



PROGRAM MATERIALS

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## Family Business Succession Planning in Nine (Silo-Busting) Steps

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Dr. Sharon Meit Abrahams is a legal talent development expert with over 25 years of experience in success coaching for attorneys and executing high impact programs for law firms. She has created and implemented firm wide initiatives that help attorneys maximize their productivity while maintaining engagement. When individuals produce, a firm increases its profitability. As a talent development leader, she has handled every aspect of an attorney's firm life from onboarding and integration, through mentoring and training to succession planning and exit interviews.

Dr. Abrahams has published three books with the American Bar Association and regularly publishes articles for Thomson Reuters and American Legal Media. Known for engaging and educational programs, Dr. Abrahams is a sought-after keynote speaker, program facilitator and law firm advisor.

Bringing CLE topics to law firms, legal associations and law firm networks is a labor of love. Reach out to see what Legal Talent Advisors can do for you.

**SPEAKER**



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Gregory F. Monday is a shareholder in Reinhart's Corporate Law and Trusts and Estates practices. His primary focus is family business law. His practice includes:

- Governance and management of private companies and charitable entities
- Succession planning for family businesses
- Estate planning and trust administration

Greg has also taught business law classes as an adjunct professor at the University of Wisconsin Law School. His law degree and B.A. are from the University of Wisconsin. He is admitted to the Wisconsin Bar.

Greg primarily specializes in the following industries

- Business Counseling
- Corporate Governance and Investor Relations Services
- Succession Planning and Exit Strategies
- Estate Planning for Individuals
- Fiduciary Litigation
- Tax-Exempt Organizations
- Securities
- Family Offices

[COMPANY NAME]  
FAMILY BUSINESS SUCCESSION PLANNING

The following is an outline of the projects that will create a coordinated succession plan for [Company Name] (“Company”), as ownership and leadership pass from the senior generation of the [Family Name] family (“G1 Owner” and “G1 Spouse”) to their children (G2A, G2B, and G2C), who are currently involved in Company operations. The projects below are listed in sequential order:

1. Collecting Information.

Before we begin to design a succession plan, the advisor team needs to review copies of current business governing documents, related-party contracts, and estate-planning documents that might affect governance, ownership, or succession of Company and the family real estate holdings. We also need to review the most recent statements or estimates of value for Company and the real estate, as well as a personal financial statement for G1 Owner and G1 Spouse. (We will not share or disclose any part of G1 Owner and G1 Spouse’s estate planning or net worth information with any other family members except as they authorize us to do so.)

In summary, we would like to review onsite or receive electronic copies of the documents listed on Schedule A to this outline.

2. Valuation. Proper succession planning requires a reliable valuation of company stock, when planning commences and throughout the term of family ownership. **G1 Owner and G1 Spouse will look into obtaining a reliable valuation of Company** to assist us with succession planning and estate planning. The valuation professional can also help us draft valuation language in the shareholders’ agreement that will control future transfers of Company stock. Thereafter, Company should obtain an updated opinion of value on a regular basis (such as every two years). The valuation process may have the added benefit of providing management with insight about which elements of Company’s business or operations tend to increase value and which (if any) may be suppressing value, from a market perspective.
3. Business Continuation Plan. Currently, G1 Owner is the CEO of Company, chairman of the board, and the controlling shareholder. His sudden death or incapacity would be substantially disruptive to Company’s operations, which could impair Company’s profitability and value. Therefore, we will help Company install mechanisms that would be triggered by G1 Owner’s death or incapacity, if it occurs before governance succession can be commenced in the normal course. We have discussed the utility of having a functioning board of directors to govern Company in the event of a disruption of executive leadership (and this will be addressed in the paragraph on Governance, below). G1 Owner should clearly designate who should vote his stock if he is unable, and he should have a plan, under seal, about successor or interim executive leadership if

Company loses his services temporarily or permanently. **We will provide a template for a Business Continuation Plan and assist in preparing any documents, such as powers of attorney, that may be needed to make it effective.**

