"A family must undertake multiple qualitative assessments to understand whether its human capital is growing"

Christian Stewart looks at the forces shaping the future of the Hong Kong family office

Starting a family book club

In Chinese, there is a saying: "In books there are houses of gold and ladies of jade"; i.e. there is great value to be found in good books and in learning.

Established single family offices in Hong Kong are using the book, *Family Wealth, Keeping it in the Family*[1], written by James E. Hughes Jr. as a key guide to the question of how to overcome the Chinese proverb that "family wealth does not survive three generations" (the "Proverb").

While the author, Hughes, is a retired international lawyer and an American, *Family Wealth* is popular with wealthy families across Asia. Hughes explains that he first started thinking about the question of how to avoid the Proverb upon being flown to Singapore in the 1970s where he was asked by a Chinese tycoon in Singapore what steps American families took to avoid the Proverb.

A wealthy family that wants to avoid the Proverb might start their own "book club" and have everyone read and then discuss *Family Wealth* as a way of ensuring that there is a shared vocabulary between them and agreement on basic concepts important for the long-term preservation of family wealth.

In addition, the family office executives, the family leaders, and the family advisers can then read the more detailed second book on family governance written by Hughes,

Christian Stewart is Managing Director of Family Legacy Asia (HK) Limited

called *Family, The Compact among Generations*[2].

A third important book to add to the family office library is *Family Trusts, A Guide for Beneficiaries, Trustees, Trust Protectors and Trust Creators*[3] by Hughes and two other colleagues, Hartley Goldstone and Keith Whitaker which acknowledges that a significant percentage of all family financial capital will come to be held in family trusts; it explains how to apply the concepts from *Family Wealth* and *Compact* to the context of family trusts.

OVERCOMING THE PROVERB

Some of the key points from *Family Wealth* and *Compact* are:

- The wealth of a family should be thought of as comprising of the following five forms of family capital:
  — Spiritual capital;
  — Intellectual capital;
  — Social capital;
  — Human capital; and
  — Financial capital.
- The key to a family overcoming the Proverb comes down to family governance, or how the family make joint decisions together.
- The foundation for an effective family governance system is for each generation of the family to form their own voluntary social compact.
- The mission of family governance must be the enhancement of the pursuit of happiness of each individual member. This will enhance the family as a whole.
- Families should employ multiple quantitative and, more importantly, qualitative techniques to enable them, over a long period of time, to make slightly more positive than negative decisions regarding the employment of their human, intellectual, and financial capital.

THE FIVE FAMILY CAPITALS

The family financial capital is the only capital of the family which is quantitative in nature; the other four family capitals are all qualitative in nature.

- *Spiritual capital* refers to whether the family have their own set of unique family values. It also refers to the question of whether there is a common vision of what the family can be in the future or whether there is a common vision of a shared journey together?
- *Intellectual capital* addresses the critical question in this modern age of disruption of whether the family is a learning community or a learning organisation?
- *Social capital* has both:
  — an internal aspect: it asks can the family make good joint decisions together; and
  — an external aspect: the charity

1-3. Bloomberg Press.

"It is recommended that the family office is organised so as to recognise each of the five different kinds of family capital"

and philanthropic activities of the family, as well as the standing and reputation of the family in the community.
- *Human capital* asks the question of whether the individual family members are flourishing.

In terms of family spiritual capital, Hughes notes that to become a great family, to overcome the Proverb, takes a journey of at least 100 years.

Those family leaders who believe in the possibility of their grandchildren leading flourishing lives must know that their vision cannot be achieved in their own lifetime.

To have a vision of more than 100 years before you know if you have succeeded, is a great vision. All of the great families that he has studied had at least one person in their family who had this 100-year vision.

A second key point that Hughes makes is that what a family concentrates on is necessarily where it will end up and will therefore govern its success or its failure.

