Afridi & Angell

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Family Governance in Trust Structures

By James Bowden | 17 February 2023

When contemplating a family wealth structure that is intended to endure, such as a family trust or foundation, it is important to consider how the structure will be governed, particularly in the longer term after the founder's lifetime. Governance mechanisms that are designed to encourage ongoing family involvement in the structure have proven to be effective at averting second, third and future generation conflicts that can undermine the structure. The most common family governance mechanisms are the family charter and the family council. This inBrief will provide an introduction to those mechanisms and explain why they can be useful for many families.

Trust Governance versus Family Governance

Most family trusts are fully discretionary, meaning the trustees are given very broad discretion to manage the trust assets and distributions. Such trusts are also normally made subject to some common governance and control mechanisms which set out either firm rules or soft guidance for the trustees. Those mechanisms typically consist of the terms of the trust deed, the appointment of a trust protector, and the issuance of a letter of wishes. These governance structures are discussed in more detail in our inBrief "A Matter of Some Discretion: Controlling Your Trust."

The usual control mechanisms for a trust are a necessary starting point; however, if the trust is intended to survive through multiple generations and successfully serve the needs of the family, family governance becomes very important. When a family wealth structure fails over time, it is most often because of relationship breakdown among family members, no matter how well-drafted the trust deed was or how effective the tax planning. It would be rare, for instance, for a founder to be able to successfully lay out the detailed investment and distribution scheme for a trust beyond one or two generations into the future, after which that exercise becomes overly cumbersome and complex and will probably be incorrect.

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James is the founder and Managing Director of Afridi & Angell's Toronto office, which primarily services the private client space in local and international estate planning, and creating structures using trusts and foundations.

Areas of expertise include succession planning, the use of trusts locally and internationally, tax planning, asset protection, tax-driven changes in residency, and estate structuring. The Toronto office also continues to provide corporate and commercial support in many instances.

The main purpose of a family governance structure is to enable long term harmony between family members; it achieves this by keeping all family members engaged with and informed about the trust, and by placing some important decision-making powers in their hands. When a grandchild or great-grandchild is a beneficiary of a trust, they will likely lack personal context around the ancestor (founder) who established it and why, and they may quite naturally view the trust through the lens of self-interest without any broader family context. They may not know or care about the ongoing future success of the structure. The natural outcome over time is conflict between family members or with the trustees or both.

Family governance mechanisms can be especially important when there is a family business that is owned by the trust, since trust ownership can lead to a lessening of family members' emotional attachment to the business over time. There is also a natural divide between passive family member beneficiaries, and family members who are involved in the family business.

Good family governance seeks to remedy these disconnects and prevent that sort of conflict by ensuring each family beneficiary, over generations, is kept informed about the structure and has a voice along with other family members in decision-making for the trust.

Family Charter and Family Council

A family governance structure sets out how a family makes decisions in the context of a wealth structure like a family trust, how family members are kept informed, and how family governance integrates with other structures such as a trust or family business. Family governance usually consists of two main components: the family charter and the family council.

The Family Charter

The family charter is essentially the family's constitution or code of conduct. Its contents are unique to the particular family's needs and wishes and should retain some flexibility for amendments so it can adapt to future needs. It is a document that should have moral and ethical value to the family, while operationally it is intended to set out how family decisions will be made, when such decisions are required, and some principles or guidelines to inform those decisions. It has been aptly described as a bridge between family and business, or family and trust. Some of the topics typically addressed in a family charter include[1]: a preamble for important context; the family history; core values or goals of the family; adherence by family members; formation of a family council and its functions, decision making and voting rights; relationship with the family trust/business structure; family philanthropic/charity/education goals; conflict resolution; and procedures to amend the family charter.

Although family charters are generally not intended to be legally binding documents, that possibility is not ruled out. While it is not an area that has been sufficiently tested given the private nature of such documents, there is a growing belief that family charters can be legally binding (at least in part) if they are drafted and executed in a manner that indicates a clear intention to be bound. Even where a family charter is not legally binding, it can of course remain very morally persuasive. Importantly, it can carry tangible consequences by properly linking compliance with the terms of the family charter to one's ongoing entitlement to benefits from a family wealth structure. That is, a family member might be given reduced or suspended entitlements to receive trust distributions in case of non-compliance with requirements set out in a family charter, and such consequences can be given effect by a family council using influence or control that it enjoys over the role of trust protector, for example.

[1] This is not an exhaustive list of topics that can be included in a family charter. For further information on the drafting and substance of family charters, please contact the author.

The Family Council

If the family charter is the family constitution, then the family council is the parliament or board of directors, made up of representative members of the family. The family council is tasked with giving effect to the family charter, making decisions on behalf of the family as a whole, balancing competing interests, and communicating trust and company business to the other family members who otherwise would not have visibility into or involvement with the family wealth structures.

The family council can build harmony by communicating with the broader family and representing their interests at family council meetings thereby giving them a voice through representation, among other things. It can also advise on how and when to make distributions equitably across branches of the family and across generations, taking into account the purpose of the structure, individual needs, or current versus future needs. Sometimes the family council can also be a useful vehicle to track informal shared ownership arrangements in which one family member may be tasked with owning property for the broader benefit of other family members, in an arrangement that relies on family integrity rather than legally enforceable obligations. Such informal arrangements can be very beneficial because they do not generally trigger reporting, disclosure, registration, attribution, FATCA/CRS, tax, and other consequences that arise when formal trusts are created. This is a benefit of greater family strength, and is one way in which tangible value is produced by good family governance.

Integration of Family Governance

As noted above, family trusts are usually the sole creation of a founder with little or no input from family members (although that dictatorial approach seems to be softening these days). One way to promote the success of a family trust over multiple generations is to have the founder consult representatives of the family members during the trust planning process, and in particular in the family charter drafting process. The trust document may integrate the family charter and family council and include ways for the family representatives to select, remove and replace the trustees, or to act collectively as trust protector or trustee advisory committee. It could also include dispute resolution provisions to avoid future litigation among beneficiaries and trustees. Allowing for future members of a family council to exercise control over a trust, in the role of protector or otherwise, ensures that the trust's operations remain flexible over time and are adapted to best serve the family through evolving needs and successive generations. Having room to adapt to changing family and legal environments is crucial to the long-term success of any wealth structure.

Vesting trust protector and advisor powers in a diffuse, multi-person committee can also be important from a tax planning point of view. Where only one person has effective control over the trust in the role of protector, there is a risk that trust income will be taxable in such person's hands, or that the trust itself will be deemed tax resident in the place of such person's residence.

This inBrief has focused on family governance in the context of a family trust. We would note that the same concepts apply to private foundations as well, and to family businesses through the terms of shareholders' agreements, partnership agreements, or other comparable constitutional documents. In all cases, the goal is to provide for a vehicle through which family interests are represented and communicated, in an effort to achieve a fair and sustainable balance between family interests versus business interests, and immediate needs versus future needs.

Finally, although our focus as a firm is to ensure a robust legal and tax structure, we would be remiss if we did not acknowledge the fact that family governance structures can be valuable beyond the wealth management context, and we encourage families to capture their broader beliefs, values and goals and reflect them in their family charters.

Planning with trusts, foundations and business structures is complex, and particularly so in the cross-border context. It is critical to obtain legal and tax advice from experienced professionals before embarking on such planning. Please don't hesitate to contact us and we will be delighted to discuss how we can assist.■

Afridi & Angell

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