The Family Governance Pyramid: *From Principles to Practice*

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Virtually every family of significant wealth lives within a family governance system, yet few know that this is the case and even fewer know how to ensure that they are in charge of the system and that it operates for their benefit. This article aims to assist families in understanding the systems that they are creating and learning how to manage them for the well-being of their family members. Drawing from the developing theory and practice of family governance, it provides a new framework (the "family governance pyramid"), an overview of the stages of development ("chaos" through coordination), and practical steps to create and manage a family governance system that will work across generations. Studies have shown that even the most successful estate planning, tax minimization, and investment returns do not necessarily ensure wealth preservation. Rather, it is the framework and process of family governance that transcends and integrates these disciplines to increase the likelihood of successful preservation of a family's human, intellectual, and financial wealth.

WHAT IS FAMILY GOVERNANCE?

Although the term "family governance" is used increasingly in family business and private wealth management, there is no universal definition to date. This has led to some confusion and misuse of the term. In order to create more clarity and consistency, a brief review of the term and its applications follows.

DEFINING "FAMILY"

In family governance, the definition of "family" is necessarily broader than a group of persons related solely by blood or marriage. Today, a family includes individuals who are joined through important relationships that do not fit the stereotypical nuclear model. For example, divorce may divide the traditional family tree, and many families now expand their tree to include couples, same sex or otherwise, that are a part of the family but who wouldn't otherwise fit in the traditional slots. In a governance system, "family" can also include close friends or professional advisors who have developed intricate and intimate relationships with individual family members.

GOVERNING THE FAMILY

Webster's New Collegiate Dictionary defines governance as "to control the actions or behavior of; guide; direct. To make and administer public policy for . . . exercise sovereign authority in. . . ." While only certain (i.e., royal) families rise to the level of sovereignty, this definition gives a sense of family governance in which some family members, often including outside advisors, are given legal authority to guide and control the behavior of others within the family.

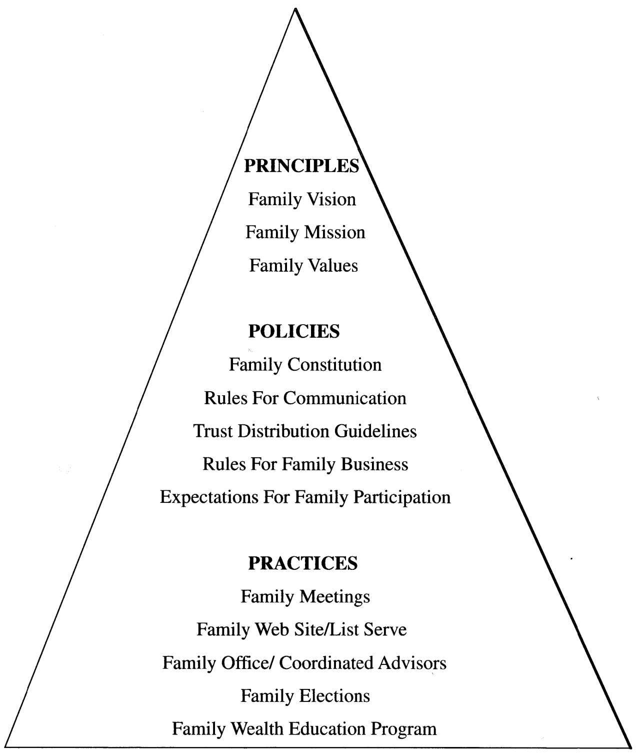
All individuals live their lives in recognition of how public governance, especially policy and law, impacts their behavior. Although they may not realize it, there are aspects of public governance that are paralleled in the ways that wealthy families manage their affairs. Jack H. Friedenthal, former dean of George Washington University Law School, has observed that law consists of *regulating human behavior through language*. When family members create legal structures for their family business, or write wills, trusts, and other legal documents, they set out governing rules that guide, direct, and often control the behavior of others. They create new legal relationships that reflect a form of governance. However, unlike most nations or states, they create the system on an ad hoc basis without a formal process of governmental institution–making. People are appointed to positions of authority without ensuring that they represent their "constituents." There is usually no internal system of accountability or checks and balances. Also, rarely is there any form of "civic education" to ensure that family members are properly prepared to run the system.

