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Current Legal Trends Impacting Family Offices

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Introduction to Family Offices

Today's Agenda

- Introduction to Family Offices
 - What Is A Family Office?
 - Family Office Structures & Types
- Current Trends
 - Investment Debacles
 - Formalization of Structure & Practices
 - Compliance
 - Philanthropy
 - Succession
- Best Practices



Introduction to Family Offices

■ What Is a Family Office?

– Legal Definition

- The U.S. Securities and Exchange Commission defines “family offices” as “entities established by wealthy families to manage their wealth and provide other services to family members, such as tax and estate planning services.”
Investment Advisers Act Rule 202(a)(11)(G)-1.

– Two Major Questions

- What does it mean to “manage” the wealth of a family, especially as opposed to an individual?
- What are these “other services” you speak of?



Introduction to Family Offices

■ What Is a Family Office?

- Wealth management in a family office often includes:
 - Financial reporting, accounting, and tax preparation
 - Asset allocation decision-making or advice
 - Cash and liquidity management
 - Creation of specialized investment pools that can be accessed by multiple family members and trusts (regardless of investment minimums)
 - Managing direct investments, including through vehicles that make investments directly in operating companies, real estate, and other types of companies or asset classes



Introduction to Family Offices

■ What Is a Family Office?

- Among the “other services” offered by a family office are:
 - Family education including on investment topics
 - Coordination of family activities and family meetings
 - Succession planning and estate planning
 - Insurance and risk management
 - Management of philanthropic activities
 - Concierge services, including travel arrangements and household management
 - Specialized asset management, including aircraft, boats, real estate, and art



Introduction to Family Offices

■ What Is a Family Office?

- The “big three” types of family offices are:
 - **Single Family Offices (SFOs):** These entities serve a specific family group. Due to the overhead expenses involved, SFOs generally have assets of \$50-100 million dollars. Most families will establish a stand-alone corporation or limited liability company when establishing an SFO. See Wis. Stat. chs. 180 and 183.
 - **Multi-Family Offices (MFOs):** These entities provide family office services to more than one family group. Because the costs are lower, the entry-level for such an office is more like \$25 million to \$50 million.
 - **Virtual Family Offices (VFOs):** More a platform for management, governance, and communication rather than true family offices, VFOs are offered at the \$10m level.
- These basic labels can be applied to an incredible variety of different structures, with different goals and services.



Introduction to Family Offices

■ Common Family Office Types

- Investment Management Type
 - Manages a pool of investments diversified across many asset classes, often including assets from many family members.
 - Usually large and sophisticated, with significant expertise. Sometimes is acting as its own captive private equity fund.
 - This is the sort of office you might read about in the Wall Street Journal.
 - Among the least common due to the significant assets required.



Introduction to Family Offices

- **Common Family Office Types**
 - Professional Trustee Type
 - Manages family trusts and / or provides support services to the trustees of those trusts.
 - Sometimes manages investments directly, but more commonly manages outside investment managers.
 - Usually a strong focus on next-generation activities such as education and philanthropy.
 - Public profile can vary from extremely private to extremely public depending on preferences of the family but is usually on the private, closely held side.



Introduction to Family Offices

■ Common Family Office Types

- Philanthropic/Foundation Type
 - Focused on charitable giving, often to distribute most or all of the owner's wealth to chosen causes
 - Vehicle may be a family foundation or other non-profit rather than an ordinary business entity
- Embedded Type
 - A family office that is operated out of an existing operating business
 - One or more executives perform services that are unrelated to business objectives of the operating company





Current Trends Impacting Family Offices



Current Trends

■ Investment Debacles

– The Big Picture

- Since almost all family offices have significant investments, the biggest trends currently impacting the industry are the downturn in the markets, the rise in inflation, and lingering supply chain issues.
- These trends have impacted almost all aspects of family office operations, from the core investment management functions, to tax and estate planning, to more eccentric items such as travel and aircraft management.