4. Business Restructuring. After we review the existing business documents and obtain input regarding business valuation, we will work with Company's accountants to help determine whether the business should be restructured or reorganized. It may be that making changes to the legal structure or tax treatment of the components of the business will facilitate succession planning. For example, it may be easier to plan transitions of ownership if the primary source of cash flow is taxed as a partnership rather than a C corporation, or if the real estate assets are held in entities that are separate from primary operations. We will work with Company's accountants to make sure that any restructuring will be tax efficient (including income taxes and transfer taxes). We will take into account other advantages of restructuring, such as limitation of liability, operational efficiencies, and diversifying ownership opportunities for family members. We also will help make plans for how new ventures will be added to the structure in the future.
5. Current and Future Governance, Ownership, and Exit Mechanisms. Before we consider lifetime transfers of stock or update G1 Owner and G1 Spouse's estate plan with respect to the allocation of stock among their children, we need to determine how Company should be managed currently and in the next generation. This includes four topics, which can be addressed in Company's governing documents and an agreement among the shareholders:
  - a. Share Voting—Power to appoint the board and approve major transactions. It may be desirable to create a class of nonvoting shares to make it easier to allocate voting rights among future owners.
    - i. Now. For now, G1 Owner controls the voting stock. He needs to designate (consistent with the Business Continuation Plan, above) the person or persons having authority to vote his shares in the event of his death or incapacity.
    - ii. Future. For succession planning, the family should consider how the voting shares should be allocated in the next generation. In some cases, voting shares can be held in trust, to be voted by a fiduciary or a committee of fiduciaries. Company's governing documents can enlarge or otherwise redefine shareholder voting powers.
  - b. Board of Directors—Power to appoint and remove top executives and determine their compensation; power to issue dividends; and power to oversee budgets and long-range business planning, risk management, and strategic planning.
    - i. Now. G1 Owner and G1 Spouse are the sole directors, but they have indicated an interest in establishing an independent presence on Company's board. This could have many advantages, including benefits to

current operations, opportunity for next generation leaders to learn from a formal board, and governance strength and continuity in the event of a sudden loss of G1 Owner's leadership services. **We can make several suggestions for appropriate candidates. Also, we will provide some examples of a Board Matrix, which will help Company to identify an appropriate mix of talents to be present on the board.**

- ii. Future. For succession planning, the family should consider how the board should be composed and elected after G1 Owner and G1 Spouse cease to be involved. For example, it may be desirable to "classify" the board so that each substantial shareholder can have one or two seats on the board. Company governing documents can enlarge, restrict, or otherwise redefine board authority.
- c. Executive Authority—Power and responsibility to run the day-to-day business, hire and terminate staff, and develop budgets and plans for approval by the board of directors; power to sign checks and contracts, including loan agreements (within limits set by the board).
  - i. Current. It is anticipated that G1 Owner will continue to serve as CEO until he retires, phases out, or is unable to serve. Company continues to utilize the services of a non-family CFO and is working toward some redundancy or technical backup for that position. As long as G1 Owner is involved in company management, he can determine hiring, advancement, and compensation of family members. Any special relationships between Company and particular family members should be memorialized if they are to be continued/honored even after G1 Owner and G1 Spouse are no longer with Company (a point which is also addressed in the Business Continuation section, above). **We will prepare resolutions to formalize appointments of officers and executives to make sure that the Company record book is up to date.**
  - ii. Future. For succession planning, the family should decide upon rules that apply to family member employment in Company. If Company's board of directors includes independent directors, then Company can rely on a committee of the independent directors to make decisions about family-member employment, advancement, and compensation, consistent with the rules that the family drafts and agrees upon while G1 Owner and G1 Spouse are able to assist and guide them. It would be impossible to make decisions now about which family members will be assigned to particular leadership posts in the future; instead, Company's governing documents should be updated to create systems for addressing family employment in an equitable manner.
- d. Share Ownership—Gives the owner the right to receive profits and appreciation from business operations. (Note: If the shareholders are also key employees, they may receive most of their annual economic return in the form of compensation.)

The key questions are whether non-employee family members should own stock and whether stock should be held in trust (primarily to protect it from estate taxes, divorce of a shareholder, and claims of creditors).

