The Family Office: *Insights into Their Development in the U.S., a Proposed Prototype, and Advice for Adaptation in Other Countries*

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Throughout Europe, the United Kingdom, and Japan, there has recently developed an increasing and intense interest in family offices, which have become widespread in the United States. Professionals in other countries have been asking how to create family offices in the manner of the United States. Clients in other countries have been asking whether or not they should have their own family office.

This article* describes the ways in which family offices have taken hold in the United States. Yet, it incorporates a critique that offers suggestions for improvement as they are adapted for use outside the United States.

It seems that, as family offices have grown in size to resemble financial institutions, they have lost the family relationship appeal that is their strongest attribute. Ironically, this institutionalization of family offices enables traditional financial institutions to compete to become the family office for any number of clients, which is the current condition in the United States.

In summary, this article emphasizes that the core value of a successful family office is to retain its focus on complete dedication to the needs of its family.

INSIGHTS INTO THE DEVELOPMENT OF FAMILY OFFICES IN THE U.S.

Family offices have become a rather widespread phenomenon in the United States during the last ten years. No longer the exclusive province of the "big names" in the country, there are an estimated 4,000 family offices, or even more. The numbers seem to change every month.

Part of the difficulty in counting accurately is:

- Family offices are on the whole very, very private.
- The definition of a family office is vague enough to cover everything from a one-person part-time assistant to a full-service private trust company with a staff of dozens. Indeed at the present time a number of enormous financial institutions are trying to represent themselves as being a family office also.

Why the explosive interest? What is a family office? What are the benefits of a family office? Who should have one? How much does it cost? How should it be structured?

With other countries beginning to look to the United States for advice, what insights do we have about the best manner in which to design and operate a family office?

I believe that many of family offices today in the United States are not models that should be copied. They have strayed too far from the original needs that created them. Filled with superstructure and overhead, they are unable to provide either the personal care that is essential or the optimized financial performance that is often viewed as their primary justification for operating at all. Adding additional clients—becoming a multifamily office—seldom cures either of these, and often seemingly adds even more difficulties.

Historical Development of Family Offices in the United States

In the United States there are three typical situations that lead to the creation of a family office. The first two, tied closely to one large operating company as the source of the wealth, are more traditional. The third, resulting from the recent "dot.com" wealth, is somewhat different.

Inside an operating business. The majority of family offices in the United States began when the patriarch had become a successful entrepreneur. His personal financial situation began to need time and attention. Even while the operating company was a full-time occupation, someone needed to help with the individual tax returns, accounting, and investments.

Without conscious direction, some part of the company staff began taking on functions that would now be classified as family office functions. The range was often as broad as the needs of the entire family: obtaining financing for a child's home purchase; screening and hiring household help; planning private business/social functions; keeping bank accounts in order; paying household and personal bills; getting the tax returns filed; monitoring investments; and so on.

As the needs increased, it became increasingly awkward to fulfill all of the family services through staff of the operating company. At a minimum, to preserve the tax deductibility of the business salaries and overhead for the company meant that internal allocations of time should be maintained. The personal time should have been paid for in some other way. In most cases, though, this was probably not done.

From a family perspective, it also became increasingly awkward to have its personal finances scrutinized and organized by operating company staff. If one or more family members were actively involved in managing the company, other family members faced the additional problem of concealing confidential matters from those members who were managing the company.

The relationship between the family and the operating company was often opaque. Unsure of their rights as family owners of the company, younger family members in particular were hesitant about asking for personal assistance. The operating management team was often unclear about what, if any, involvement the family members should have in the direction of the business. Using internal company staff to handle family office functions often looked like a bridge between these two groups. Ultimately, though, the confusion of roles, overhead allocation, and concerns of confidentiality would prompt a split. A separate family office would be created.

Sale of the operating business. The other instigation for the creation of a separate family office has come when the operating business is sold or goes public. This has two major effects on the family owners. First, they suddenly have much more liquid wealth than ever before. Second, there is no more company staff to take care of their personal and family needs.

Many owners become paralyzed at this point. The activity they knew so well—operating the business—is gone. The liquid wealth is not something they have had much experience with, and they don't know whom to trust. A surprising number simply put the money into simple Treasury bills while wondering what they need to learn about the sophisticated investment world. The day-to-day conveniences are also gone: no more secretary, no more staff, etc. This sudden transition is tough.

