All in the Family:
Corporate Governance Issues Facing Family-Owned Businesses

by Fred D. Tannenbaum
Partner, Gould & Ratner LLP

The patriarch of an established successful family-owned business died and went to Heaven. At the gates to heaven, the patriarch asked God when there would be a family-owned business that was governed efficiently and in compliance with the rules on corporate governance. God thought for a moment and then replied, "not in my lifetime".

While an exaggeration, this story is intended to illustrate the fact that family-owned businesses are unique in many respects, perhaps the least of which is how they are governed. Tolstoy observed that all happy families are like one another and each unhappy family is unhappy in its own way. The same observation applies to the governance of family-owned businesses. This article delineates certain guiding principles to enable family-owned businesses to be governed in a like manner and be more like Tolstoy's happy family.

This subject deserves a treatise. In the confines of a few short pages, however, we will attempt to provide the reader with a broad overview of the many shoals and crevices through which a successful family-owned business must be navigated. We are focusing our attention on corporations, since many businesses take this form. Many of the principles set forth in this article should also apply to businesses operating in non-corporate form.

While the rules discussed below apply to the governance of all corporations, the uniqueness and complexities of family-owned businesses require greater focus and attention to this regulatory scheme. These rules may be fairly easy to state. Their application, however, is more of an art and not a science.

1. <u>Background: Why Family-Owned Businesses</u>? The family-owned business is the backbone of the U.S. economy. According to The Firm Family Institute, over 90% of all business enterprises in the U.S. are family-owned and 60% of all employees are in family-owned businesses. Family-owned businesses accounted for over 50% of our country's gross domestic product in 2000. Therefore, the proper governance of a family-owned business will lead to more successful businesses and a better and healthier economy.

Family-owned businesses will be discussed uniformly in this article. However, in reality, family-owned businesses defy easy categorization. However, family-owned businesses may generally take one of the following basic arrangements and most of the rules on corporate governance apply with equal force to each of these forms.

- Single family, one generation
- Single family, multiple generations
- Multiple families, one generation
- Multiple families, multiple generations

- All generations active in the business
- Some active/some passive
- None active
- Single Family/Managed by Non-Family-owned Members
- Multiple Families/Managed by Non-Family-owned Members
- Publicly-Traded Company owned in part by Founding Family
- Investments, controlling or otherwise, in several public companies

Statistically, only 30% of family-owned businesses survive one generation and pass the torch to succeeding generations. This phenomenon can be explained in part by observing that many businesses fail, whether or not they are family-owned businesses. The ability to adapt with the times, product and service obsolescence cycles, capital needs, management and succession uncertainties, ferocious competition, regression to the mean regarding luck, the innovator's dilemma, and the ability to cope with change doom all but the most resilient and fortunate institutions. Business failures are not confined to family-owned businesses. Only 2 of the Dow 30 still survived after the Dow Index's first one hundred years yet our country's economy has flourished. Schumpeter's "creative destruction" of capitalism marches onward.

These genetic time bombs which are inherent in every business are particularly acute in family-owned businesses for a variety of reasons. First, family-owned businesses may not always try to maximize all shareholders' welfare. Decisions may be made for purely non-business reasons. The controlling shareholders may desire to entrench and perpetuate management (e.g. giving jobs to all children of the patriarch whether or not they are deserving or not selling the business even when the time may be right) at the expense of doing what makes good business sense. Family financial needs and the desire to improve or maintain its lifestyle may compel a family to make decisions which are not in the best interest of the business. Keeping an unproductive family member on the payroll, entering into a lease for a building owned by a family member, buying supplies from a family member at uncompetitive prices are just some examples.

Second, decision making in family-owned businesses may not be as careful and well organized as that in public companies. Those providing input may have many disparate goals and different influences on the decision makers. Input may be multi-dimensional from a variety of sources, and not always fully informed. Family members may participate and give input in decisions formally (as directors) or informally (as spouses, siblings) or otherwise. Some family members may be trained in the art and sophistication of professional management and business and other may not be as experienced. Further, many decisions in a family-owned business may be based not on the merits of the business issue but rather on the relationship of the parties. The brothers may always vote against the brother-in-law no matter how meritorious the latter's point of view. Dad may always get undue deference. Hostilities, tensions and anxieties percolating and festering since childhood may be acted out at the boardroom of a family-owned business. The boardroom almost becomes a forum for acting out deep rooted or simmering family conflicts.

Third, disgruntled shareholders of a public company can "vote with their feet" and sell their stock or launch proxy or other contests for control of the business. Given that ownership of family-owned businesses tend to be concentrated and privately held, unhappy family members may have no escape to sell their stock at a fair price or avenue to let their frustrations be heard and acted upon. Undue pressure may be placed on operating members to sell or refinance the business just to raise cash to satisfy the lifestyle or other priority needs of other family shareholders. Conversely, undue pressure may be placed upon family members who wish to sell their shares. In some cases, the family-owned business borrows money to purchase the shares of a disgruntled family member, or the junior generation buys out the senior generation with a note. In such cases, the family-owned business possibly endangers its continuing financial viability to accommodate the ownership goals of some of its members.