- i. Now. G1 Owner owns all the stock. We can help Company split its stock into voting and nonvoting shares (1:99). G1 Owner and G1 Spouse are considering whether they should begin making gifts of nonvoting shares, primarily to give their children an even greater sense of engagement with the family business. (G1 Owner and G1 Spouse should consider making these gifts in trust, as discussed below in the section on “Lifetime Transfers”.)
- ii. Future. For succession planning, the family should agree on a new shareholders’ agreement that will restrict the ownership group and will provide mechanisms for owner exits that are fair to the exiting shareholder but are not disruptive to Company. It is our current understanding that G1 Owner and G1 Spouse would support a rule that requires owners to be active in the company, but only after each of their children has had a full opportunity to make a career choice after completing their advanced education and perhaps working outside Company for a period of years. One important element of the shareholders’ agreement will be to establish a mechanism for determining purchase price when family members buy stock or Company redeems a shareholder.

**We will review current Articles, Bylaws, and the Shareholders’ Agreement to suggest immediate changes and to frame up the discussion for changes that may be desirable for the succession plan.**

Although Company’s governing documents can provide the legal rules by which Company is governed and operated, the family should draft a family constitution, mission statements, and other policies that will guide decision makers when they apply the legal rules. The company’s legal documents cannot express the spirit and philosophy of the family as effectively as the principles that family members write in plain English and agree among one another to uphold. We can provide samples of such documents to assist with these important projects.

6. Key Contracts. We will help Company negotiate restatements of key contracts with third parties that should be (or must be) updated to be more consistent with business restructuring and anticipated changes of control or ownership. Such contracts include loan facilities and franchise/dealership agreements. The extent to which such contracts cannot be changed may affect decisions about how or when to implement other elements of the business succession plan.

The family should also consider whether written contracts for related-party transactions would make the succession plan more effective. Such contracts may include the following: leases between the operating business and family-owned entities that hold real estate or equipment used by the operating business; debt instruments for loans from

owners to the business; reimbursement/contribution agreements among the business and the owners who have personally guaranteed business debt; and employment agreements for family members who work for the business.

7. Update G1 Owner and G1 Spouse's Estate Plan. After the family has reached consensus on future ownership and governance structures, we can update G1 Owner and G1 Spouse's estate plan to be consistent with such structures. In particular, we should consider whether Company stock should be held in trust for family members who own stock, to protect ownership and keep it in the family. Under recent changes to Wisconsin trust laws, it would be possible to hold each child's stock in trust, but allow the child to vote the stock as though he or she owned it outright.
8. Plan for G1 Owner and G1 Spouse's Resources in Retirement. Before we work on more substantial transfers of stock from G1 Owner and G1 Spouse to the children (or trusts for them), we should determine G1 Owner and G1 Spouse's needs in retirement and make sure that mechanisms are put in place to address those needs (preferably without regard to the success of Company after G1 Owner has retired or transferred his ownership to the next generation). This will require the assistance of G1 Owner and G1 Spouse's financial advisors.
9. Consider Lifetime Transfers to the Next Generation (by gift or sale). After we understand how Company would be owned and governed by the next generation and after we are sure that G1 Owner and G1 Spouse will be secure in their retirement, we can consider the possibility of more immediate transfers of stock to the next generation (by gift or sale), to reduce the potential estate tax burden that might otherwise be imposed on the value of the stock when G1 Owner and G1 Spouse die. In addition, each time a new investment or growth opportunity arises for Company or the family, such as development of real estate, we should consider whether the venture should be owned by the children to keep future income and appreciation out of G1 Owner and G1 Spouse's taxable estate.



SCHEDULE A  
Request for Documents and Information  
for Business Succession Planning.

Please provide us with access to or electronic copies of the following:

**a. Key Individuals and Entities.**

- i. Key advisors, with contact information, including accountants, investment advisors, insurance advisors, business valuation or asset appraisal professionals; and other important financial service providers, such as primary banking relationship, corporate trustees, or outsourced retirement plan administrator.
- ii. Family tree, showing the business owners and their offspring.
- iii. Organizational chart showing the entities that constitute the family business, including how each business is taxed (e.g., C corporation, S corporation, partnership).
- iv. Governing board members and key executives, such as general counsel, CFO, controller, and family-member employees.

