



# Compensating the CEO of a Single Family Office

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As a family member responsible for a single family office, assume you have just hired the ideal candidate to be the CEO – he or she is smart, personable, with great communication skills and with the background and maturity to manage all the multiple issues that can arise in operating the SFO. But the next challenge is how to motivate that person to stay for many years and to focus on the interests and goals of the family, while still protecting the interests of the family.

There are as many answers to this questions as there are family offices, but the purpose of this article is to briefly touch on some common ways to meet such a challenge.

### A. Employment Agreement

Probably the first task is to negotiate a proper employment agreement, preferably before the individual is hired, which protects the CEO from arbitrary termination, properly defines the CEO's duties and compensation, and also protects the family through appropriate restrictive covenants and "golden handcuffs." Since a SFO is a unique environment where data regarding compensation and other matters for other families is not readily available, benchmarking proposed terms against information "on the outside" with public companies, and perhaps other professional service firms, becomes important. The essential ingredients of a well thought out employment agreement include the following:

1. **Duties.** The responsibilities of the CEO should be detailed and ideally a job description should be referred to and attached. Since the role of a CEO can vary greatly depending on the family's needs, this becomes important. The primary function may be money management, coordination of an existing staff, client services, education of the next generation, development and

implementation of a strategic plan, coordination of outside counsel and other advisors, or all of the above. Specifying the CEO's role in some detail makes it easier for the CEO to manage the family's expectations and makes it easier for the family to review performance. This section should also specify to whom the CEO reports, whether it be a Board, Trustees of family trusts or a senior family member. This insures proper communication of issues between management and the family.

2. **Term.** A term of two to three years would be typical. After confidence in the individual develops, it may be appropriate to add an "evergreen" clause which automatically renews the agreement for another year unless prior notice is given by either party.

3. **Salary.** This should certainly be negotiated before hiring the CEO, but should be specified in the formal agreement. It is often useful to secure the help of a compensation expert to "benchmark" the level of salary against comparable positions. Although it may be difficult to access data from other family offices, compensation levels of law firm partners, accounting firm principals, and managing directors in the investment world may be useful benchmarks, the choice being dependent the CEO's job description and the nature of the CEO's principal functions. It should also be recognized that these may evolve over time and some adjustment may be necessary to reflect changes in these responsibilities.

4. **Bonus.** An annual bonus, based on performance, is common. The danger with it is that, once paid, it is often viewed as a matter of right by the CEO in the family context. This effect can be modified by deferring the payment of the bonus and conditioning it upon meeting certain,

such as continued employment for a period of time, or other important family office goals. Legal expertise is often needed here because of the complex rules of Section 409A of the Internal Revenue Code which constrain flexibility in these arrangements and result in 20% excise taxes, penalties and current taxation if the deferral is designed incorrectly.

Bonuses designed as long term incentives have similar deferral issues and are more complex in design and scope and often are not contained in detail in the employment agreement itself. The types of arrangements that are often considered by family offices are described in more detail in Section B below.

5. **Benefits.** Employment agreements usually contain reference to having its CEO participate in customary medical and life insurance plans, and long-term disability programs also seem to be of interest. In addition, there are special medical programs available to families of means who travel a great deal, providing worldwide coverage and coordination of medical care, but these are expensive and often not necessary or desirable for the CEO.



Regarding pension arrangements, surveys have shown that a significant majority of family offices have 401k plans for the CEO and staff, and most of them provide for a 100% matching contribution by the employer. Typically, where the staff of the family office is small, for example, under 20 people, it makes sense to establish a prototype (standard) arrangement with a mutual fund sponsor or an insurance carrier to save ongoing compliance and administrative costs.

Since a typical 401k plan will usually give a CEO with 20 years of service a retirement income of only 30% - 40% of final pay, it is often useful to consider establishing a SERP (supplemental executive retirement plan) which is an unfunded contractual arrangement to pay the difference between what the 401k plan rules allow and what is the desired target level of benefit. For family offices who hire experienced and older CEOs who already have a pension from a prior employer, this may not be necessary, or at least the SERP benefit could be offset by the previous employer's benefit. Again, counsel should be consulted here to be sure the design of the arrangement complies with Section 409A of the Code.

6. **Severance.** The heart of any employment agreement is usually the severance provisions, designed to encourage the executive to take the job, and to protect the executive from a termination without cause. No severance should be paid in the event of a termination for cause or resulting from a voluntary resignation, often called a "bad leaver" termination. A properly designed severance arrangement protects the family by discouraging improper behavior because no severance would be paid upon bad leaver terminations - such as terminations for

cause, constitute “cause” producing no severance upon termination. In addition, consistent with recent trends in the public company world in response to the global financial crisis, it may also be appropriate to have “clawback” provisions which provide for a mandate to return severance paid out in the event of a post-termination violation of these covenants by the CEO.

### B. Incentive Pay

If designed correctly, an incentive pay program can encourage long term employment by the CEO and key members of family office management, and by focusing behavior on achieving targeted goals. It can also create a productive relationship. The practical difficulty faced by families establishing a family office for the first time, and hiring a CEO to run the new office, is that proper design may be an evolving process, that needs input from the CEO in order to be successful. In addition, a family establishing a new office may need to be clear about the mission of the office and its near term goals in order to properly design an incentive program which will accomplish those goals. While this is possible to do with the help of outside advisors in advance of hiring the CEO and other management, the input of the CEO and key staff members can often be valuable in making sure the design properly motivates them.