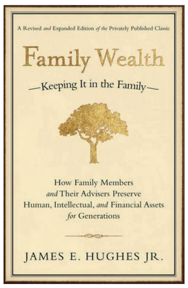
If a family spends all of its time on the financial capital; then the other four qualitative capitals will tend to disappear fulfilling the Proverb.

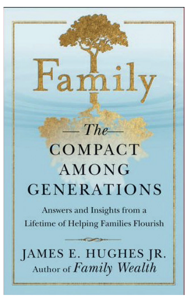
For a family to overcome the Proverb and to become a great family the family must focus on the four qualitative capitals and use the financial capital to support or invest in the four qualitative capitals.

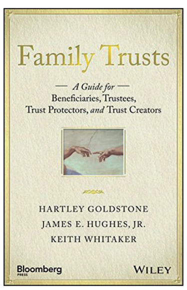
It is recommended that the family office is organised so as to recognise each of the five different kinds of family capital. Single family offices in Hong Kong will typically be organised around managing family financial capital as well as playing a role in the external social capital of the family (i.e. charity and philanthropy).

In addition, to ensure that attention is being focused on the qualitative capitals, the family office also needs an officer who is responsible for coordinating all initiatives that relate to family human and intellectual capital.

One approach would be to create the role of Chief Learning Officer (or CLO) for the family office.







IMPLEMENTING QUALITATIVE ASSESSMENTS

According to *Family Wealth*, a family must undertake multiple qualitative assessments to understand whether its human capital is growing. There are two different dimensions to this.

AT THE FAMILY LEVEL, THESE INDIVIDUAL ASSESSMENTS NEED SOME LEADERSHIP AND SUPPORT FROM THE FAMILY LEADERS

First there are recommended assessments for each individual member of the family to carry out. These assessments and tests are to be found in Chapter 19 of *Compact*. These include assessments to enable each family member to understand how he or she learns, how he or she works, what his or her vocation or calling might be, and his or her personality type.
- For the individual, this information is critical for them to know themselves and live a life in pursuit of happiness.
- At the family level, these individual assessments need some leadership and support from the family leaders/the family council. There should be a family policy encouraging each family member, once they reach a certain age, to start carrying out these assessments with the financial support of the family.
- From the family office perspective, the role of the CLO would include helping organise and coordinating these individual assessments, as well as to ensure that there is a consolidated record maintained of the results for each member of the family (assuming they consent to having their personal results shared with the family office). The CLO would also help design individual programs for each family member that ensures they will continue to work with and build on the results of their individual assessments.

The second dimension is that this requires the family leaders or the family council, again with the support of the family office executives, carrying out a periodic survey of the state of the family human capital – to consider are the family members flourishing?

Qualitative questions for this family survey can be found in Chapter 13 of *Family Wealth*.

The survey questions can also focus on the strengths, dreams and vocations of each member of the family, as well as the state of the family relationships. This family survey process is to provide guidance and direction for the family leaders/family council.

The family leaders need to be aware of and to consider the trend of the family as a whole. Family leaders will also find that this assessment process helps them to know how they might be able to offer help or support to individual family members.

The family survey process could also be incorporated into an annual process for considering enhancing distributions from the family trusts, which is discussed below.

REVIEWING THE FAMILY TRUSTS

One of the roles for the family office executives in Hong Kong will be to conduct periodic reviews of the trust structures set up for the family patriarch or matriarch and for other members of the family, whether the trustees are external professional corporate trustees or

"Family governance has to become intentional, and the family office should help ensure there is this intentional focus"

whether there is a private trustee company that has been established for the family.

Traditionally, when family trust structures are designed, it is very common to see a "prevention focused" mindset applied to the planning process.

Having a prevention focused mindset means trying to predict problems that might occur and then designing a plan to avoid or mitigate the downsides should such problems materialise.

When applying this kind of mindset to trust design, you would think of questions such as "what if a beneficiary becomes divorced, what if a beneficiary became bankrupt, what if a family beneficiary becomes a spendthrift or what if in the future there are family members who are addicted to drugs?"