Fourth, succession planning in a family-owned business is not always careful and based on merit. Many family-owned businesses may be characterized by the enlightened genius founder and the next generation comprised of some competent managers and some incompetent "ne'er do wells". The next generation may not have the founder's drive, intensity or vision. Alternatively, some members of the next generation may be motivated by fear of failure or burning desire to prove themselves. The founder may spend little or no time planning for her inevitable retirement due to her unwillingness to confront it, lack of confidence in her successors, or distaste at having to alienate one family-owned member at the expense of another. The transition may come sooner than expected in which case the family-owned business is left scrambling for a successor when the lines of succession are not clearly marked. Conversely, the founder patriarch may have outlived his productivity and vision and stifled the business' growth to the detriment of the business.

Finally, due to their frequently conflicting goals and objectives, as well as encumbered decision making process, family-owned businesses do not tend to be governed as efficiently as non-family-owned businesses. (This does not mean to suggest that all non-family-owned businesses are the paragon of virtue and efficient government.) The family-owned business is not always run as a meritocracy. The "best and the brightest" are not always asked to serve as leaders of the business. Many times, unqualified albeit well-intentioned family members participate in positions far exceeding their skill set and experience level. Sometimes, primogeniture prevails over competence or even desire.

The balance of this article discusses basic principles of corporate governance and suggests ways that they may be applied better to family-owned businesses.

2. Why Care About Corporate Governance?

To paraphrase Mark Twain, many people talk about corporate governance, but not a lot is done about it. Arguably, considerable shareholder activism and scholarly discourse has heightened sensitivity to and reformed many aspects of corporate governance in publicly-traded corporations in the last ten to twenty years. However, many of the reforms in the public corporation context have either not filtered through to family-owned businesses or family-owned businesses have not yet recognized their value. "Best practices" of corporate governance achieve several fundamental goals.

- Fundamental Fairness. Many of the rules we discuss below intend to treat all owners fairly and equally. Consistent with the governance principles of our society, an open, known and due process philosophically maximizes the welfare of any organization, whether government or business. This principle is especially important in a family-owned business. While a disgruntled public shareholder may be able to "vote with his feet" and simply sell shares in the public company if dissatisfied with its treatment, the shareholder in a private business rarely has this flexibility.

- Most Efficient Allocation of Resources. While the purpose of the corporation is to serve and maximize the interests of its shareholders, society imposes some minimal level of standards of organization and behavior. These minimum standards attempt to insure that society, which is the sum total of all of its component parts including corporations, will continue to progress and benefit.

- Certainty of Result to Reduce Administrative Cost and Expense. To the extent that certain minimal standards of corporate governance affect behavior of management and serve as a blueprint for governance, greater certainty will result from this guidance. The greater certainty will reduce acrimony between the parties, keep the best interests of the corporation and its shareholders paramount over personal interests and save time and diversion of energy from challenges which would result from the lack of clear rules.

3. Over-Arching Principles of Corporate Governance.

The overriding goal of corporate governance is to promote the best interests of the corporation and its shareholders. These principles apply to both the publicly-traded and closely-held corporation. While, as a practical matter, one or a small handful of shareholders may govern some family-owned businesses, as a legal matter, in most cases it is the directors, not the shareholders, of all corporations who are charged with managing its affairs and operations. The directors, in turn, choose officers to execute the directives of the board and to administer the day to day operations of the business.

The duties of a director and officer are fiduciary in nature, given his[1] position of trust and responsibility. As will be discussed in section 6, most states also impose fiduciary duties on majority and controlling shareholders and a few states, such as Illinois, impose fiduciary duties on all shareholders of a privately-held corporation. Since the directors are primarily responsible for the governance of a corporation, the prime focus of this article will be on their fiduciary duties and overall conduct.

In a family-owned business context, directors are not always chosen for their business acumen and insights. Moreover, in family-owned businesses, the board is sometimes dominated by a director who wields considerable power in non-business milieu. The discharge of fiduciary duties is particularly difficult in these situations.

---

[1] For purposes of this article, we will use the masculine pronoun generically instead of repeatedly saying "his or her".

What should a director do to fulfil these broad and vague concepts of "fiduciary duty"? How can a director ask the strong-willed founder (who is also his mother) for more information on a transaction so he can discharge his fiduciary duty more properly? How can a director risk upsetting his wife by challenging the views of his brother-in-law? How can a director interfere with his uncle diverting funds from the business to pay for an apartment in the city? Adherence to these below-stated duties will give a principled rationale for taking these uncomfortable stands.

a. Duty of Oversight. The Model Business Corporation Act (the "Model Act") states that "all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors…"

The oversight duty is central to everything that a director does. This oversight responsibility includes approving fundamental operating and financial plans; hiring, firing, replacing, providing for succession of and evaluating the performance of management and key personnel including directors; adopting policies of corporate conduct and compliance with laws; considering organic changes such as acquisitions, joint ventures, sales and mergers, and approval of significant contracts and transactions.

Oversight duties in a family-owned business are particularly challenging. Many "directors" meetings are held around the kitchen table and additional input is sometimes received from relatives, friends or others who are not directors. Additionally, many disparate issues are frequently addressed, such as employing relatives, acquiring or retaining a disparate or unprofitable line of business merely to assist a family-owned member in feeling productive, and compensating relatives in accordance with their needs and not necessarily their contributions.

To carry out this duty of oversight properly, the directors need to exercise the other fiduciary duties of loyalty and care described below.