It may be uncomfortable to think that a family has created something comparable to a government or that its members are given power to guide, direct, and control one another's behavior. However, this is often the case. For example, a mother may create a trust for her son and appoint her brother, the son's uncle, as a trustee. Depending on the terms of the trust, the uncle may have discretion to withhold or make distributions of income and/or principal to the nephew. The uncle becomes subject to local and national laws governing his behavior as trustee, yet he may be unfamiliar with them. The nephew is also impacted by the terms of the trust and what is required of him. Both uncle and nephew alike may be uncomfortable or overwhelmed by this legal reality, and consequent change in their relationship. For this reason, the definition of family governance goes beyond a simple focus on legal entities and the relationships created by them. In ways that are unique to each family, governance also includes the web of relationships that exist among family members aside from the structures they have created. James E. Hughes, Jr. provides an extensive overview of this broader view of family governance in his book, *Family Wealth: Keeping It in the Family*. In *Family Wealth*, Hughes makes a compelling case that families who seek to preserve wealth across generations must support the family's human, intellectual, and financial capital through a governance system. Further, he recommends that families establish some form of representative government that is tailored to the needs of the family.

NEW FAMILY GOVERNANCE FRAMEWORK

How can families better handle their governance systems? What constitutes effective family governance? Just as every family is unique, there is no single system that applies to all families. Nonetheless, observations of successful families reveal that there must be an agreed-upon set of *principles*, *policies*, and day-to-day *practices* that are followed by the family members who choose to be part of it. The family must also maintain an *environment* that supports the governance system. The system must be flexible and open to all family members, who should be given the choice to join or leave (or, in some cases, to defer their involvement). It must be adaptable to the inevitable changes that will occur within the family and the world in which they live. A new framework showing a few examples of each aspect can be visualized as set out in Exhibit 1.

EXHIBIT 1
The Family Governance Pyramid



Note: The examples listed under principles, policies, and practices are not meant to be exhaustive, but rather a sample listing.

PRINCIPLES

Nothing truly extraordinary happens without an overriding vision or set of unifying beliefs. Traditional estate and financial planning have failed precisely because they fail to take this key component into account. The goals are usually limited in scope to short-term investment returns or minimizing taxes and therefore do not rise to the level needed. Indeed, for a family to preserve wealth successfully, it must start at the top with some sense of the principles that will guide the family's interactions for their joint affairs. In *Family Wealth*, Hughes asserts that the goal of any family governance system should be the support of each individual family member's pursuit of happiness. Ivan Lansberg asserts in *Succeeding Generations* that a family must pursue its "shared dream," which transcends the dream of any single family member. Regardless of which term is used (e.g., dream, vision, mission), a family governance system, and all actions related to it, must be built on a set of overarching principles.

Since most families (and their advisors) have not thought about these issues in this way before, they must develop ways of ascertaining their principles through the work of the family members themselves. At a minimum, the family must consider issues including:

- What are our shared beliefs?
- What distinguishes us from other families?
- What is our common vision?

There are many tools available to help families in this process. Principles can be ascertained through an organic process that is both aspirational (How do we wish the family to be seen?) and practical (What is an example of our family's uniqueness?). A useful tool for families is a family meeting (or series of meetings) to gain a better understanding of their values, which are often left unspoken. The family might use the services of an outside facilitator or advisors who have skills and expertise in this area. Drawing upon academic work in the area of values assessment, families can now utilize computer software programs to assist them in the process. Any family can start by sharing family stories to get a sense of the threads that weave the family heritage together over time. Family history can provide great insights into family values that can form the basis of the family's principles.