IN TERMS OF FAMILY SPIRITUAL CAPITAL, HUGHES NOTES THAT TO BECOME A GREAT FAMILY, TO OVERCOME THE PROVERB, TAKES A JOURNEY OF AT LEAST 100 YEARS

Mindsets in the context of the administration of trusts are discussed and explained in *Family Trusts: A Guide*. There is a proper place for a prevention focused mindset in the design and the administration of family trusts. Indeed, this tends to be the default mindset of lawyers, tax advisors and trustees. However, it is not the only mindset and in general terms a "prevention focused" mindset tends to narrow down possibilities.

The authors of *Family Trusts: A Guide* explore the question of how to ensure that family trusts can operate to enhance the lives of the beneficiaries, thereby contributing to the growth, and the freedom of the family human capital.

They recommend that if the goal is for the family trusts to help enhance the lives of the beneficiaries of those trusts then it is also important to bring an additional mindset into play, which is called a promotion focused mindset.

This different kind of mindset calls for intentionally planning for – or imagining – how the distributions from the family trusts might help each beneficiary to develop into mature, flourishing adults, who can integrate the family financial capital into their lives. Applying a promotion focused mindset can to lead towards more expansive, creative thinking.

The family office executives could initiate these promotion focused exercises first with the settlor of the family trusts (i.e. the family patriarch or matriarch) and then expand the process to include the members of the family council and/or other family leaders from behind. They can start by asking the settlor of the family trusts to plan for scenarios where everything works out perfectly and the family trust is a huge success in helping each of the beneficiaries' flourish, to know themselves and to become free.

This kind of planning using a promotion focused mindset could lead to thinking about discretionary distributions to help beneficiaries to participate in the kinds of individual assessments mentioned above, to explore their own strengths, to invest in their dreams and vocations, or anything else that might help to enhance their lives – therefore "enhancement distributions".

Other points for reviewing Family Trusts:

- Is the mission or purpose of the trust clear?
- Is the trust intended to be a gift of love intended to enhance the individual lives of each of the beneficiaries?
- Has the mission or purpose of the trust been communicated by the settlor to the adult beneficiaries?
- Is there a forum so that the adult beneficiaries can have a voice with respect to the administration of the trust?
- Is the family office arranging for trustee and beneficiary education sessions so that the family members understand the roles and relationships involved in a trust?
- Especially in the case where the trustee is a corporate professional trustee, is there a distribution committee[4] appointed that can give non-binding advice to the trustee with respect to trust distributions so that they will be enhancing to each beneficiary?
- Could the trust protector be a neutral party such as a trusted family elder, who could help mediate disputes between the beneficiaries and the trustee?
- Does the design of the trust structure reflect the reality of the family dynamics and the family culture?

FAMILY GOVERNANCE

In Hong Kong, there are a small number of family offices who have as their primary purpose, not the management or oversight of the family financial capital, but to provide support for the ongoing family governance activities of the family. Sadly, it would be fair to say that these would be the exceptions and that the more normal scenario in Hong Kong is that there is usually scope for improvement when it comes to implementing effective family governance practices.

Many of the wealth creators/patriarchs in Hong Kong tend to have traditional values that are Confucian. They come from the "collective harmony" culture[5]. They believe that among the family, things should be "understood" and they may see little need for formal agreements and family constitutions amongst family members. They often expect that family values can be sustained and that the family members will stay together, even after they have passed away.

On the other hand, as might be expected, the need to implement more intentional and more formalised family governance practices (including family meetings

4. The Distribution Committee is discussed in detail in Family Trusts; A Guide.
5. See Cross Cultures: How Global Families Negotiate Change Across Generations, 2016, by Dennis T. Jaffe and James Grubman.

"When it comes to family constitutions, the process is the key, not the product"

where there is a focus on developing trust and communication) increases with each new generation of the family.