While state statutes delegate oversight powers to the board of directors (the "board" or "Board"), most states permit the functions of the board to be performed by the shareholders or other delegates subject to certain statutory requirements. In Delaware, for example, the corporation's certificate of incorporation may provide that the shareholders, rather than the directors, may manage the corporation. In this "close corporation", the stockholders will serve as directors and exercise the fiduciary duties of directors. Many family-owned businesses will either elect to be treated as a close corporation or conduct their affairs as if they had made that election.

b. Duty of Loyalty. This duty requires directors to exalt the corporation's best interests over their own personal or family-owned goals and desires. "Self-dealing" and other similar acts are prohibited. This duty manifests itself in two basic forms.

- Conflicts of Interest. When a director or family member or affiliates of a director has a financial or personal interest in a contract or other transaction in which the corporation is to be a party (such as lease of office space or a sale of a machine to the corporation), such facts must be fully disclosed to and approved by all disinterested directors. The approval by all "disinterested" directors may obviously be impossible in a family-owned business context.

What makes a director "interested"? Mere payment of fees or other receipt of compensation will not necessarily taint the director and make him interested. Typically the director is interested if he stands on both sides of the transaction or stands to financially benefit directly from the transaction. In other words, a disinterested director is one who bases his decision on the merits rather than being governed by extraneous influences or considerations, such as financial and personal gain.

Some large corporations have attempted to define the term "disinterested director". General Motors, for example, requires a majority of its board be composed of disinterested directors. General Motors defines disinterested directors as individuals who have not been employed by the corporation for at least five years, are not "significant" advisors or consultants, are not affiliated with significant suppliers or customers, are not closely related to insiders of the company, are not affiliated with a tax-exempt entity that receives significant contributions from the company, and do not have significant personal services contracts with the corporation.

Even if a corporation is asked to approve a transaction where a director may be interested, most states have "safe harbors" to approve a transaction where a director is indeed interested or not disinterested. Delaware, for example, will uphold a transaction which is shown by the proponents of the interested transaction to be both fair and approved by the informed and disinterested directors. Fairness of the transaction is obviously subjective. It will vary based on an inquiry regarding comparable arms-length transactions, how the transaction was initiated and then disclosed and other relevant factors. Delaware has condoned the use of independent committees of directors to evaluate and approve interested transactions.

The heightened responsibility of an interested director is typically not present in a family-owned business. Often, one director or shareholder of a family-owned business may lease a building or equipment or license intellectual property to the corporation. The rental rate may be above or below market based on the goals and objectives of the individuals. For example, for estate planning reasons, the senior generation may try to transfer ownership of the corporation to the junior generation while retaining a steady stream of income for themselves. These transactions are often scrutinized to make sure they satisfy the Internal Revenue Code's requirements for "reasonableness".

The transactions are seldom evaluated based on possible repercussions affecting any minority shareholders who are non-family-owned members. Either the acquiescence of the non-family-owned member is presumed or sufficient sensitivity is not shown.

- Corporate Opportunity. A director must be sensitive to exploiting or diverting business opportunities to himself and away from the corporation. For example, if a director of a family-owned business learns of the availability of a parcel of land which would be an ideal site for the corporation's expansion, the director may have to offer the opportunity first to the corporation or at least disclose to the corporation the existence of the opportunity. The director's obligations will vary with the facts and circumstances. For example, did the director learn of the opportunity in his capacity as a director while specifically looking for the site or did he learn of the availability through some other means or other capacity? How interested in the site is the corporation likely to be? How significant is it to the corporation's overall operations? Does the site really relate to the corporation's business or is the idea of expansion really just a "pipe dream" or far off in the future? Does the corporation have the resources to pursue the transaction? If the corporation is not likely to be able to pursue the transaction, even if it wanted to, then a director may well be advised to make a full disclosure even if he is not required to do so.

c. Duty of Care. The Model Act requires a director to discharge his duties (I) in good faith (i.e. acting honestly and lawfully), (II) with the care of an ordinarily prudent person in a like position would exercise under similar circumstances and (III) in a manner he reasonably believes to be in the best interests of the corporation. This last part establishes the notion that the test is based on objective, not subjective, standards. Following are some suggestions to enable directors to exercise this duty of care. These are perhaps easy to state but not as easy to carry out, especially given time and family-owned pressures.

- Take Your Time. There may be circumstances where an immediate action is required. For example, a transaction may be available for only a limited time due to the multitude of competing bidders. However, in most cases, prudent practices follow Colin Powell's 50-80 rule: obtain at least 50% of the material facts but, to avoid "paralysis by analysis", make a decision prior to having 80% of the facts. Directors should read, ask questions and interview appropriate corporate personnel to get the requisite facts. Then deliberate over at least one board meeting.

- Prepare. Courts severely criticize directors who have not acquainted themselves with the relevant information.

Management should provide adequate information to directors in a timely fashion to enable the directors to prepare for the board meeting and make an informed judgment. If the information is not timely or adequately provided, directors should ask to delay the consideration of the matter until the requisite information is supplied.

- <u>Ask Questions</u>. Courts encourage, and sanction the conduct of, activist directors. Questions elicit facts, keep people honest and demonstrate that the director is not a mere rubber stamp.

- <u>Make a Record</u>. Minutes and other records of directors meetings and deliberations are critical to documenting the thorough and reasoned conduct of directors' actions. A contemporaneously prepared record is persuasive evidence of the boards' deliberations. Many family-owned businesses do not maintain corporate records with the same rigor and discipline as publicly-held businesses where decisions may be more likely to be scrutinized. Board meetings in family-owned businesses also tend to be more informally conducted, with little or no notice. Many may take place in hardly exotic locations like the kitchen table or car.