Consultants are often hired at this stage to give advice on how to set up a family office to take care of the new financial needs. Facing the family office market for the first time can be bewildering. Other family offices wishing to expand will offer to add the new family to their original family group base. Large institutions will compete for the financial management services, and promise that they can be the family office substitute themselves.

This is a very confusing time for a family. Those who are able to speak directly to other families who have been through similar experiences are extremely grateful. Families have found particularly helpful the opportunities to participate in off-the-record small group discussions of many of the issues that need to be addressed when creating a family office. Every family is different, and their needs and interests vary considerably. There is no one perfect design.

The "overnight" wealth created by young entrepreneurs. From the Silicon Valley in California to the Northeast Corridor of the United States, some unusually young entrepreneurs are finding themselves awash in wealth, while still working hard in their careers. They usually did not grow up in extremely wealthy families and have accepted traditional United States values about family wealth. These values often include a belief that an individual's work efforts are what should be rewarded, and that for anyone (such as their own children) to be handed large sums would be to remove the incentive for hard work and would be a bad thing.

Although individual effort did in fact produce the wealth, in a case where millions of dollars pour in from a one-year effort, there is often a sneaking suspicion that it was not "earned" in the manner respected by one's parents, i.e., from a lifetime of sheer hard work. Some recipients of new wealth, embracing the American mythos of pulling oneself up by one's bootstraps, are even convinced that inherited wealth is bad for the country.

Faced with large wealth that has come over a short time, and may continue to come from ongoing ventures, such parents are concerned about its effects on their young children. They are afraid to talk to their children about the money, and have not grown up with a comfort about the complications that large amounts of wealth entail. The role a family office can play for them is to provide a measure of reassurance that the wealth can be managed for the benefit of the entire family.

The family office in this situation often will be actively involved in assisting with a family's philanthropic programs. As with Andrew Carnegie—an influential proponent of philanthropy and an outspoken and often-quoted believer in the "evils" of inherited wealth—giving the "surplus" away seems to remove some of the guilt about having a disproportionate share of wealth. In addition, though, it is likely that their successful entrepreneurial approach will be carried over to their philanthropy, since these are young people who are used to very active involvement.

Services Provided by Family Offices

Once there is a decision to create a family office, the next question is what services should be provided. Ideally, most families would like to have "everything" taken care of: from seeing that the money is well invested to renewing the car license plates and hiring the nannies. This breadth of services makes it difficult to recruit. Investment professionals also expect to be highly compensated (which raises other issues) and are not accustomed to providing "concierge" services.

Looking at the question of the benefits offered by a family office, what is realistic? Who are the families who would need and/or be able to afford these services?

First, looking at who might consider needing or appreciating the services, we find statements like the following. (Some have been reworded.)

- "Our goal is to simplify the financial lives of high-net-worth individuals and families." (Note: the definition of the target market is often vague and clearly includes more than the very wealthy.)
- "The Family Office is a technique pioneered by very wealthy families to efficiently manage the great complexities and responsibilities of their wealth."
- "Our goal is to relieve you of the administrative burden of managing your hard earned wealth, so you can experience the real freedom it should offer."
- "If your net worth is more than $2,000,000 our Family Office Services are a wise choice to efficiently manage, preserve and transfer your wealth."
- "We service families who have a substantial net worth, and cater to sophisticated and diverse family requirements with flawless execution, keen sensitivity and ultimate confidentiality."
- "The object of a family office is to provide for the financial management and security of a family's wealth and to also assist them with the organization of their financial and legal affairs."
- "Families of exceptional wealth have complex needs when it comes to managing their fortunes. More and more families are recognizing that their requirements can only be met by using a Family Office."
- "The office is a resource that provides both a legal framework and administrative support to enable a family's joint assets and interests to be coordinated—thus benefiting from significant economies of scale, efficient investment and coherent financial planning."
- "Financial Families can obtain unique benefits from a Family Office: confidentiality, proactivity, group purchasing power, integrated reporting, and downside risk management."
- "Historically a Family Office was only feasible for wealthy families with a net worth in excess of one hundred million dollars. Today, you too find that more of your time and resources are needed . . . to manage your family's wealth."
- "Our Family Office Services group provides a one source solution for all financial and investment concerns of wealthy individuals."