**b. Business Governing Documents.** For each business entity, the following documents (including amendments):

- i. Articles of Incorporation/Organization
- ii. Bylaws
- iii. Shareholders' Agreement/Operating Agreement
- iv. Voting Agreements or Voting Trusts
- v. Table of current ownership

**c. Related-Party Contracts.**

- i. Leases or other agreements between one family business entity and any other family business entity
- ii. Employment contracts with family members
- iii. Any deferred compensation or other nonqualified retirement benefit contract between the business and a family member
- iv. Any personal guaranties of business debt (and related business loan facilities)



**d. Estate-Planning Documents.** For the owners, the following documents:

- i. Wills
- ii. Revocable Trust or Trusts
- iii. Irrevocable Trust or Trusts (if any) (whether they are the grantors or the beneficiaries)
- iv. Marital Property Agreement (if any)
- v. Powers of Attorney for Health Care
- vi. Powers of Attorney for Financial Matters
- vii. Estate-Planning Flowchart (if any)
- viii. Most recent gift tax returns

**e. Business/Asset Valuation.**

- i. Most recent formal or informal valuation of the business or its component companies
- ii. Most recent indication of value of business or farm real estate (and statement of balance of any mortgage debt)
- iii. All loan facilities for substantial business debt and related security

**f. Owner Financials.**

- i. Statement of assets and liabilities (including face values of any life insurance)
- ii. Summaries of retirement plan assets and benefits, including social security, deferred comp, and any pensions for owners
- iii. All contracts of insurance on the lives of owners including policy owner, beneficiary designations, pledges or assignments, and in force illustrations

**g. Family Governance Documents.**

- i. Family Constitution, family mission statement, family employment policy, family council charter
- ii. Family (charitable) foundation documents, donor-advised fund account statements, or other collective charitable giving information

# **FAMILY BUSINESS SUCCESSION PLANNING IN NINE SILO-BUSTING STEPS**

**Celesq® Attorneys Ed Center  
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## **I. INTRODUCTION: OVERVIEW**

### **A. BENEFITS OF GOOD FAMILY BUSINESS GOVERNANCE SYSTEMS**

**Good family business governance provides value now . . .**

Better governed businesses have higher operating performance, higher valuations, and pay out more cash to their shareholders.

**. . . And in future generations**

Better governed businesses have longer lives and are more likely to survive leadership transitions and ownership succession events.

### **B. RISKS OF AD HOC, UNCERTAIN FAMILY BUSINESS GOVERNANCE**

Businesses with ad hoc or uncertain governance systems may be too reactive, too dependent on current leaders, and susceptible to litigation among owners during leadership transitions or after ownership succession events.

### **C. KEYS TO IMPLEMENTATION**

Implementing good governance systems requires coordination among:

- ▶ governing documents for each company in the family business;
- ▶ contracts for related-party transactions; and
- ▶ estate plans for senior owners and their successors.

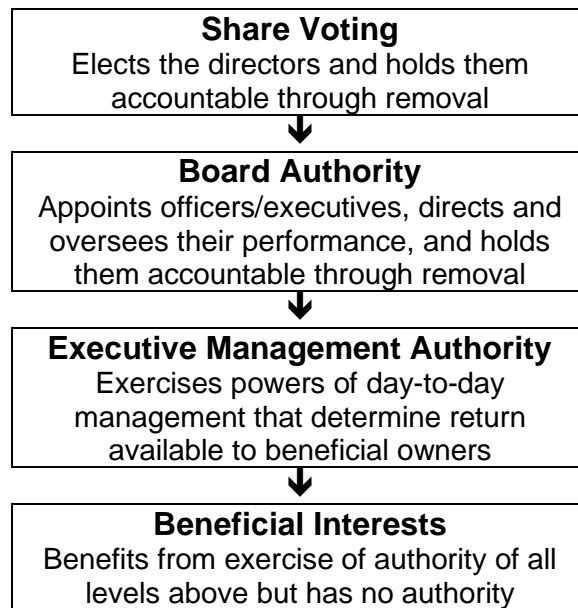
## II. DEFINING THE FAMILY BUSINESS

To create a proper family business governance structure and succession plan, first identify all the companies and ventures that compose the family business. Often the family business includes a primary company, plus one or more affiliates that provide goods or services to the primary company, as well as real estate or investment holding companies. It is always helpful to have a graphic organizational chart that identifies each of these entities, their ownership, and their economic relationships with one another. It may be desirable to reorganize these entities, their holdings, and their ownership to improve business governance or create better mechanisms for leadership and ownership succession.