- <u>Review all Materials</u>. Courts may exonerate directors who ask to receive and then review all materials. Boards should avoid acting on matters before this careful review.

- <u>Attend Meetings</u>. Woody Allen once said that 90% of life was just showing up. So too, directors should attend all or a substantial number of meetings and participate to the extent they have something meaningful to add.

While directors may insulate themselves from scrutiny if they follow the suggestions set forth above, directors should not, and cannot, be expected to know everything. Directors are entitled to, and should when appropriate, rely on reports, opinions, information and statements (including financial statements) prepared by those who are better informed. Of course, directors are entitled to reasonably rely on the opinions and judgments of experts such as corporate officers who are competent in the matters at issue, the corporation's legal counsel and accountants and duly authorized committees of the board. In considering whether to rely on such persons, the directors need to ask themselves whether the person or report on which they are relying appears to be knowledgeable, well researched and well reasoned, thoughtful and deliberate in the preparation and analysis, and whether the methodology used is reasonable and generally accepted?

d. To Whom are These Duties Owed? The paramount goal of the directors and officers, and all others owing a fiduciary duty to the corporation, is to further the interests of the overall corporation and its shareholders. Some states, such as Pennsylvania and Ohio, permit the directors to consider the interests of and the effects of a merger or sale of the corporation upon other "constituencies such as the employees, customers and suppliers of the corporation and its subsidiaries and upon communities" in which the corporation and its subsidiaries are located or do business. Directors of an insolvent corporation should consider other constituencies as well, as will be discussed below. However, the laws of most states allow and require directors to retain the single-minded focus of furthering shareholder and corporate interests.

4. Application of Corporate Governance Principles in Specific Circumstances.

The principles discussed in the previous section serve as over-arching guides for the conduct and decision making of a director and officer and majority (and perhaps minority)shareholders in privately-held corporations. These overriding fiduciary duties of loyalty and care pervade every decision and should loom omnipresent to guide a director and officer. A myriad of fact situations arise in which these general principles need to be applied.

a. General Management Decisions. Courts have created a business judgment rule whereby the court will presume that a decision of the board was made in compliance with all laws and fiduciary duties. Absent a showing by a plaintiff shareholder that the board breached any of these duties, or otherwise committed some act of fraud or outrageous conduct, courts will generally decline to second guess or intervene in corporate decision making or substitute its business judgment in place of that of the board. Many of the policies and goals of corporate governance discussed in the first section of this article would be hamstrung, if not severely frustrated, if every action or inaction of a board was challenged by second-guessing courts and shareholders.

Therefore, as long as the board exercises the duties described in the preceding section of this article, and as long as the subject matter acted upon by the board does not fall within the fact patterns set forth below, the courts will defer to the judgment of the board and dismiss any lawsuit challenging the wisdom of the decision. A court will not play "Monday morning quarterback" as long as the board acted carefully with loyalty to the corporation, and as long as the decisions do not involve the subject matter set forth below. Courts temper any inclination to interfere even if the action of the board turned out to be unwise or unsuccessful. Therefore, great deference will be given to most decisions of the board and challengers will confront a real uphill struggle to overturn any decisions of those in power.

If a court finds that the fiduciary duties of a director or several directors (even less than a majority) may have tainted the corporation's decision, the burden of proof will then shift to the board to prove that the transaction was inherently fair to the corporation and in some circumstances the shareholders collectively, that the directors acted in the good faith belief that the transaction would benefit the corporation or maximize the collective value of the equities held by the shareholders, and that the directors were not interested and did in fact act with due care.

b. Mergers, Sales or other Changes in Control. The rules of director conduct and scrutiny change in exceptional circumstances such as a proposed takeover or sale of the corporation, or a proxy solicitation contest. The "omnipresent specter" of director entrenchment at the expense of the best interests of the shareholders heightens the suspicion and scrutiny of courts in these circumstances. Many of these rules and principles have been determined in the wake of several hostile takeover attempts during the past two decades. However, and perhaps surprisingly or counter-intuitively, many of these rules also apply in the privately-held family-owned business context.

In many cases, a hostile takeover of a family-owned business and the consequent application of the below discussed rules is simply not possible due to the commonality of shareholders and directors. They may also not apply since the corporation may be a close corporation and therefore controlled by the shareholders without any board of directors. Many times majority shareholders will also be approached directly to sell their shares or, if there is a recalcitrant board which refuses to authorize a merger or sale of the corporation's assets, they can simply remove the board by exercising their shareholder rights.

However, in many cases, the composition of the corporation's directors and shareholders may differ and that is where potential conflict could arise. For example, mother founded the family-owned business and transferred all of the stock to her children for estate planning reasons. She, however, remains the sole director of the corporation. If she is approached as a director to merge or sell the assets of the corporation, her interests as a director may diverge from the interests of her children as shareholders. Employees of the family-owned business could own a minority of the shares as well and have views as shareholders distinctly different than the views of the controlling shareholders which they exercise as directors. We do not have to be regular viewers of the television programs Dynasty or Dallas to imagine the myriad of fact patterns and depth of contentiousness between relations in these situations. While relations among family-owned members may always be challenging, they become outright incendiary when huge sums of money are involved.

In a takeover contest, the board can do one of five things: (i) do nothing by simply saying "no", (ii) in addition to just saying "no", adopt one or more anti-takeover devices to thwart the bidder, (iii) find another buyer, (iv) negotiate with the bidder and try to extract a higher price or (v) enter into a "strategic" merger.