Services routinely listed include:

- Income tax planning to minimize taxes
- Coordination of all individual financial matters
- Cash flow management
- Preparation of financial reports

- Oversight of brokerage transactions
- Family philanthropic strategies
- Investment services
- Asset allocation
- Management of debt/leveraging
- Retirement planning
- Estate tax planning
- Bill paying
- Payroll tax administration for household help
- Coordination with bankers, attorneys, and insurance brokers
- Oversight of real estate investments
- Wealth transfer strategies

Occasionally the following will be mentioned:

- Mediation of intergenerational conflicts
- Assistance with succession transitions
- Serving as Trustee
- Family education
- Facilitation of family meetings
- Family governance
- Family council structures

Additional services that could be mentioned include:

- Preparing a total wealth audit, to understand the family's holdings on a comprehensive basis
- Monitoring all risk coverage, from property and casualty to substantial life insurance programs
- Offering offshore solutions as appropriate
- Overseeing and monitoring outside trustees
- Creating educational programs for the next generation, giving them the skills needed for independent evaluations in connection with the family wealth, and also preparing them to serve as valuable board members for other organizations
- Facilitating family meetings, at the foundation or the family council

Legal Structure of a Family Office

Once a decision has been made to create a family office, the legal structure should be considered. Lawyers often overlook the benefits that a legal structure can offer for issues of family governance in particular.

The family office should be created as a proper independent legal entity, with its own taxpayer identification number, accounting, and appropriate tax filings. As with any business, the lawyers involved in the creation of the new entity would consider the advantages and disadvantages of a partnership, limited partnership, corporation, subchapter "S" corporation, or the newer Limited Liability Company (LLC). In addition, the jurisdiction will have to be selected.

Issues that are inevitably part of the above decisions include the location of the various family members and of their primary (if there are primary) assets. Convenience of communication and the desire to have in person meetings will also make a difference. Of course, the tax structure of the chosen jurisdiction can also be relevant, although this will depend somewhat on the financial projections of the family office business itself, and will be less relevant if it is intended to operate as a break-even entity.

A few family offices are actually owned by the family office staff. This is intended to provide an additional financial incentive to the staff. More often, though, family offices are owned by several (but not all) family members. The ownership issue is only of financial significance if the family office is projected to produce profits of its own, which is not a common approach. Usually the family office is seen as a convenience for the family, not as an independent business. To the extent that the family office operates on a break-even basis, the ownership is of much less interest from a financial perspective.

Another legal issue is to put into place the appropriate governance structure. This is often overlooked by the lawyers and by the family, which is a shame because not only should the entity operate as such—e.g., observe all the formalities, etc.—but also because the legal governance structure can provide valuable governance benefits to the family itself.

Assume, for example, that the family office is a corporation. It will be required to have a Board of Directors, who are required to have periodic meetings. Unlike the practical advice given to many closely held businesses—that they have the minimum possible number of meetings and handle those by written actions in lieu of a meeting whenever possible—the family office Board should be encouraged to meet, actively and often.

The business of the family office is, after all, the management of all of the family wealth. The staff should be expected to give reports to the Board. Because the relationship between family members and the office staff is often one in which the family members are reluctant to "interfere" or "criticize" the staff, the lawyer who explains and supports formal Board meetings can play a valuable role.

In addition, the transition from one generation to another is an inherent part of the family wealth. It can be extremely helpful to have representation on the family office Board by members of the younger generation. They can begin as nonvoting members or as full voting members. The inclusion of in-laws as well as direct descendants may also increase the wider family's cohesiveness. Over time, this multigenerational inclusion can assist in smoothing transitions that could otherwise become filled with acrimony and suspicion. Board involvement could remove the negative effects of very common secrecy and control patterns by a senior generation. When the senior generation becomes aware of the lasting benefits to the entire family, they can become active supporters of these changes.

These are some of the special roles that a lawyer can fulfill. Most of the consultants for wealthy families who are so aware of many of the family conflict issues, generational tensions, and the need for process and productive communication techniques do not have a legal background. If the lawyer's input on legal governance matters and proper corporate administration is added to the repertoire of tools, the family can benefit greatly.

Institutional Stresses on the Expanding Family Office

Family offices tend to grow over time as the number of family members increases and the services offered increase. Large family offices in the United States encounter unavoidable stresses. A family will feel more in touch with the family office if a fair number of "low-level" services remain available to them. As one senior staff with a solid financial background quipped: "I handled the multimillion-dollar sale while fitting in a Christmas card committee meeting." Few professionals can tolerate that breadth of expectations for long. One solution has been to identify a separate staff member to act as the family concierge. What family members really want, though, is one person who can respond with appropriate concern to all of their needs.