There are several ways that families can articulate their family principles. Some choose to create a mission statement, vision statement, or even a simple list of shared values. A family vision statement might be as simple as: "Our family seeks to use our blessings, financial and otherwise, to ensure the physical and emotional well-being of our members, promote supportive relationships with each other, and make positive contributions to the communities in which we live." If a family is not yet ready for a formal vision statement, it can start on a more basic level—by agreeing upon a goal that transcends the interests of any one individual. One family dividing an estate simply agreed: "At the end of this process, the most important goal is for all family members to still be on speaking terms. This goal trumps all others and recognizes that while assets may have symbolic meaning and financial value, they cannot replace memories and healthy family relationships." Family members cannot assume that everyone will agree to each value or aspiration; rather they must respect the differences among themselves while focusing on the overlapping principles.

POLICIES

At the next level down, the family needs to translate the agreed-upon principles into general guidelines that will apply to specific aspects of the family's activities together. Policies should be written or, if not, must be simple enough that all family members can remember and agree to them. Some of the most important issues that these policies should cover are:

- *Rules for communication.* What methods of communication will be used for making family decisions? What code of conduct applies to family meetings?
- *Estate planning guidelines.* What are the family's expectations for each member's estate planning as it relates to jointly owned assets? What distributions from trusts would be acceptable?
- *Rules for involvement in family business.* What qualifications are required for a family member to work in a family business? Will equity ownership be related to management involvement? What are the rights of family members who choose not to work in the business?
- *Expectations for family participation in joint affairs.* Who will decide whether some or all family members can participate in joint endeavors, such as family limited partnerships and trusteeships?
- *Requirements for appointment as a director or trustee.* How will individual trustees be chosen and how will the family ensure that they are prepared for their

duties? How can trustees be removed?

- *Role of spouses.* How are spouses or significant partners of family members generally to be treated in family trusts, foundations, entities? Can spouses attend meetings? How much information will be shared with them?
- *Qualified uses for family funds.* Are family members expected to be economically self-sufficient? Can family funds be used to support or supplement lifestyles? What are acceptable uses for trust distributions?
- *Investments.* How does the family view the purpose of its investments, both generally and for specific entities?
- *Education.* What are the expectations for education of family members, including areas of academia, financial literacy, business management, and in the pursuit of talents?
- *Philanthropy.* How does the family view its philanthropy? How will the family allocate its giving between joint (family) giving and individual giving?

While not always necessary, it is usually best for some of these policies (e.g., investment policy, philanthropy, code of conduct for meetings) to be written down either in a family constitution or otherwise.

PRACTICES

While traditional estate and financial planning focus almost exclusively on day-to-day practices, in the family governance system the practices flow out of the principles and policies. Practices may include such actions as writing wills and trusts, or creating legal vehicles to minimize transfer taxes. The family may choose to establish a governing body and, if so, will need a system of family elections. The family should also agree on which education programs are needed and useful for family members. For example, some might need basic financial literacy, others might need help in developing business plans, and others might avail themselves of the resources available to wealthy families through associations or peer-to-peer groups. As a general rule, all family members should be expected to make it a standard practice to take care of their own personal estate planning upon reaching adulthood and should be involved in financial affairs of which they are owner or beneficiary.

The family must also determine how it will administer its affairs. For some families, a team of service providers may suffice. For others, a family office or equivalent will be needed. The level of involvement of family members should be appropriate to their interests, availability, and capabilities. Some families may decide to establish a secure website and/or list serve that can provide access and ability to share information on investments, trusts, philanthropy, and other issues.

PHASES IN THE DEVELOPMENT OF A FAMILY GOVERNANCE SYSTEM

There are three basic phases in the development of a family governance system: "chaos," coordination, and cohesion, as summarized in Exhibit 2.

Phase One: "Chaos"

In science, *chaos theory* describes situations that from the outside appear to be the result of random or unpredictable acts, but in reality have an underlying order that can be discerned over time. While there is by definition an element of disorder in chaos, this theory has shown that merely observing the "disorder" of a given situation is helpful. For the majority of families, "chaos" may describe their situation with respect to family governance. This does not mean that the lives of the family members are chaotic! Rather, family members are focused on living their lives and, along the way, set up structures to meet specific needs as they arise. For very good reasons, they are more focused on day-to-day issues than long-term wealth planning.

