Good Governance - Key to Family Business Success and Succession

Prepared by:
Janet Fierman

SHEEHAN PHINNEY BASS + GREEN PA
the business law firm

LORMAN EDUCATION SERVICES

October 2015

INTRODUCING

Lorman's New Approach to Continuing Education

ALL-ACCESS PASS

The All-Access Pass grants you UNLIMITED access to Lorman's ever-growing library of training resources:

- ☑ **Unlimited Live Webinars** - 60-90 live webinars added every month
- ☑ **Unlimited OnDemand and MP3 Downloads** - Over 1,000 courses available
- ☑ **Videos** - Just released
- ☑ **Slide Decks** - More than 700 available
- ☑ White Papers
- ☑ Reports
- ☑ Articles
- ☑ ... and much more!

Join the thousands of other pass-holders that have already trusted us for their professional development by choosing the All-Access Pass.

Get Your All-Access Pass Today!

SAVE 20%

Learn more: www.lorman.com/pass/?s=special20

Use Discount Code Q7014393 and Priority Code 18536 to receive the 20% AAP discount.

*Discount cannot be combined with any other discounts.

Janet B. Fierman
Direct dial: 617.897.5648
Fax: 617.439.9363
jfierman@sheehan.com

Practice Areas

Business Formation and Succession Planning

Good Company

Good Governance - Key to Family Business Success and Succession

Friday, May 04, 2012

New laws and public discussion have focused on governance of publicly owned companies in recent years. However, most companies are privately owned and families control a large portion of privately owned companies throughout the United States – including some very large ones. Family owned companies require governance systems which: (1) support management of the family business in its short and long-term business goals; (2) assist the family business in addressing the diverse interests of its shareholders and stakeholders, present and future; and (3) establish a structure for family business succession planning that addresses the needs of the family business, its management and its various stakeholders.

1. Governance is the System by which a Company Manages its Business

Governance, at its broadest level, is the system by which a group manages its affairs. Generally the "affairs" of a corporation are the strategic planning, management and operation of the company business. Its "group" includes the corporation's shareholders, management and workers, tied together by the business of the corporation. State statutes establish legal parameters for the formation and dissolution of the corporation as well as the rights and duties of its directors, officers and shareholders.

Within the statutory framework, the corporation's founders and owners create governance documents. The Articles of Incorporation are a public document, required by law, that may establish the corporate purpose, form(s) of ownership, restrictions on transfer of ownership interests, fiscal year and, to some extent, capitalization. They name the initial officers and directors. Corporate by-laws define the functions, responsibilities and, to some extent, rights of shareholders, directors and officers. Typically, the corporation's shareholders elect a Board of Directors that owes a duty to the corporation to provide overall business strategy, oversight, continuity, recommendations on major decisions and special skills that benefit the business. The Board of Directors generally appoints the officers who operate the corporation's business.

Owners can and should add to the statutory framework through Shareholder Agreements (and related agreements), focusing on rights, obligations and rules applicable to major corporate decisions such as sale of the business, to stressful corporate situations such as shareholder death, disability or disagreement, and to transfer of shareholder interests in the corporation. Owners also, by agreement, can change the method of selecting directors or officers and/or limit the authority of directors and officers.

2. Family Owned Companies Have Intertwined Business and Family Interests

Family owned companies also start with Articles of Organization, By-Laws and, sometimes, Shareholder Agreements or, in the case of limited liability companies, LLC Member Agreements. However, the "group" is tied by family relationships as well as business relationships. It includes family members who work in the business and those that do not; existing family members, their predecessors and family members not yet born; people who become members by marriage (past, present and future), some of whom may work in the family business and some of whom do not. The "group" often includes trusts and other estate planning entities. These relationships add complexity and emotion to business decisions and stressful business situations.

Family ties can add strength to the family business, for example enabling the business to take a long-term view of investment returns. They can add strength to the family itself by, for example, supporting business ventures of the next generation or providing for a disabled family member. However, family ties also can negatively impact the family business if family feuds are perpetuated in the business arena or emotion is allowed to guide major decisions.

Family business "affairs" typically extend beyond the family business itself to include management of the family assets, both within the family business and outside the family business, tax and estate planning, and, often, charitable giving. Too often governance documents for family owned companies fail to take these aspects of the family business into consideration, creating serious and sometimes disastrous tax or succession issues.