As the amount of money under management increases, so do many of the costs. Multiple managers are usually selected; consultants may be retained to hire and review the managers; and someone needs to select and review those consultants. The compliance issues and filing requirements increase.

As the costs of staffing increase, the financial burden becomes an issue to the family, who may begin to wonder whether they are in fact saving money by funding their own office. Family and office staff alike will soon begin to consider whether overhead costs can be reduced by adding other families who would share those costs. This is what has led so many family offices to market actively for additional clients. At this point, though, the original benefit of having a personally dedicated office will be gone. Also, the new families will tend to feel that they are additions and not quite as important as the original founding family.

Institutional Competition

Bringing us full circle, the evolution of the traditional family office into a large institution has encouraged large institutions to believe that they can compete themselves for the family office business. This competition takes several forms.

One approach is to add a department or perhaps a new marketing name, so that large banks, investment houses, and insurance companies are presenting themselves as family offices as well. The appeal they make to families is based on the cost savings that would be realized in funding a personal family office and simply using the existing resources of the institution. The institution's interest is in managing the funds.

Another approach is for existing professional firms, such as law firms and accounting firms, to add "family office" services to their offerings. Because they usually do not generate income for themselves based on managing funds, they have not been as aggressive as the financial institutions have been. There are a few exceptions; we have been advising two law firms on how to create a family office practice.

These approaches are so different from the family's original needs and wishes that we anticipate they will not be successful unless they can learn to truly focus on those needs. They need to understand the importance of the old-fashioned values of caring and understanding, coupled with reliable and consistent availability. The investment skills can be outsourced. The care of a family cannot be. There is still a place, in other words, for the traditional family lawyer.

A PROPOSED PROTOTYPE

I would encourage those in the family office world to consider a return to the basic concepts that have led to the creation of so many thousands of family offices in the

United States. The family office is not fashioned along standard business lines; it is an institution created specifically to meet the needs of a family. We also see a need to update many of the concepts for families of the Boomer generation.

The prototype will be, once again, a very small staff in an independent family office, dedicated to the needs of one family. Large financial institutions could provide most of the other services on an outsourced basis.

Return to the Basics: Insights

The following issues are key to a successful family office.

Family cohesiveness as a value. The only families who are interested in having an office are those for whom it is important to join together as a family. Not every family will reach that conclusion.

Combined purchasing power as a given. Once they have decided to join together, the most obvious benefit from a financial point of view should be their ability to pay less when the combined size of their investment funds is larger.

Availability on demand. The family office staff would be expected to be available always, and for any matter. In today's language, this is a 24/7 service.

Understanding and caring on demand. More than simply being available, the family office must understand and care for each family member.

Coordinating outside services as a skill. With a small family office staff, most of the services will be outsourced. It is important that the family office staff have the skills to coordinate all of the outside service providers.

Legacy for the future. Every family is concerned about its own legacy. The family office can provide assistance and reassurance that the legacies will be carried out.

Adapting to the Boomer Generation: Insights

Giving back as a value. This generation cherishes the idea that one must give back to the community. This means that philanthropic programs and family foundations will play a very important role in the family office. This is another area where lawyers can provide valuable encouragement and assistance in selecting the appropriate structures.

Broad education as an interest. Very high value is placed on education. Far more than completing a fine university education, this means a lifelong learning process in a wide-ranging number of fields. It also will involve the family office in a very active role in educating the next generation to manage the wealth wisely, including the philanthropic objectives. Those skills will include reading financial statements, learning how to serve as good board members, and perhaps even gaining an understanding of the family's style of investing based on its own interests and its own tolerance for risk.

Active involvement on demand. The family members will want to be actively involved in all aspects of the family wealth. This will range from participation in the family office board, the family foundation, and in family meetings. It will also mean a proactive approach to philanthropy.

Global awareness as a value. Issues of concern will know no national borders. The breadth of interest will extend from hot spots worldwide to matters that are global in scope.

Legacy for the future. They, too, are concerned about their legacy for the future. These may include sophisticated private placement insurance products, designed for the particular family. They may also include dynasty trusts, created to support the family for a time period that, like corporations and foundations, has no fixed termination. The family office can provide assistance and reassurance that those legacies will be carried out.

In sum, in the proposed prototype the small family office staff would act as the central coordinator. This is also a role that a family lawyer could fill, as well as those financial institutions that understand the need for the special staffing they would have to provide. For example, they could train a dedicated family office team to understand the issues of concern to these families and encourage the team to provide a much more responsive and comprehensive approach.

