challenges presented by potentially divergent goals, incentives, constituencies and duties. These types of forces—some obvious, others more subtle—result in potential or actual conflicts of interest that FO leadership must identify and address, regardless of the specific structure. And not surprisingly, the more complex your client's FO structure becomes or the more that it attempts to accomplish, the more challenges that can arise relating to addressing competing duties or concerns and potential or actual conflicts of interest.

Successful families have been using FOs for generations to manage everything from family wealth, to philanthropy, to cybersecurity. FOs act as a central hub for the management of the family's wealth and related affairs, such as accounting and legal work. Although the practical or legal structure of a given FO often varies, high-net-worth families are attracted to the office structure because FOs provide much needed sophisticated financial and organizational services through a dedicated vehicle, giving some level of personalized attention, mentoring and leadership tailored to each family's unique needs and objectives. But, regardless of the structure, objectives or governance of a given FO, there will be potential conflicts around every turn that must be identified, resolved or avoided to maximize the success of the FO. The first generation's goals and objectives may not suit future generations, leading to conflicts or potential conflicts that can directly affect everyone connected to the FO. Adequately preparing for and handling that evolution will allow the family to maximize its wealth and objectives for as long as possible. But, if the FO is unprepared for those changes, it could result in a loss of value, family discord or even the dissolution of the FO.

Key sources of conflict

There are a number of ways that a newly forming or established FO may encounter thorny situations that necessitate addressing conflicting goals, duties or interests. Some common areas of potential conflicts that FOs may face include:

Divergent views within the family. These include conflicts: (1) arising between those advocating for wealth creation versus use of wealth or balancing private use versus philanthropic use; (2) on types of asset management, including industry focus, importance of family legacy, appetite for risk and extent of asset manager independence; and (3) on leadership succession and role of the family matriarch and/or patriarch.

Issues that arise from providing financial services . These include: (1) difference in rates for financial services depending on family status (for example, owners charged less), which may result in disparate treatment by the professionals and family discord; (2) multi-family offices (MFOs) that sell affiliated financial products, which may result in a conflict between the professional's duty to the family and his self-interest; and (3) compensation or evaluation structure for financial services professionals incentivizing the selling of affiliated products, which may result in pitting the professional's monetary self-interest against his duty to make the most prudent investment decisions.

Employment issues. These include: (1) a biased compensation and evaluation system (for example, nepotism, preferred salary for family members, advancement for sons over daughters and hiring family members as independent contractors), which may result in putting family goals in conflict with state and federal employment laws; and (2) an informal management structure with ambiguous roles and responsibilities, which could lead to inefficiencies, conflicts and negative impacts on performance.

Regulatory concerns. These include conflicts arising among jurisdictional requirements on issues such as privacy, disclosure, employment laws, taxes and immigration, which may impact the family's management structure, expansion goals and risk profile.

Hiring of counsel. These include (1) counsel asked to represent both FO business entities and individuals in personal estate planning or other matters, leading to duty of loyalty conflicts, confidentiality and other ethical issues and, in adverse matters, to joint defense and privilege issues; (2) conflicts arising from multi-client scenarios, particularly when the FO is structured through numerous related entities; and (3) family members acting as trustees of family trusts or serving on boards of directors or trustees related to the FO, which may lead to conflicts between the fiduciary's personal interest and the interest of the beneficiaries he serves.

Each item on this issue-spotting list, which is by no means exhaustive, could be the subject of a separate article. The FO may require your advice, as legal counsel, to ensure that the conflicts are minimized and resolved in a compliant manner. But, it's often up to the FO leadership or the family itself to recognize when an issue may require your advice. To assist in that goal, share the following tips with your FO clients to aid them in self-evaluation and conflict avoidance.

Ten tips

Discuss these 10 tips with your FO clients.

1. Identify the FO goals and objectives. Just like any company, those providing services to an FO—whether in-house or as an outside advisor—should always keep in mind the specific goals and objectives of the FO in question. Unlike the typical corporate entity, the goal of which is almost always to maximize profit, an FO may have multiple objectives, including philanthropy, legacy or commitment to a certain business or market segment. Many potential internal philosophical and leadership conflicts may be avoided by having the FO objectives identified in writing and adhered to by its professionals.

2. Choose a structure and governance aimed at avoiding ambiguity. An FO's governance and structure is imperative to the success and longevity of the family's wealth. Whether there's a single decision maker who speaks to advisors and then makes decisions on his own or a robust board of directors with power to make FO decisions, a clear structure that identifies how decisions will be made is vital. In addition, the FO structure should be set up to anticipate: (1) family succession issues to avoid power struggles in future generations, and (2) the role of independent non-family members in leadership to address the potential that future generations lack the interest or ability to run FO affairs. Ambiguity in the FO decision-making process or in the mechanism to choose future leadership is a frequent source of internal conflict. The structure should also be robust enough to address what must be done for the FO to evolve should future generations decide to alter the objectives.

3. Commit to the structure and avoid informality. Often, the difficulty with appropriately structuring the FO is adding formality to the informal world of family relations. Formalizing the structure, however, is an important safeguard against conflict stemming from ambiguity or lack of clarity in decision making. A professionally prepared operating agreement or other document governing how decisions are made and the flow of communication can create structures and systems to maximize communication and identify and address conflicts. Although this point may be obvious for larger sophisticated FOs, it's important that all FOs consider whether they've adequately documented their management structure and thought about that structure. This will ensure that anyone in a decision-making role—whether part of the family or not—adheres to the family's stated goals and objectives. The operating agreement should outline the mechanism by which the decision maker can consider differing opinions and make an informed decision in a manner that limits infighting as much as possible. In addition, committing to a formal structure and adhering to its form will permit professionals retained by the FO to understand and address their ethical obligations and avoid potential conflicts of interest.