Current Trends

■ Investment Debacles

- Legal & Practical Issues
 - **Crypto Collapse:** Family offices that invested heavily in crypto assets during the booming market are now facing significant financial losses, which have many assessing their legal options for recouping those losses through lawsuits. See, e.g., *Lockhart v. BAM Trading Services Inc.*, No. 22-CV-03461 (N.D. Cal. 2022).
 - Depending on the role the office played (e.g. acting as a venture investor or promoter) some are also facing potential legal exposure themselves.



Current Trends

■ Investment Debacles

– Legal & Practical Issues

- **SPAC Attack:** Another speculative investment with significant family office involvement is the special purpose acquisition vehicle or SPAC.
- Dubious due diligence and inflated values have resulted in significant retrenchment and even some litigation. See *In re P3 Health Grp. Holdings, LLC*, No. 2021-0518-JTL, 2022 WL 8011513 (Del. Ch. Oct. 14, 2022) (lawsuit over a SPAC merger transaction valuation); *Bernstein v. MP Materials Corp.*, No. 22-CV-315 (D. Nev. 2022) (class action complaint alleging poor due diligence of SPAC merger target company).



Current Trends

■ Investment Debacles

– Legal & Practical Issues

- **Know Your Partners:** While investing outside of traditional public companies or funds can be lucrative, know your partners. See *Metro Storage Int'l LLC v. Harron*, 275 A.3d 810 (Del. Ch. 2022) (family office investment into cold storage business implicated in usurpation of corporate opportunity claim); *United States v. Greebel*, No. 15-CR-637, 2018 WL 3900496 (E.D.N.Y. Aug. 14, 2018), *aff'd*, 782 F. App'x 72 (2d Cir. 2019) (discussing family office direct investments in private company alongside “Pharma Bro” Martin Shkreli).



Current Trends

■ Increased Regulatory Scrutiny

– Changing Rules

- U.S. Financial Crimes Enforcement Network (FinCen) issued new rules in September implementing the Corporate Transparency Act that may impact family offices that have traditionally obscured the beneficial ownership of their assets or used complex entity structures to avoid taxation.
- The new rule comes into effect on Jan. 1, 2024. See 31 C.F.R. § 1010.



Current Trends

■ Increased Regulatory Scrutiny

– Possible New Legislation

- Following the high-profile collapse of Archegos Capital, Congress has considered a number of changes to the regulatory treatment of family offices, including a bill that would have repealed the “Family Office Rule” that exempts them from being regulated under the Investment Advisers Act of 1940. See H.R. 4620, 117th Cong. (2021).
- None of these proposals has yet been enacted.



Current Trends

■ Increasing Formality

– Corporate Governance & Controls

- Although sophisticated investors, small shareholder groups can lead to informal corporate governance.
- Inadequate controls combined with placing trust in the wrong employee can lead to shocking results. See *Agnelli v. Lennox Miami Corp.*, No. 20-22800-CIV, 2022 WL 2788875, at *1 (S.D. Fla. July 15, 2022) (case involving financial fraud against Argentinian family office that continued for years).
- “But, as is often the case, when you trust someone blindly, you end up being robbed blind.” *Id.*



Current Trends

■ Philanthropy

– Family Foundations & Conflict

- Often families use a charitable vehicle, such as a family foundation, as a family office vehicle. However, making the family office a charity does not exempt it from conflict.
- An example of this issue can be seen in the dispute between the Newman's Own Foundation and the two daughters of the late actor Paul Newman. See *Susan Kendall Newman v. Newman's Own Foundation*, Case No. FST-CV22-6058968-S (Conn. Sup. Ct. 2022).



Current Trends

■ The Long Tail

- Family Offices Must Take The Long View
 - The time horizon for multi-generational family enterprises like family offices is uncommonly long. Decisions made decades ago can have an outsized impact.
 - A good example of this can be found in a recent series of decisions from the District of Delaware interpreting a trust established for the household staff on a DuPont family member. *See, e.g., Wright v. Elton Corp.*, No. 17-CV-286, 2022 WL 911395 (D. Del. Mar. 29, 2022).