## III. UNDERSTANDING LEVELS OF OWNERSHIP AND CONTROL

To establish an appropriate family business governance structure, it is essential to understand how ownership and control rights are formally allocated in applicable business law. It may be easiest to think of ownership and control in terms of "levels" because each set of rights and authority seems to be conferred by or dependent upon the set of rights and authority that precedes it.

### A graphic representation of control:



In the illustration of control, share voting is at the top and beneficial ownership is at the bottom, consistent with the flow of authority. In contrast, an illustration of economic interests might be inverted, consistent with the flow of economic benefit.

**A graphic illustration of economic interests:**



Summarized simplistically, a corporation is managed through a tiered system of checks and balances for the economic benefit of the relatively powerless beneficial owners. Other business entities, such as a limited liability company, may use a similar separation of powers in its governance structure.

**IV. NINE RECOMMENDATIONS FOR EFFECTIVE BUSINESS GOVERNANCE**

**ONE**

**Know the Owners' Objectives.**

A family business can provide four primary benefits to an owner:

- Cash flow (e.g., compensation, dividends, rent, interest)
- Wealth accumulation (through appreciation in value)
- Occupation/career
- Legacy

Governance systems should be tailored to serve the owners' priorities with respect to these benefits.

**TWO**

**Be Fair, Not Equal; Do What Makes Good Business Sense.**

When organizing, reorganizing, and growing a family business, and especially when planning for the succession of ownership from one generation to the next, the owners should be guided by sound business principles. They should adopt mechanisms that:

- allocate management authority to the best managers;
- compensate and incentivize managers at market rates;
- provide a reasonable return for the persons whose capital is at risk in the business (regardless of whether they earned or inherited that capital);
- allow owners a reasonable means of holding managers accountable; and
- provide an exit for the disgruntled or unworthy.

Karl Marx advocated, "From each according to his ability; to each according to his need." The family-owned company in America is not the place to test that theory, although many senior generation owners feel compelled to give it a try when planning for the succession of their business, and many nonmanagement, next-generation owners who otherwise would be staunch economic conservatives become wild-eyed communists when it comes to what they expect to receive from the family enterprise.

On the other hand, to paraphrase 19<sup>th</sup> century historian and moralist Lord Acton, "Power corrupts; absolute power corrupts absolutely." Family members who manage the family business may also be prone to an unreasonable sense of entitlement with respect to their interest in the business. Their compensation should be transparent and consistent with the market, and they should be held accountable by objective standards.

### **THREE**

#### **Use Checks and Balances**

The best model of governance for a family business may be one in which everyone is accountable to someone else—like staircases in an Escher drawing that each lead up to the bottom of another staircase, including the final one, which leads up to the bottom of the first one. This may not be a viable suggestion while the founder is active in the company, but may be a mechanism that can be worked into the succession plan. This requires attention to the company's charter and By-Laws/LLC agreement, and the senior generation's estate planning documents.

#### **1. Management Leadership**

The executives will run the day-to-day operations of the business. Executive hierarchy and each executive's authority can be set forth in the By-Laws, or it can be left to the discretion of the board of directors to be set forth in resolutions the board may issue from time to time. The authority of even the top executive

can be limited by the board, which may require some actions of the executives to be specifically approved in advance by the board. The board will also determine compensation of the top executives. Usually, the By-Laws will provide that the executives serve at the pleasure of the board, and thus can be removed with or without cause. However, the board can approve an employment contract that compensates an executive who is terminated without cause.

Although one advantage of family ownership of a company is that it can provide employment opportunities to family members, executive leadership should be reserved for individuals inside or outside of the family who are best suited to lead the company to success. The directors should be allowed to choose those individuals based on merit, and should actively and objectively review their performance. Family members who do serve as executives should be incentivized and rewarded, but should not be over-compensated. The directors also should maintain an updated plan to replace the top executive if he has to be replaced due to an unexpected event, such as death, disability, or wrongdoing.