- Just Say No. With deference to Nancy Reagan's defense against drugs, courts have allowed boards to simply reject any takeover proposal. The board has no duty to sell the company regardless of how attractive an offer may sound as long as the board has exercised its fiduciary duties, carefully evaluated the merits of the proposal and concluded, in its business judgment, that the long term best interests of the corporation (and implicitly all of its shareholders) will be maximized by rejecting the bid. In a family-owned business setting, therefore, the non-family-owned member executives who are desirous of causing the company to be sold, and who find a buyer who proposes a wonderful offer, will not likely have any recourse against the board and majority shareholders who simply reject the bid out of hand.

- <u>Take Action to Obstruct the Takeover</u>. Primarily applicable in the public corporation arena, the board has any number of avenues available to it to protect the corporation from the takeover or make it less appealing to the suitor. It can adopt poison pills (such as requiring supermajority approval by directors and shareholders, or issuing new preferred stock or special dividends to existing shareholders if a new shareholder not approved by the board amasses a certain threshold of shares), payment of bonuses, establishing "golden parachute" programs, split offs or sales of major or attractive divisions, purchases of other businesses, or leveraging of the corporation. Many states, notably Wisconsin, have enacted laws permitting its domestic corporations to adopt many of these protections.

  Courts will carefully scrutinize these actions to prevent and assure that the board is not simply entrenching itself in power to the detriment of the mass body of shareholders. Delaware has a well established body of case law stemming from the takeovers of the mid to late 1980s. This body of law, which has been followed in many states (including corporate "havens" such as Nevada and Alaska), places the burden of proof on the directors to show that any action which the board has taken to thwart a takeover attempt is (a) a reasonable response to a perceived "danger to corporate policy and effectiveness" and (b) reasonably related to the threat posed.

  To oversimplify a dense body of case law, factors to consider in evaluating whether the bid posed a danger to corporate policy and effectiveness include the adequacy or inadequacy of the bid and its financing, the nature and timing of the offer, whether the bid complies with law and possibly creates regulatory or antitrust obstacles, the risk of the bid not being consummated, the character of the bidder, and the prospect that the financing will actually go through. Some states also allow consideration of the impact of the bid on other constituencies such as the community, employees and suppliers.

  If the board concludes after exercising its duty of care that the bid would pose a danger to the corporation, then the board has an absolute duty to oppose it. The only question at that point is whether the board's response is proportionate in relation to the posed threat. Some of the responses outlined above have been upheld, and some rejected, based on the unique facts of each case. While it is difficult to fashion any immutable guiding principles to the board, the construct of the response should be carefully evaluated and documented and sprinkled with a good dose of common sense. Overkill and draconian measures will likely lead to a court striking down all or part of the measures or granting awards to aggrieved shareholders of potentially significant monetary penalties.

These issues are not as prevalent in a family-owned business context for several reasons. While the boards of both family-owned businesses and public corporations may adopt the "just say no" policy described above, the viability of that policy is greater in a family-owned business since the shares are illiquid and often subject to contractual and other restrictions on transfer.

- Find Another Buyer to Maximize Sale Value. Delaware law does not engraft any "single blueprint that a board must follow to fulfill its duties" once it has decided to sell the company or once the sale of the company is inevitable. Its sole mantra at that point is to maximize shareholder value. Typically, it accomplishes this goal by one of two means: (a) conduct of an auction to maximize the value of the company or (b) negotiate privately with one or more bidders.

  The structure, timing and conduct of the auction is beyond the scope of this article. Auctions are conducted in one of two basic forms: a controlled auction (where the board solicits bids from only a limited universe of qualified potential buyers in order to better manage the process, minimize the perception that the company is being liquidated in some "fire sale", and reduce publicity) or a full-blown auction inviting bids from all interested parties. The procedures must be designed to assure that all parties have (a) access to information, (b) sufficient time to evaluate the information and make a meaningful bid, and (c) the benefit of other procedures to assure a fair and level playing field among bidders. In any case, the board must discharge its fiduciary duties of due care and loyalty simply to maximize the value of the sale proceeds to the shareholders. Even in this context, however, courts will tend to defer to the sound business judgment of the board. For example, a board is well within its rights to adopt a "cash is king" philosophy favoring cash-based offers over even higher offers predicated on risky or over-priced stock, notes or other forms of non-cash consideration.

- Negotiated Sale. If the board has decided to sell the corporation, and the board decides to sell pursuant to a negotiated sale, the directors may face additional scrutiny regarding how they determined that the price was fair and that they indeed discharged their sole duty to maximize shareholder value. The directors will need to insulate themselves from challenge that an investment banker's fairness opinion was a poor substitute for an auction which allows the marketplace to better determine the corporation's value.

One approach to insulate the board from such scrutiny is the "market check". This mechanism allows the board, after a definitive transaction is signed, to canvass the marketplace to see if a higher price on essentially identical terms exists for the company. A properly constructed market check mechanism effectively establishes a floor price for the company (i.e. the signed contract for sale), and allows the seller to contact other potential buyers and disclose confidential information and solicit and entertain bids.

A buyer who has negotiated and signed a binding agreement obviously is not thrilled with such a provision and will attempt to limit the time and scope of the market check, and only permit the board to react to offers as opposed to solicit them. The buyer will also seek "break-up" or "topping" fees and reimbursement of its expenses including legal fees in the event that a second bidder is accepted. The buyer may also ask for an opportunity to match that bid or have that bid be a certain percentage higher than the buyer's bid. Courts have upheld reasonable break-up fees (typically in the range of 2 to 3% of the transaction value) and the sale to the original buyer of a desired piece of the seller's business such as real property or a division.