4. Ensure the proper dissemination of information. Many conflicts arise due to a lack of proper information dissemination. Professionals and family members need adequate access to information to assess objectives, performance and conflicts of interest. Regular family meetings are an important way to review past performance and assess or create future objectives. Family meetings often serve as meaningful platforms to make significant decisions, with participants receiving and discussing the same information to make an informed recommendation or decision. In addition to meetings, it's important the FO professionals regularly receive information on what's happening throughout the enterprise to avoid the possibility of one professional of the FO conducting business in a manner that may present a conflict situation with other family business. The meetings should also allow advisors to share information on applicable laws or market forces relevant to FO business and reduce the risk that some family members receive incomplete information.

5. Scrutinize all aspects of MFOs. Due to increasing FO costs, many wealthy families join MFOs so that the costs are shared among multiple families invested in a given office. MFOs are often directed by a lead family with assets managed under one system. While cost savings often drive the success of MFOs, the number of families pooling their money together, with varying circumstances and objectives, increases the risk that potential conflicts become actual conflicts. This is especially true when one family has an ownership interest in the MFO, while other families are simply passive investors. Families considering or already engaged with an MFO should understand every existing aspect of office structure to make sure that their interests are sufficiently protected. Specifically address the tips above regarding goals, structure, decision making and communication. And, to the extent a family may be forced to compromise a goal or objective to participate in the MFO, make this clear to the entire family.

6. Coordinate satellite offices. MFOs are sometimes used when a family wants a satellite office in another jurisdiction for foreign investments. Having such a satellite or outpost office can provide support to family members living in or frequently traveling to another country. In some instances in which only discrete services are needed, an FO can create a joint venture with an existing MFO established in the other region. The primary FO can then rely on the local knowledge and capabilities of the satellite office, without having to investigate the rules and regulations of the foreign country. To avoid conflicts or managerial inefficiency, FO professionals should conduct due diligence with respect to all of the potential satellite offices. The diligence should include scrutinizing the investment approach and compensation structure, as well as handling the engagement of professionals. Specifically address the tips above regarding goals, structure, decision making and communication when coordinating a satellite office.

7. Pay special attention to how individuals are getting paid and for systemic incentives. Families must always perform their due diligence when hiring any advisor. Although qualifications and performance are important, the FO professional and client should always understand how the financial advisor or planner is being compensated to ensure that there are no adverse incentives in play. For example, a larger financial institution may incentivize advisors to push one of its affiliated products by making such metrics a factor in compensation or advancement. If the advisor is servicing more than one family, you should help families consider how the advisors address the differing needs of different families and should have systems in place to protect family confidentiality. The FO must always scrutinize its advisors to ensure that it's receiving the most practical, cost-efficient and beneficial advice.

8. Identify the client early and often. You, as the lawyer representing the FO or its affiliates, whether in-house or external, should take special care to consider the ethical and conflict issues triggered by representing the business manifestation of what's really a myriad of individual interests. You must carefully craft an engagement agreement to identify the specific entity or parties covered by the engagement and obtain the appropriate conflict waivers when required. Once the representation is set, you must take special care to avoid mission creep, with non-client affiliated parties seeking legal advice and assistance. And, you should clearly and repeatedly state attorney limitations. For example, you must make it clear when communicating with family members that you only represent the FO. Indeed, ignoring conflicts of interest can lead to your being disqualified from representing the FO.

9. Avoid becoming a personal advisor. If you're a tax advisor, you're an important member of the FO legal team. While under certain circumstances, estate planning within a family can occur with the same attorney with appropriate conflict waivers, the analysis becomes more complicated when the tax advisor is representing an entity or trustee in an FO setting. There may be actual conflicts of interest that prohibit you from providing personal estate planning or personal legal advice for an individual family member on matters involving the family business. But, even if the conflict is waivable, you need to consider carefully whether you can harmonize the personal work conducted for a family member with the existing duties to the FO and its stated goals. Often, requiring separate counsel will avoid serious problems such as the individual attempting to use personal representation as a basis for disqualification or termination.

10. Consult with client early and often. Consulting with your FO client early will allow you to spot potential conflicts and advise how the effects can be minimized or altogether avoided. And, while not every conflict in the FO setting is avoidable, the damage caused by the conflict may be minimized if you're involved before the conflict becomes a distraction to the operation. You can also help scrutinize regulatory and tax issues that can detract from the family goals or can propose changes that prioritize family objectives in response to ever changing regulations (for example, taking advantage of a December 2017 tax opinion finding that FOs are treated like a business for expense deduction purposes and maximizing the benefits and structural advantages of the 2018 tax reforms). You can also seek advice from employment advisors who can review compensation and employment contracts to make sure that the family objectives for treatment of specific individuals, favorable or less favorable, is consistent with the jurisdiction's employment laws.

Staying on course

While the individualized services that an FO provides are attractive to many families, the merging of a complex business structure with family legacy planning is inherently vulnerable to diverging interests and priorities. Some of these divisions rise to the level of actual conflicts of interest. Careful planning and constant review of FO structure and procedures are the best ways to implement and further a business designed to minimize and resolve such conflicts. Taking the necessary safeguards to prevent the conflicts allow the FO to function exactly as it was intended: to achieve the family's goals and objectives.

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