## 2. Fiduciary Board

Founders and family members who are executives of a family business will often resist the idea of constituting and empowering a board of directors that has objectivity and authority. They do not want a board that will cramp their style or second-guess them. While the founder is serving as CEO and the ownership interests are "all in the family," the company may be able to succeed with the CEO serving also as sole director or with a rubber-stamp board of family members. However, that model usually does not translate well into the next generation of owners.

Requiring the board of directors to include independent outside members can have numerous advantages in the family business. With independent directors, the board can provide formal and objective oversight, experienced or expert advice, a means of approving insider transactions, and an internal mechanism for addressing owner concerns or resolving owner discord that family directors might only exacerbate.

The charter or By-Laws should set forth the number of independent directors required, their terms, and how they will be elected. It may be advisable to stagger the directors' terms to provide stability on the board from year to year. It may be desirable to classify board seats so that different lines of family members are each represented on the board by at least one independent

director, or it may be desirable to adopt cumulative voting so that minority owners can pool their votes to elect at least one director, notwithstanding the voting of owners with larger positions.

Even if the founder will not permit a functioning board to serve during his tenure as CEO, the owners should put in place documentation that will immediately install a functioning board in the event of the founder's exit. Such provisions can be worked into a shareholders' agreement or operating agreement, or they can be implemented by fiduciaries pursuant to directions in the founder's estate plan. In such cases, it may be wise for the founder to establish an advisory board of individuals who can be kept apprised of the company's activity and thus be prepared to serve as the company's fiduciary board upon the founder's unexpected exit.

### 3. Board Election and Oversight

The preceding section mentions some mechanisms to help allocate representation on the board of directors among the owners, such as classification of board seats or cumulative voting. In some cases, however, the family members who own (or may succeed to) ownership of the company may be too inexperienced, uninformed, or contentious to responsibly exercise shareholders' rights to vote for directors or hold the board accountable. (Note that in most jurisdictions, minority owners have no fiduciary duty to the company or the other owners with respect to how they exercise their voting rights or the other rights that accompany stock ownership.) In such cases, it may be necessary to insulate the company from the beneficial owner by allocating legal ownership to a fiduciary for the beneficial owner.

This issue can be addressed through trust ownership of the company stock or membership interest. A key decision in planning for such trusts is to determine who will have authority to vote the ownership interests and who will have authority to appoint, remove, and replace such persons. Often, corporate fiduciaries may be best at the ministerial duties of a trustee, but may be completely inadequate to exercise an owner's rights in a family business. In such cases, a "directed trust" may be the most appropriate approach. Under a "directed trust," the trustee's authority and discretion with respect to ownership in the family business is delegated to a special trustee or board of advisors who exercise all the trust's ownership rights, and even decide whether the interests should be held or liquidated.



#### 4. The Voice of Beneficial Owners

The terms of a directed trust (or other mechanism for delegating share voting control) will provide which beneficiaries or other persons can appoint, remove, and replace the agents or fiduciaries who are exercising the ownership rights on behalf of the beneficial owners. These provisions can mark another level of the structure of checks and balances in the company's governance. For example, if the ownership interests are held for a particularly large family group, the trust agreement may provide a means for beneficiaries to elect a family board that will have the right to appoint and oversee the fiduciaries under the trust.

Even if beneficial owners have no authority in the governance structure, it can be helpful to organize a family advisory counsel that occasionally meets with the company's management to receive information about the company's performance and express concerns of family members who otherwise are not involved in the company.

#### 5. Parents, Subsidiaries, and Affiliates

This system of checks and balances in company governance should be adapted to the whole structure of the family business, if it involves multiple companies. It is possible through global owner agreements or trust ownership to ensure that each component company in the business is consistently governed and that owners of component companies are treated fairly in fundamental transactions involving the business.

### **FOUR**

#### **Get It In Writing, including How It Can Be Changed.**

Too often family businesses neglect documentation of economic rights and understandings among family members and other insiders. The default statutory or common law rules that apply to these relationships rarely satisfy the expectations or intentions of the parties involved. Sometimes these unwritten understandings can be given effect by moral force of the senior generation, but often they become the subject of disputes after company interests pass to the next generation or to parties outside the family.