The simple conclusion is that when taking a three-generation view, family values, family glue, family harmony, and family togetherness, are all things that cannot be taken for granted. The governance of the family needs to be planned for and requires effort.

Family governance has to become intentional, and the family office should help ensure there is this intentional focus.

Drawing on books such as *Family Wealth and Compact*, as well as research into continuity of family wealth in Hong Kong and in the rest of Asia, the following general principles for effective family governance can be stated. Family office executives, family advisors and family leaders should keep these principles in mind when considering (i) family governance arrangements, (ii) the organisation of the family office, and (iii) the ownership (including through trusts) of family financial capital:

- Together and apart. The foundation for an effective family governance system is for each generation of the family to form their own voluntary social compact. One aspect of this is for the family members to be able to strike the right balance between the things they do together as a family, and the things that each family branch (or each family member) do on their own (i.e. balancing "together and apart").
- Freedom to pursue you own dreams. A voluntary social compact means that each adult family member perceives that he or she receives benefits from being a member of the family and a participant in the affairs of the family. He or she perceives that his/her best chance for attaining their own dreams and happiness is to be found as a member of the family. Another way of thinking about this is to say that the foundation for a successful succession is the development over time of a shared dream.
- The importance of vocation. Roles for family members, whether in family governance, on the board, in investment management, or in the family foundation should take into account, among other factors, the strengths and vocation of the individual family members. In other words, try to avoid putting family members into roles where there is no match between the role and their vocation.
- Monitor emotional commitment. Asian families cannot afford to take family glue for granted. This includes things like shared family values and emotional commitment to the family business or family office. This naturally fades by the third generation unless it has been actively cultivated by the family leaders. It is typically very hard for the family patriarch to accept this point. It follows from the above that family leaders must learn to pay attention to family emotional commitment and must know how to preserve it and to grow it.

MANY OF THE WEALTH CREATORS IN HONG KONG TEND TO HAVE TRADITIONAL VALUES THAT ARE CONFUCIAN. THEY COME FROM THE "COLLECTIVE HARMONY" CULTURE

- Trust and accountability. Family members in leadership or representative roles have to demonstrate accountability to family members who are owners or beneficiaries; they have to act in a manner that builds their trust and credibility in the eyes of their fellow family members, especially those that are "outside shareholders" or "outside beneficiaries".
- Respect for boundaries. Family members who are in ownership or beneficiary roles, but who are not in management or leadership roles, have to know how to respect the boundary between ownership and management. Such an "outside beneficiary" might have an opinion on how the family enterprise should be managed, but they need to know that if they are not in a management role, then they cannot insist on their ideas being adopted.
- Develop the ownership role. Paradoxically, ownership is more important than management when it comes to family enterprise continuity in ethnic Chinese owned family firms. Here the term "Ownership" also includes family members who are only in beneficiary roles. Therefore families, with the support of the family office, need to spend time in developing the ownership role, including educating family members so that they can be good stakeholder owners.
- Develop family roles. Family governance requires the development or cultivation of family members to play various other roles, including the roles of:
  — "Family Champions"[6];
  — "Leaders from Behind"[7]; and
  — "Family Elders[8]".
- Participation is voluntary. The word voluntary implies that there is a fair mechanism for family members in ownership or even in beneficiary roles to elect to opt out of the joint family assets. Paradoxically the right to a fair exit can lead to increased emotional commitment. However, while the exit mechanism should be fair – for both the party that exits and for those that remain – the price for exit does not have to be cheap. Family members should have a general understanding of commercial discount rates applicable to minority and illiquid interests. In a family enterprise

6. One or more members of the family who are committed to ensuring that the family governance initiatives of the family are put into practice.
7. Hughes says that a family needs to have its own Family Leaders from Behind in every generation of the family. Family members concerned to see that "all boats rise".
8. Family Elders are discussed in Chapter 18 of Family Wealth. They are also discussed in Compact.