- Strategic Merger. Through a series of cases, Delaware and many other states have concluded that the business judgment rule is the proper standard to analyze transactions where control of the corporation is not relinquished. Thus, in the case of a merger of equals (such as was claimed to be occurring in the Daimler-Benz and Chrysler "merger of equals" and what may actually be occurring in the Time-Warner and AOL's nuptials), where no control is relinquished upon consummation of the merger since the shareholders of each corporation had the right to choose an equal number to the board, there was no "extraordinary event" such as a sale, and the application of the business judgment rules instead of the rules of higher scrutiny discussed above, was proper.

c. Insolvency or Other Financial Distress. In a solvent corporation, directors owe their fiduciary duties exclusively to the corporation and its shareholders since the shareholders own all the assets of the company if it were sold and then all liabilities were paid. In an insolvent corporation, however, the creditors of the company may have a claim on the assets since the net worth of the enterprise may be less than its assets. Courts, therefore, have imposed higher and different duties on directors of financially troubled corporations. A salient question involves how and when a director knows the corporation is in financial distress and then where on the continuum of distress, from nearly to clearly insolvent, is the corporation.

- "Nearly Insolvent" Corporations. These are entities which may be teetering on the brink of financial ruin but are still solvent. While this determination is an art and not a science, and based on experience not hope, directors have very nuanced and subtly different duties in this case. Unfortunately, little or no guidance exists to instruct a board how to take into account the interests of creditors, suppliers and other non-shareholder interests. No clear blueprints offer ways for the board to balance competing interests for the dwindling funds. The board should, at a minimum, exercise its duty of care to assure that all funds of the company are being properly used and channeled toward proper corporate purposes. The board should also engage experts to provide balanced objective information regarding the entity's financial condition, prospects for salvation and ways to salvage the business. The reliance on experts, including the internal financial personnel, will go a long way to protecting directors from claims that they should have known the corporation was even worse off financially than they thought it was.

- Clearly Insolvent Corporation. While not every state law is in agreement, the clear majority of states alter the duties of a director when the corporation has crossed the mythical line from nearly insolvent to clearly insolvent. Many states have created a "trust fund" doctrine. This doctrine requires directors of insolvent corporations to radically metamorphose, and shift their focus from furthering and protecting the rights of shareholders to furthering and protecting the rights of creditors. This transformation could be daunting. Whereas most boards encourage and expect the corporation to take risks and be entrepreneurial, boards of insolvent corporations have to behave far more conservatively. Courts are still split, however, over whether the board has to entirely change the focus of the corporation to that of a liquidating trustee. New York law takes this view, yet Delaware suggests that directors of an insolvent corporation will still be entitled to some degree of business judgment rule insulation even if they do not act as strict trustees, unless, of course, the corporation is actually in liquidation.

- Bankruptcy. Under the federal bankruptcy code, the directors of a corporation in a Chapter 11 reorganization become trustees of the bankrupt estate. In such capacity, the directors are required to safeguard and recover assets of the estate, operate the business of the debtor corporation and formulate a plan of reorganization. Directors become fiduciaries for all parties to the reorganization, including both creditors and shareholders. Courts are split, however, whether directors at this stage are entitled to the protection of the business judgment rule or may be liable for their mere negligence. This ambiguity should encourage directors to seek court approval of any controversial decision.

d. Government Investigations or Other Potential Wrongdoing. In the Frank Capra film It's a Wonderful Life, Uncle Billy was under investigation by federal bank examiners for gross mismanagement of the family-owned savings and loan business. While all ended well in that classic film, the role of George Bailey and the other bank directors in ferreting out and reigning in the fraud was hardly an Oscar winning performance.

Directors and officers (and shareholders in the case of family-owned businesses) have a heightened duty to weed out employee misconduct and establish an environment promoting and facilitating compliance with laws. Potential liability to these fiduciaries for the misconduct and other illegal acts of others can be staggering. First, directors and officers may be liable for the recurring similar illegal acts or other misconduct of those employees. Additionally, such fiduciaries may be liable for failing to halt and cure any such recurrences. The Securities and Exchange Commission has publicly criticized directors and officers for failing to take such measures.

Second, Delaware courts have held that a component of a director's duty of care includes a good faith attempt to assure that corporate reporting and information systems exist and such systems are reasonably designed to provide senior management with timely and quality information on which to make reasonably informed business decisions.

Third, recent federal legislation requires a corporation's independent auditors to look for and assess management's response to indications of potential illegality. This statute creates a classic "chicken and egg" conundrum since if the corporation does not have a history of responding, it is difficult for the auditors to respond. The auditor's inability to respond may create an inference, albeit unjustified, that the corporation does not have proper response measures in place.

Fourth, the Corporate Sentencing Guidelines impose severe penalties on and possible criminal liability for corporations that fail to take voluntary action to redress employee misconduct. Prosecutors, moreover, typically give leniency or special consideration to corporations which take effective action in the face of suspected wrongdoing by personnel.

While director and officer liability and obligations may be well established, little guidance exists, however, to advise fiduciaries how to carry out these high minded statements. One article[2] offers many constructive suggestions to prevent or reduce the chances of such liability.