Best Practices

Best Practices

- **Recognize That It Is Family First**
 - Family Dynamics Cannot Be Ignored
 - In family offices—or any family enterprise—business considerations will always take a back seat to family considerations at the end of the day.
 - Executives and advisors working with these enterprises will find that even the best-laid plans can be overtaken by family events.
 - As a result, only shared goals belong in a shared framework like a family office, and family offices need a process for determining what stays in and what stays out in terms of goals for the shared enterprise.



Best Practices

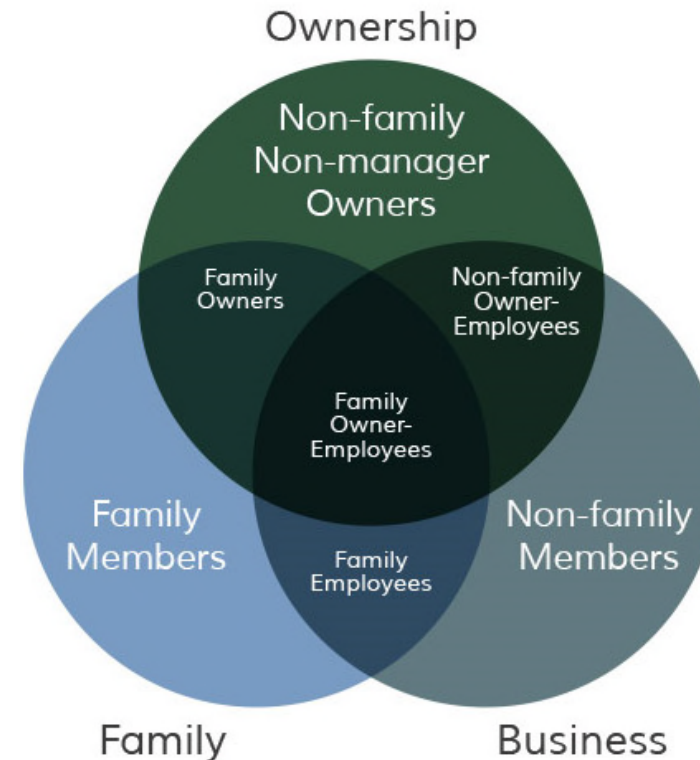
- **Build Governance Structures**
 - A Framework For Shared Decisions
 - To address the many issues facing a family enterprise, a framework is needed for joint decision-making.
 - This framework should be grounded in shared values, a shared purpose, and a collective vision for the future.
 - A common “miss” for family enterprises is failing to tie the legal governance of the organization to its family governance
 - This is especially problematic when a dispute arises because shared understandings may or may not be enforceable in court.



Best Practices

■ Build Governance Structures

- Understanding Family Dynamics
 - The three-circle model is a common expression of the dynamics present in family enterprises
 - Created by Renato Tagiuri and John Davis at Harvard Business School, the model is a tool for explaining the roles, issues, and tensions in family business systems.
 - The model is a good starting point for understanding how decision-making should be structured in family office.



Best Practices

- **Leverage Structures for Communication**
 - Shared Decision-Making Requires Clarity
 - Once there is a structure for joint decision-making among family members, it needs to be used.
 - Many of the key missteps and issues described in the trends can be avoided through family engagement and communication.
 - The structure should help defuse any potentially explosive conversations, and if it isn't going to then you have the wrong structure.



Best Practices

- **Professionalize Where Appropriate**
 - **Wielding The Double Edged Sword**
 - Deciding where and when to hire non-family members as executives, engage outside advisors, and leverage outside resources is a critical juncture.
 - Outside advisors cannot do the hard work of building family engagement and making shared decisions, but can help with structure.
 - Be cautious about treating the family like a threat rather than an opportunity, as it can de-motivate the next generation.



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