Whatever the family relationships, success of the family business is almost always in the financial interests of all family members. This business tie should promote family consensus in the business arena, emphasizing the positive aspects of family ties, if the family dynamics are addressed separately.

3. Family Agreements Express Consensus on Family Business Decision Making Processes

Participation by all family business owners in the operation of the family owned company is unrealistic and interferes with business success. Participation by all family stakeholders in family business decision making also interferes with the success of the family owned company. However, it is both realistic and helpful to obtain the consent, if not the agreement, of family stakeholders to processes for such decision making as well as resolution of objections to decisions, and to bind family business owners to those processes.

The process of achieving family consensus incorporates many of the features of mediation of legal disputes and often takes place in the context of legal disputes among family members. The expense and publicity of family business disputes is a helpful tool in encouraging consensus to decision making and dispute resolution processes. The decades-long Demoulas litigation is a useful example of what family businesses want to avoid. It is preferable that the process first take place during the lifetime of the founder of the family owned company since the founder sets the initial culture, values and vision of the family business, all relevant factors to the family business. In any case, the process, as with mediation, should include a full airing of issues and look for areas of agreement (as well as disagreement).

Family business consensus building should also look for areas of shared values (business, family, personal, community, charitable), goals for the family business (from perpetual life to orderly liquidation) and ways for differences in values and goals to be addressed. A broad view of family business affairs can provide a useful vehicle in achieving consent to limiting family member involvement in the family owned business, for example. A family member may find it easier to give up power in the family owned company if (s)he has a significant role in the family's charitable giving. The family agreement should identify and address the interests of all stakeholders who potentially have significant influence on business owner decisions (spouses of family members, for example). Soliciting input from such stakeholders need not provide them with any decision making authority, but the open exchange is likely to result in fully informed decision making and consent to decisions on which unanimous agreement is lacking.

As with mediation, the process should result in a written agreement among the participants, outlining rules of the road. If possible, periodic family meetings or gatherings help maintain consent to the established family processes. The family agreement should:

- separate governance of the family business from governance of other family affairs,
- establish an agreed upon system for decision making in the family owned company, clearly identifying
  - decisions which do and do not require approval by family owners
  - reporting requirements
  - system for informing and receiving input from family owners,
- establish guidelines for stakeholder participation in the family business affairs, both presently and in future generations;
- establish rules for transfers of ownership interests in the family business, including
  - corporate and/or family rights of first refusal,
  - corporate and/or family rights to purchase the interest on death, disability
  - family policy on in-law participation, ownership
  - valuation methods for intra-family interest purchases/sales and
  - estate planning considerations

Such an agreement goes a long way to promoting family harmony and should not be amended lightly or frequently.

4. Independent Advisors are Important to the Long Term Success of Family Owned Companies

Well selected independent business advisors are helpful to any privately owned company. Independent directors provide industry information, specific business skills and knowledge as well as the distance to dispassionately assess major business issues, opportunities and decisions.

In family owned companies, independent advisors are particularly important. They facilitate communication between management and ownership on business operations, performance, transparency, accountability and transfer of ownership or control. Thus they create and add to the mutual confidence between owners who are not employed in the family business and the company’s management. Outsiders also are more likely than family to be able to dispassionately assess the business related abilities of various members of the family, including members of the younger generation.

Families that control businesses, however, often are reluctant to open up decision making to outsiders. Outsiders’ input may be difficult to hear or misinterpreted as criticism. However, if all family members benefit from the family owned company, on some level all family members understand that good business decision making benefits them all. Incorporating outsiders improves decisions making.

There are many ways for family businesses to include independent advisors in their decision making. Most family agreements create standing advisory boards which include outsiders. Some set up advisory boards for specific tasks, such as reorganization, improving business performance, modernization, transition to independent management, sale of a business or a set of assets. Some set up standing boards of independent advisors with valuable areas of expertise, to which they delegate some powers (with clearly delineated limits). Some create standing boards with independent advisers and family members selected by the family at large. The agreement decides whether the family members may or must include family employees of the family owned company. Independent advisors may play a role in family dispute resolution, as the independent members are knowledgeable about both the family business and the family.

5. Conclusion

Family owned companies which survive from generation to generation generally operate, implicitly or explicitly, on stewardship principles: that is, a system of responsible planning and management of the family business now and in the future for the long-term benefit of the collective family group. That system ensures both the short-term and long-term success of the family owned company.