---

[2] "Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct", Pitt, Groskaufmanis and Tsaganos, Corporate Counsel Quarterly

- Foster a Tone of Respect for the Law. The fish stinks from the head down. Top management should show a respect of the law and proper conduct. A code of conduct and swift and decisive action for violations thereof are essential. The board should require that all persons under investigation properly cooperate with all internal (not necessarily external) investigations. Training and other compliance programs are also critical. Once a corporation learns of significant wrongdoing by an employee, it should review and improve its compliance program to assure that it functions properly.

- Create a Mechanism to Assure Directors Quickly Learn of and React to Allegations of Substantial Illegality. The Board should consider setting up a special committee of the Board whose function is to evaluate serious allegations of impropriety. Obviously, not every claim of misconduct or illegality needs to rise to the board's level in the first instance. While a matter is being investigated, the board should consider whether to suspend or restrict the activities of those under investigation. It should also consider whether disclosures need to be made to shareholders, independent auditors and government officials since the federal securities laws, investor relations and relatively recent federal statute requires disclosure at some point. The board should also consider whether to recommend that those under investigation retain separate counsel or share joint representation, and who should pay the cost of counsel.

5. Specific Governance Approaches and Issues.

Corporate governance is an art not a science. While over-arching principles of conduct may be easy to state as we have done above, their application is rather nuanced and varies with the facts and circumstances of each action. As corporate governance principles evolve, and "best practices" become discussed and applied under the microscope of each corporation, certain basic minimum standards or practices and trends have emerged. While nothing compels any corporation from adopting any or all of these best practices, the failure to adopt some or any of them calls into question the corporation's modernity and adherence to an early twenty-first century norm.

Appendix A sets forth a result of a Survey which the American Society of Corporate Secretaries compiled in 1999. This survey sought the current and possible governance practices of 680 member corporations, as well as the most commonly adopted and least commonly adopted practices. These members tend to be publicly-traded or large privately held corporations. While some of these approaches may be impractical in a family-owned business, many family-owned businesses may need to consider the feasibility or practicality of some of these practices. Following are some of the items surveyed. In general, family-owned businesses have not adopted most of these approaches. However, family-owned businesses tend to be in the forefront of corporate governance principles when it comes to the size of the Board (not part of the Survey but see section 7(b) below) and the commonality of ownership and director responsibility.

- Majority of Board being Outside Directors. Over two-thirds of the respondents have adopted or will adopt this approach, while one-third have not or will not likely consider the idea. This practice is unheard of in most family-owned businesses and would not likely ever occur or be considered due to the likely majority or controlling ownership of the business by a family-owned or families.

- Former Chairman or CEO on the Board. Only one-sixth of all respondents would not permit a former chief executive officer to sit on the Board. This could be due to that person's elevation to Chairman or due to the desire to retain the benefit of that person's past experience. In a family-owned business, it is likely that the former CEO, if it is the founder or other family-owned member, will likely stay on the board for a variety of business as well as family-owned reasons (unless removal was due to being bought out or a sincere desire not to participate in the business any longer). If the CEO was not a member of the family, however, it seems unlikely that he would remain on the board.

- Separating the Position of Chairman and Chief Executive Officer. Only one-sixth of the corporations responding have adopted such a policy. The proponents believe that separating the two functions will provide greater independence to the Board and greater oversight of and input into executive leadership. Very few family-owned owned businesses separate these roles either, at least in the first generation of the business. The titles, however, may be more that of a figurehead and the true power and authority may rest with family-owned members whose titles do not match their purported responsibilities.

- Board Committees. Most corporate respondents to the Survey had various committees of the Board. The committee approach enables a smaller group of directors to have more responsibility for and heightened information and analysis of crucial corporate issues. Such committees included an audit committee, compensation committee and perhaps technology committee. Very few family-owned businesses have formally adopted this committee approach.

- Mandatory Retirement for Directors. About two-thirds of the survey respondents adopted this policy. This practice, like term limits, attempts to insure "new blood" in management and prevent entrenchment of management. Family-owned businesses are notorious for wheeling in the founders to board meetings and perpetuating the founding generation on the board. More enlightened family-owned businesses, however, will certainly consider the adoption of this practice.

- Term Limits for Directors. Surprisingly, over 90% of the respondents have not imposed any term limits on directors. Perhaps the rationale is that the director can continue to serve as long as he is performing or as long as he has not reached the mandatory age.

- Stock Ownership. The survey results were somewhat contradictory. On the one hand, most directors receive stock or stock options as part or all of their compensation package. On the other hand, only about one-third of the respondents surveyed had any stock ownership guidelines and only a small number link director compensation to overall corporate performance. Family-owned businesses epitomize the synthesis of stock ownership and participation as a director.

- Written Guidelines on Board Practices. Only a little over half of the respondents have adopted written guidelines on board practices or corporate governance principles. Less than twenty percent, however, will make the policies available to the shareholders or in other SEC filings.

6. Specific Issues in Family-owned Business Context.

This section explores the greater duty and exposure that shareholders of family-owned businesses have to other shareholders of the corporation. It then discusses the creation of agreements among shareholders to govern the family-owned business more effectively and harmoniously, and minimize deadlock and friction. Finally, this section will review statutory remedies to avoid deadlock.

a. Heightened Duties of Owners of Family-owned Businesses. To paraphrase F. Scott Fitzgerald's observation to Ernest Hemingway, "family-owned businesses are different from all other businesses." One of the many ways they are different is the heightened fiduciary duty that shareholders have to other shareholders. Most states recognize that majority or controlling shareholders, in both the public and private context, owe fiduciary duties to minority shareholders. Some states, such as Illinois, go so far as to impose fiduciary duties on all shareholders, even minority shareholders, and even if those shareholders no longer have an employment relationship with the corporation. Illinois also requires minority shareholders to have the right to participate in the business if they choose.