During this phase, estate and financial planning will generally respond to immediate needs and be uncoordinated. For example, a young couple will write their wills after their first child is born or before they take their first family vacation. Many entrepreneurs establish and fund a private foundation as part of the sale of a business, even though they may not have time to do long-term planning. In many cases such as these, family members do not focus on administrative needs or long-term planning. More often than not, the older generation maintains control of most of the family wealth and dominates the discussion and handling of family wealth issues. Family members aren't necessarily unhappy about this, but often the facade of stability belies underlying chaos.

There are some critical action steps that must be taken during this phase. If the family has not yet done so, the first step is to do some basic estate planning to cover potential emergencies so that they can "sleep well at night." This will most likely include some basic investment, tax, and estate planning. It is crucial that plans not be held up

Exhibit 2

Phases in the Development of a Family Governance System

PHASE	CHARACTERISTICS	ACTIONS	GOALS
"Chaos"	o Uncoordinated o Short-term focus o Respond to immediate needs o Independent actions by family members o Older generation may dominate	o Create basic estate plans o Select advisors	o "Sleep at night" o Cover emergencies o Minimize transfer taxes
Coordination	o Family members begin to view big picture o Need for family meetings o One or more leaders emerge	o Define/clarify family goals o Identify and begin intergenerational tax planning o Begin education program o Work with advisors o Convene family meetings for specific issues	o Create coordinated system o Choose leader(s) o Begin succession planning
Cohesion	o Actions viewed per long-term goals o Open and regular communication o Leaders change over time	o Choose family leader o Choose lead advisor(s) o Create family office (or equivalent) to manage affairs o Establish and keep regular meetings	o Sustainability o Integration of family members o Clarity between joint and individual needs/wants

for lack of comprehensiveness. Too many individuals delay this initial process and risk leaving their families in disarray. Successfully completing a plan, even if it is understood to be temporary, can help unlock the inertia that keeps many individuals and families in this stage indefinitely.

After a family has done this initial planning or, more likely, if they already have some structures in place, the next step is to take a full inventory of financial and non-financial aspects of the family's affairs. Some of the questions that each family member must review are: What is the financial and non-financial health of family members, individually and as a group? What structures have been created or need to be created to hold and transfer wealth? Is there a central repository for information? Who are the family's advisors and are they appropriate to family needs?

As each family member reviews what he or she has created, they should focus on the intended and unintended consequences that might result from what is already in place, and whether that fits with what they had imagined—or hoped for. They must ask: Have we created any trusts? Who are the trustees? How well do they know our family? Have we created any new positions of authority (e.g., trustees, directorships) for family members? Are they prepared? Are we putting family members into co-ownership situations? The family needs to review the skills and interest of each member involved and make sure that they are matched to the rights, duties, and responsibilities given to them.

Phase Two: Coordination

In some cases, a family member or group might take initiative to create formal ways for the family to work together—for example through joint investments or even

EXHIBIT 3

Practical Tips for Effective Family Governance

1. Know which stage the family is in at all times, and attend to the actions needed for that stage.
2. Use family meetings to cover both immediate and long-term needs of the family.
3. Ascertain the family's principles to serve as a guide for policies and practices.
4. Educate family members on the duties and responsibilities of their positions.
5. Allocate resources to support the governance process.
6. Develop written policies for investments, trusts, family communication, and related issues.
7. Review principles, policies, and practices from time to time.

by using a group inventory. More often, it is a crisis or other significant event, such as a death in the family or sale of a family business, that forces a family to move into the next phase: coordination.