Therefore, all agreements and contracts affecting the economic rights and legal relationships of family members and other insiders with respect to the company should be documented in a writing that is signed by the parties, and contains express and appropriate

provisions about how they can be amended or revoked. Examples include the following:

1. Governing Documents

Corporation and LLC charters are always reduced to writing because they must be filed with the appropriate state agency to give the company legal existence; but a charter that meets the bare minimum standards for filing may not include some provisions that must be in the charter to be enforceable. Also, it is more difficult for the board or shareholders to unilaterally change the charter than to change the By-Laws under default rules.

Owners should not use off-the-rack charter forms or By-Laws. They should carefully consider which provisions should be in each of these documents and be very specific about how these documents can be changed. For example, a provision in the By-Laws requiring unanimous consent of shareholders to dissolve the company may be meaningless if a simple majority of shareholders can amend the By-Laws, including the liquidation provision.

2. Employment Agreements for Family Members

When family members are employed by the company, a written employment agreement can protect both the employee and the company. The agreement should be specific about their responsibilities, authority, compensation, and rights upon termination. Such agreements and any changes to such agreements should require approval of independent board members. A written employment agreement reduces opportunities for abuse by the employee and his proponents, and conversely reduces the risk of challenge or change by coalitions of other family members.

3. Other Insider Contracts

Other contracts for goods or services between the family business and individual family members or companies owned by them also should be in writing, such as leases, consulting arrangements, and supply or distributorship agreements. In particular, the terms of loans from family members or guaranties of third-party debt by family members should be clearly established in an enforceable written contract. If a family lender has a security interest, that interest should be perfected. If a family member has guaranteed a third-party loan to the company, his right to recover

from the company or other guarantors for any loss under the guaranty should be set forth in a written indemnification agreement.

## **FIVE**

### **Restrict the Ownership Group.**

In a family business, it is often desirable to keep ownership within the family until a formal decision is made, through appropriate governance mechanisms, to admit outside owners or investors. Buy-sell agreements with transfer restrictions, estate planning documents using trusts to own company interests, and prenuptial agreements for individual owners can all be important elements of maintaining control of the ownership group. It is important to prevent even a small portion of ownership interest from falling into the hands of an owner outside the approved group because of rights that minority owners may have to review books and records of the company, bring derivative lawsuits, veto changes to governing documents, and allege minority oppression—all without a corresponding fiduciary duty to the company or other owners.

With respect to estate planning, the senior generation should be realistic about whether their estate beneficiaries can all co-exist as owners of the company. If they probably cannot, the estate plan should put some focus on ways to strategically allocate estate assets to exclude company ownership from the shares of the estate passing to beneficiaries who will not be involved in the business. Depending on the proportion of family wealth represented by company interests, this may require aggressive planning to reduce the senior generation's federal estate tax liability, or creative alternatives for payment of that liability, such as through a redemption of estate interests or a loan from the company.<sup>1</sup> These liquidity needs might also be met through strategic use of life insurance.

## **SIX**

### **Preserve Exit Strategies.**

Some family members seem to thrive on conflict, but all parties are generally best served if owners can liquidate their interests when they want out, or the company can expel disgruntled owners who refuse to leave.

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<sup>1</sup> A unique arrangement called a "Graegin loan" allows the estate to take an estate tax deduction for the accumulated future interest on a loan to pay estate taxes, even if that interest will be paid to a company owned by some of the estate beneficiaries.

### 1. Avoid the Minority Veto

Sometimes, the owners of a family business may be best served to liquidate the company or accept a stock purchase offer from a third party. The company's governing documents and owners' agreements should contain provisions that allow the owners to proceed with such a transaction without concern that a small minority owner will be able to veto it. Provisions such as supermajority share voting for fundamental transactions and drag-along rights for stock or membership interest transfers can allow the family to exit for the full value of their interests.

### 2. Expel the Hecklers

Some minority owners are determined to find fault in everything company management does. Their carping is ill informed or based on family issues unrelated to business performance. Such malcontents can rattle management, stir up ill will among other owners, and cost the company unnecessary attorneys' and accountants' fees. For these cases, it is best that governing documents and owner agreements preserve a right of the majority to expel such owners. To discourage challenge, such provisions should allow the expelled owner to be redeemed at fair market value, determined by specific procedure set forth in the documents. The company should maintain a plan for producing the liquidity that such a redemption might require—for example through a sinking fund, an untapped line of credit, or capital contributions by other owners.