"Family office executives are typically not going to be regarded as neutral participants by the family members"

context, payouts might occur over 10 or even 20 years.

- Culture always overrides structure. The final general principle is that the form of any governance arrangements, and the form of any ownership arrangements including family trusts, should always take into account the unique culture of the family including the way that the family naturally work together and function. The family culture will always eat the governance structures and trust structures for breakfast. The legal form of an arrangement should follow the way the family can function. For a family enterprise, evolution is better than revolution.

FAMILY MEETINGS

A critical practical component of family governance is to ensure that the family members are holding periodic family meetings.

This is more important than whether or not the family have a written family constitution in place. A key family office task is to ensure that the family meetings are held and to provide support for their organisation and planning.

There are different kinds of family meetings.

Here it is assumed that the term family meeting refers to a meeting where trust communication and being able to discuss differences are important goals of the meeting. In those circumstances, some portion of the meeting agenda should be allocated to addressing relationship issues including the effectiveness of the group (these are known as "process issues"); and some portion of the agenda allocated to addressing "task" issues such as education and updates or deciding on specific issues.

The aim of a family meeting should always be to improve trust and communication and to improve the capacity of the group to work together, even if the purpose of the meeting is about voice rather than vote.

Frequency of meetings can vary depending on the circumstances but will often be in the range of between four times a year and a minimum of one annual meeting.

While the family office executives should play a role in arranging family meetings – in ensuring that they happen – if improving trust and communication and improving group effectiveness are important goals then the meetings need a neutral facilitator.

However, the family office executives are typically not going to be regarded as neutral participants by the family members. In other words, family office executives might not be suitable to facilitate the family meetings.

ANY GOVERNANCE ARRANGEMENTS, AND THE FORM OF ANY OWNERSHIP ARRANGEMENTS INCLUDING FAMILY TRUSTS, SHOULD ALWAYS TAKE INTO ACCOUNT THE UNIQUE CULTURE OF THE FAMILY

FAMILY CONSTITUTIONS

As in other parts of the world, it is important to remember that when it comes to family constitutions, the process is the key, not the product. More than this, the ongoing processes that the family agree to engage in (including ongoing family meeting processes, family education & development, and family assessment processes) are going to be more important than having a formal written constitution document. Therefore, at least in an Asian context, a simple approach to the family constitution might be sufficient.

Key points to cover are:

- The constitution reflects a fair process for making joint decisions together;
- The Shared Vision (or Dream) and Shared Values are articulated and are referred to for making joint decisions;
- The necessary communication forums are created;
- There is role clarity; that the family know who makes what decisions and who has a voice in the process;
- There is an agreed step by step process for addressing conflicts;
- There are fair exit and valuation mechanisms in place;
- The family know who their "Family Elders" are;
- If there is an operating business(es):
  — the role and composition of the board is articulated;
  — the "job description" for a director is clear; and
  — the board includes at least one to two, non-family, non-executive directors.

How distribution decisions are to be made would be set out in the terms of non-legally binding letters of wishes provided to the trustee of the family trust(s).

The family office executives can take the initiative to ensure that each of the above listed topics are addressed; that the constitution and its terms are implemented once completed; that there is periodic review of the constitution and that the family office is generally providing administrative support for any bodies (e.g. family council) or committees (e.g. family education & development committee) created under the terms of the constitution.

FUTURE OF THE HONG KONG FAMILY OFFICE

The single-family office of the future will have evolved so that family human and intellectual capital – the qualitative issues – are being addressed in a professional, systematic manner and the family office has its own CLO, alongside the more traditional management of Financial Capital and Social Capital (charity and philanthropy).

In the most sophisticated of family offices the qualitative issues of the family and the state of family human and intellectual capital will be viewed as being more important issues than the management and preservation of the financial capital, and all family trusts will all have a mission of enhancing the lives of beneficiaries of those trusts. ■