This is a crucial phase, as it represents the transition from ad hoc planning to a more cohesive approach to long-term family affairs. There are some essential actions that must be taken by the family during this phase for the transition to be successful. Usually, there is a need for an initial family meeting or a series of meetings, which may start with specific issues that need immediate resolution. These meetings present an opportunity to expand beyond the specific task at hand to work on core governing principles and policies. Ideally, it is during this phase that a cohesive team of advisors is formed and a primary coordinator is chosen. Through these interactions, family members will need to learn how to diffuse the intense emotional issues that bind families and, for their long-term welfare, develop healthy methods of communicating together. Some of the actions that family members must take include: defining and clarifying family goals, inter-generational tax planning, and ensuring that proper education is available and used by family members. The family must understand the roles that they play and how to distinguish them from each other.

It is also during this phase that the primary family wealth holder (if still alive) will need to understand that open communication with the family members who will inherit from him/her is essential to ensure the healthy transfer and use of inter-generational wealth. Just as a business must focus on succession planning, so too must the family openly address succession issues. While the actual dollar amounts and minute details are not necessary, it is crucial for family members to understand some basics about the legal structures, advisors, and education that they will need so that they can become responsible heirs.

Phase Three: Cohesion

A minority of families reaches the final phase, *cohesion*, which can last for years, decades, and sometimes across generations. The overriding—and ongoing—goals for this stage are: integration of family members as appropriate into the governance system, clarity between individual and joint needs/wants, and long-term sustainability. The most important test of success is the individual happiness and health of family members—both financially and emotionally.

During this phase, the family must continually develop and apply an integrated system for handling its commonly held assets and intertwined affairs. Family members must separate emotional issues from the practical issues to be managed and decided. They must work as a team with their advisors but ultimately be in charge. One or more family members might take the lead and serve as point person for their generation or for the family as a whole. Most importantly, the family must understand when they must work together and when it is appropriate to function separately. The family will need to prepare, choose, and from time to time replace family leader(s) and advisors. The family might choose to create a Family Council or other governing body. It is important that the family maintain regular meetings, either through a Family Assembly or otherwise.

It should be noted that the infrastructure of the family governance system derives in part from legal structures, but more importantly from the emotional and personal relationships among family members. Each family has its own way of functioning, regardless of the structures that they create and the entities that they manage. This family "glue" must be recognized and taken into account in creating and managing the system.

PROPER ENVIRONMENT

Experts agree that families must foster an environment with the following characteristics for family governance to be successful:

Open communication. The lines of communication must be open, both among family members and between the family and their advisors. The family must strive to overcome the challenge of communication across distances.

Respect for the uniqueness of each family member. The family must understand that members of different generations—and even the same generation—will view the world and their lives very differently.

Sense of community. As a corollary to respecting each individual, there must be a sense of community among family members for their joint endeavors to succeed. Focusing on commonly held goals (such as co-investing or grantmaking) can help foster community within the family.

Clear distinction between group and individual needs/wants. Individuals and groups both need to be accommodated. For example, it is inevitable that members of different generations, and even those from the same generation, will have very different views of how family foundation funds should be disbursed. In anticipation, families should create guiding rules to minimize the potential conflicts that might arise. For example, allowing discretionary grants or dividing the foundation's funds into separate groups—by mission or otherwise—might be more appropriate than seeking unanimity on all decisions.

Respect for rules. The media has been increasingly focusing on families who have used their businesses and charitable funds for their own purposes. It is essential that family members understand and live with the guidelines that are created externally (e.g., public laws) and through their own internal process.

CONCLUSION

One can easily ask: can a family actually be "governed"? Certainly, it could be argued that it cannot or should not. However, this response misinterprets family governance and fails to recognize the potential gains that some form of governance can provide. Some of the wealthiest families around the world have used family governance, knowingly or not, to their benefit for generations. More and more families today are finding it helpful. These families understand that the system takes years to develop and must constantly adapt to the changing needs and circumstances of the family. They also understand how to distinguish between those areas that must be governed (e.g., trusts, family business) and those that do not (e.g., personal lifestyle choices). History shows us what happens when traditional estate and financial planning are used without the benefit of family governance. Families are yearning for something more. The new framework proposed in this article may help provide a useful perspective for families, even if they do not fully apply family governance to their affairs. For others, family governance may just be the crucial component that increases the family's chances for successful preservation of its human, intellectual, and financial wealth across generations.

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