### 3. Special Exit Planning

The company and its owners should plan for exits under other special circumstances as well, such as retirement, death, or disability of an owner. In such cases, the exiting owner (or his estate) may need the liquidity more than other owners. Having liquidity available in such circumstances through insurance, nonqualified retirement plans, structured redemptions, or buyouts by insiders (including, if appropriate, an employee stock ownership plan) can avoid the difficulty of having an owner who is financially compromised.

## **SEVEN** **Always Know the Value.**

Many management and ownership decisions are dependent on the value of the business and its stock or other units of ownership. Because the business is not publicly traded, however, the managers and owners will not know the value unless management retains valuation

professionals to determine the value. The advantage of having a realistic estimate of value for purposes of succession planning, retirement planning, purchase options, put options, buyouts, compensation, performance evaluation, dividends, business planning, and many other business decisions and transactions far outweighs the cost of obtaining a valuation and keeping it current.

## **EIGHT**

### **Discourage Litigation.**

The threat of litigation, including derivative claims, can be a potent way for minority owners to harass management into compliance with unreasonable demands. However, company owners can adopt a number of strategies to neutralize this threat.

#### 1. Exculpate, Indemnify, and Insure Managers

The company's governing documents can expressly exculpate managers, directors, and officers for claims that do not involve breaches of loyalty or willful misconduct. Under the company's governing documents, the company also may indemnify managers, directors, and officers against losses, including attorneys' fees, that they incur as a result of such claims. Such provisions can set forth procedures by which the company can be required to advance indemnification and/or insure against such losses through directors and officers ("D&O") policies. Sometimes, the governing documents will provide general enabling language, and then more detailed provisions will be set out in employment agreements with executives and indemnification agreements with board members. D&O policies should be reviewed from time to time to make sure their terms are completely consistent with their purposes.

#### 2. Control the Derivative Power

Sometimes, the legal owner of stock or membership interests may have the right to bring a lawsuit derivatively (*i.e.*, on behalf of the company) if the board of directors refuses. Often the board itself and the officers are the target of such derivative litigation. Senior generation owners can control who will have this right in the next generation by controlling how ownership will be held. If stock or membership interests are held in a trust, then the trust fiduciary, not the beneficiary, holds any power to pursue derivative claims. Although a trust beneficiary might pressure the trust fiduciary to pursue derivative claims, the trust can be drafted to reduce the beneficiary's leverage in such matters, for example by directing the trustee not to pursue derivative claims absent direction

by a court or even by penalizing a beneficiary who commences litigation against the trustees.

#### **NINE**

#### **Require Alternative Dispute Resolution ("ADR").**

In some cases, owners of a family business may have legitimate disputes that cannot be resolved internally. However, it is possible to require the disputants to pursue an adjudicated resolution through private binding arbitration to hold down the expense of the dispute and prevent it from being dragged into a public venue. To be thoroughly effective, binding arbitration provisions should be included in virtually all agreements signed by family members with respect to the company, including stock subscription agreements, shareholders' agreements, LLC agreements, employment agreements, and other insider contracts. (It may even be possible to require binding arbitration in a trust agreement by use of a penalty clause for beneficiaries who do not comply.) Such provisions may require a good faith effort at mediation before the parties resort to arbitration. In any case, ADR provisions should not be treated as boilerplate. They should be carefully drafted to apply in all situations anticipated and to be enforceable without court construction. Such agreements can make protracted proceedings especially unattractive by allowing (or requiring) the arbitrator to award attorneys' fees to the prevailing party.

#### **V. CONCLUSION**

Family businesses are especially susceptible to the adverse effects of owner discord because the owners are engaged with one another on a strong emotional level, unrelated to the business. However, a tailored, systematic approach to company governance, insider transactions, and owner succession that includes the company's governing documents, transaction contracts, and owners' estate plans can reduce the impact that owner dysfunction can have on the operations and success of the business.