Regardless of the timing of the establishment of the incentive program, family offices often have common goals which impact on the design of incentive pay. Although there are great variations here, some typical goals are the following:

#### 1. Wealth Management and Preservation.

Probably one of the most common goals, this lends itself to objective measures of performance, with a greater effect on CEO pay as his or her direct level of involvement increases. Some family offices outsource all investment management functions, leaving the CEO with the role of monitoring the managers’ performance, reporting to the family periodically on that performance, sourcing other opportunities, and orchestrating changes in investment personnel when needed. In such a case, incentive pay would be more based upon subjective decisions about the CEO’s skills in managing the managers, than on an objective formula based on investment return. The reverse would be the case where the CEO was brought in to have a direct role in investment management, alternative investment selection, and the like. In this case, a more objective approach to incentive pay would make sense, whereby a cash bonus could be based upon the investment returns of the funds managed by the CEO, over a period of time. Alternatively, for a CEO with disposable assets,, the family could allow co-investment by the CEO of the CEO’s own funds with those of the family, assuring a community of interest in the investment results of the co-mingled funds

#### 2. Management of a Family Owned Company.

Where the family owns its own business, the CEO’s role may be a mandate to take a hands-on approach to running the business and making it profitable. Here also an objective approach to incentive pay could work, where a bonus might

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be based upon a targeted rate of profitability of the business,, or perhaps the increase in equity value of the business, over time. In case of the latter, a phantom stock plan could be established where units awarded to the CEO would pay out in cash based upon the growth in the book value of the equity of the business owned by the family. Or, if the family were not concerned about equity dilution, actual shares could be awarded to the CEO, with buy-back rights on termination, but this can get complex and repurchase obligations can adversely effect the liquidity of the company. Cash programs are always easier to manage and have fewer legal issues than stock programs.

**3. Sale of Property or Business.** Often a family will be interested in the liquidity of different generations and a consensus will develop regarding the need to sell off a family business, or perhaps significant real estate holdings. Both of these events are major events which require a tremendous commitment of time and effort by the CEO and the office management team. One incentive approach here would be to establish a cash incentive plan, where the reward is based upon a percentage of the consideration received in the sale. In this way, the CEO's interest is aligned with the family in trying to maximize the sale price. If timing is an issue, an additional amount could be awarded for an early closing. The danger in bonuses paid for this type of large transaction is that the CEO (or other office personnel) receiving large sums of money on closing could lose their incentive to remain employed. One easy way to handle this is through a "golden handcuff" arrangement, whereby the bonus is deferred, and paid at retirement after a stated age (say, 60), or where the bonus is paid in increments over time, in both cases with a forfeiture of unpaid amounts in the event of an early resignation or a termination for cause.

Such provisions are very effective in motivating a CEO to remain employed. Again, care should be taken to insure that the deferral arrangements comply with Section 409A of the Code.

**4. Deferred Compensation.** Whenever a deferred compensation plan is established for bonus compensation, consideration should be given to awarding hypothetical earnings on deferred amounts, so that the executive is compensated for the delay in the use of the funds. The simple way to do this is to apply a simple interest factor to the deferrals. In the family office context, however, it sometimes makes sense to provide that the hypothetical earnings will track a private equity portfolio of the family. In that way, the CEO can "share," in a manner of speaking, in the returns of the family on their private investments, without requiring an actual "co-investments" approach. One complication with this arises when a "rabbi" trust is set up with a financial institution to secure the eventual payments of the deferred compensation at a later date. The trust is an excellent idea to secure the payment, but the financial institution will often not be able to "shadow" the investment return of the family's investments with actual funds, since it will often be ineligible, or unwilling, to so invest. The result will be that the actual funds available in the trust may be less than the deferrals plus the agreed upon hypothetical return, resulting in a shortfall. This can be solved by a periodic "top up" of funds in the trust by the family office.



5. **Quality of Service.** One of the most common goals to be addressed by incentive compensation in a family office is setting the quality of service expected of the CEO and the office staff. Some areas in which this is particularly important include the following:

- a. Financial Planning – providing budgeting and cash flow advice to multiple generations who may have differing needs, perspectives and goals.
- b. Accounting Services – providing timely accounting services including all tax returns and estimates and IRS and Department of Labor forms for household employees.
- c. Philanthropy – setting strategic goals for philanthropy for each generation, managing the process, and educating the younger generation.
- d. Communication – being able to communicate regularly and effectively with multiple generations on matters involving the family and the office – being trusted, respected, and (hopefully) liked, by all.
- e. Concierge Services - Arranging for travel, major purchases and other special lifestyle needs.

All of the above may be part of the CEO's duties, but it is clear that judging performance in these matters is subjective. Also, performance in these areas lends itself to an annual review approach, consequently it is probably best if a discretionary annual bonus be used to reward performance in these areas. Of course, deferred arrangements described above can be established here as well, but often on a voluntary basis at the election of the CEO. In this case, except for special rules which apply to new plans, the election to defer should be set up in the year before the year in which the amounts are earned, in order to comply with the rules under Section 409A of the Code.

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A family office is a unique environment with unique challenges for a CEO. Designing a proper employment agreement with appropriate incentive pay arrangements can go a long way towards insuring that the relationship between the CEO and the family is a long and happy one.

**FOA Newsletter Guest Columnist**

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