ADVICE FOR ADAPTATION IN OTHER COUNTRIES

Continental Europe—Historical Role of the Private Bank

During the last ten years the banking industry seems to have undergone unending changes: mergers, acquisitions, and consolidations. One result has been a sharp decrease in the number of small, independent private banks. The services these institutions had provided to wealthy families in Europe had in many ways been similar to the role of the family office in the United States.

Now families across Europe are looking for alternatives. In some cases the family *notaire* takes on a more expanded role. In other cases it is the accountant who is beginning to fill the void. In fact, many European families are looking to find out how family offices work in the United States.

What follows are a few personal observations about differences in the wealthy family market. These and other differences should be taken into account in designing appropriate family office structures in countries other than the United States.

Switzerland

Switzerland continues to be the financial center for a significant potion of the world's private wealth. As a corollary to using Switzerland as a financial center, many families have come to rely on Swiss advisors on a number of other issues, even though (or sometimes because) they live in non-European countries.

Recently, for example, a few Saudi families have asked their Swiss advisors to develop an educational program for the younger generation to learn how to manage the family wealth in the future. Related to those concerns is a growing interest in creating family offices. At least one of the well-known Swiss banks is actively marketing its offering of "family office" services. Lawyers have begun asking how they can assist their clients in creating family offices of their own. Accountants are studying how they can be the "family office" for a number of clients.

France

Most wealthy French families seem preoccupied with the subject of French wealth taxes. Unlike in the United States, where our estate and gift (and income) taxes apply to United States citizens no matter where they may live in the world, France (and other European countries) will apply those taxes only to those who have their "domicile" in France. Unlike in the United States, where an estimated 95% of residents do not even have a passport, Europeans are accustomed to visiting other countries and often have a second or third home in other countries.

Factors such as this make it relatively easy for a French family to relocate, often to London, to avoid the imposition of French taxes. England can serve in fact as a significant "tax haven" for new occupants who were never British nationals or residents. The influx of wealthy French families into London will increase the need for sophisticated cross-border estate planning. In addition, this may well be a niche market for family office services, provided by someone who has a good feel for French customs and preferences combined with a solid understanding of the impact of English laws upon the family.

Germany

Germans seem much less inclined to establish domiciles abroad. A number of small private banks continue to exist and do act as the "family office" to some of the well-known German families. The level of financial, estate, and tax planning seems to be relatively less sophisticated than in several other European countries, although there is an increasing interest in those fields.

England

There appears to be a growing interest in England in the concept of the family office. Whatever form is selected will have to be one in which all of the staff are very well attuned to the extreme importance placed upon privacy and confidentiality.

With London being perhaps the most sophisticated financial center in the world, the ability to outsource extremely good services would be an option, but as stated above the requirement of complete confidentiality would require a very discreet staff.

Japan

The concept of the family office is still relatively new to the Japanese. At this stage it is a matter of study and comparison. In many respects the Japanese have remained traditional and conservative in regard to individual and family investments. For example, they are still unsure about the use of trusts (which are a legal entity in Japan) for families, and the tax system does not yet seem to coordinate well with trusts. The high rate of Japanese inheritance tax (up to 70%) has fueled interest in finding structures to help preserve and manage family wealth.

Latin America

Any family office staff in the Latin market must expect to be included on a social basis in family activities. The family will want someone who enjoys their company, who cares about them and about their children.

The education of the children, and teaching them as much as possible about wealth management, will be extremely important. Political instability may lead to a preference for a family office located in another jurisdiction. In addition, in several countries family members face physical dangers which unfortunately will require particular attention.

SUMMARY

The best family offices in the United States are those headed by someone who deeply understands the unspoken role of taking care of "everything" and "everyone" in a way that creates a very special home for the family. All of the services can be outsourced, but the primary staff must be the active, available conduit, always keeping the personal interests of the family in mind.

As the family office spreads to other countries, a number of adaptations will be appropriate. At the heart of any successful family office, though, will be an extremely dedicated and devoted staff.

In short, the best family office is a true financial home for the entire family. Filled with warmth and care, backed by capability and competence, these are the family offices that will endure.

ENDNOTE

The author acknowledges valuable contributions from Suzan Peterfriend, co-founder of Private Wealth Advisors LLC and director of the Family Advisory Council (private gatherings of families with an interest in topics such as family offices).

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