Shareholders of family-owned businesses are different than those of publicly traded businesses in several respects. They tend to know each other to a greater degree. They have illiquid shares and cannot readily cash out their shares and thereby "vote with their feet". Management of a family-owned business, at least a first or second generation family-owned business, tends to own a higher percentage of the shares than does management of a public corporation. Ownership and control of operations of a family-owned business are more interlocked and intertwined than in a public corporation. Because of these distinctions, courts have engrafted higher fiduciary duties on shareholders of family-owned businesses (and other private corporations) than on those of public corporations. Courts have reasoned that the proximity of the relationships of shareholders treats them in many ways like partners in a partnership rather than shareholders in a corporation.

Illinois courts have consistently followed this approach in cases involving family-owned businesses. Courts have heightened this fiduciary duty of shareholders in the closely-held business arena for the reasons stated above. Courts have admonished that shareholders need to "deal fairly, honestly and openly with fellow stockholders and...make disclosure of all essential information." All trickery, deception, secret dealings and preferences have been judicially condemned as violative of a stockholder's fiduciary duty.

Examples of abuse in family-owned business cases typically involve majority shareholder "oppression" or "freeze-outs" of minority shareholders. Such conduct can take many forms. Its goal is to avoid dealing with or providing any meaningful input or remuneration to minority shareholders. For example, a family-owned patriarch could pay himself and his daughters large salaries and bonuses while paying non-family-owned member shareholders (or black sheep family-owned members) little or nothing. In the case of a subchapter S corporation, where net income of the corporation is taxed at the shareholder but not corporate level, the controlling shareholders could pay no dividends and thereby subject the minority to income tax liability without the cash to pay the taxes. Other examples include (a) buying out a minority shareholder for one price while at the same time negotiating to sell the corporation for a far larger price, (b) denying access to financial data and other pertinent information about the business, (c) putting pressure on a minority to sell his shares at a low price (such as firing him, increasing others' salaries and not giving any meaningful alternative but to accept a low price or risk deterioration in the equity value) and (d) entering into real estate and equipment leases, trademark licenses and other relationships with the majority shareholders at inflated prices, thereby reducing the profitability of the company.

Not every action by a majority shareholder in its own self interest is a breach of fiduciary duty or oppression of a minority shareholder. The conduct of the majority, however, is always under the microscope.

The principle of majority shareholder fiduciary duty to minority shareholders is virtually universal throughout the country. What is unique to Illinois is the imposition of this fiduciary duty on minority shareholders, even those who have been unfairly treated. In one case, for example, a twenty-five percent shareholder was fired from his position as Vice-President and Treasurer, but still retained his stock. The corporation was then administratively dissolved due to its failure to file franchise taxes. The minority shareholder then set up another corporation using the same name (Rexford Rand) as the dissolved corporation. When the dissolved corporation attempted to become re-instated under its prior name, the Secretary of State refused, since the name was then registered to the new corporation which the minority shareholder formed. The federal appeals court found that the minority shareholder violated his fiduciary duty to the corporation and the other shareholders by misappropriating a corporate asset, even though the minority shareholder had himself been fired and even though the corporation had at the time been dissolved. The court reasoned that the minority shareholder's conduct was "unscrupulous and improper". Even if he had been "frozen-out" of the business, this fact did not minimize his duty of loyalty to the corporation. If the minority shareholder felt harmed by the majority's freeze-out tactics, the minority had access to the courts and should not have resorted to self-help remedies.

Compounding this problem for a minority shareholder is his separation from the corporation. Illinois courts have held that since a minority shareholder owes a fiduciary duty to the majority shareholders as well as to the corporation, then the minority shareholder may not compete with the corporation after his employment terminates. Therefore, minority shareholders need to be sure that either they have the opportunity to sell their stock for a fair price upon the termination of their employment, or that they obtain a release from the corporation from such restraints on their actions after termination of their employment.

In addition to compensatory damages, punitive damages are available in the case of outrageous conduct and breaches of shareholder duty.

b. Shareholder Agreements and other Contractual Attempts to Promote Effective Governance. While few, if any, public corporations have agreements in place among their shareholders to provide for voting, delegation of authority, and restrictions on transferability of the shares, many prudent family-owned businesses have these agreements in place. An important function of a shareholders' agreement (also known as a buy-sell agreement) ("BSA") is to clearly set forth the roles and responsibilities of the shareholders in managing the business and to keep the shares in the same hands. Other agreements with less far ranging scope than a BSA are voting agreements and voting trusts. These agreements are typically limited to voting rights and rarely deal with transferability of shares.

i. Control over Decisions. Issues regarding the control of the corporation vary dramatically based on the size and stage of development of the business. In the simplest case, one owner or a select few will make all decisions, regardless of the magnitude or importance thereof. This is typically the case in family-owned businesses where one owner or his spouse own a large percentage of the stock and the other investors are employees or family-owned members from a junior generation.

On the other end of the spectrum, some BSAs will state that all decisions (except perhaps some day-to-day operational decisions delegated to certain key management personnel) require unanimous or supermajority approval. This approach is typically found in corporate joint ventures or businesses with two or more persons or families owning equal or close to equal blocks of stock.

Many middle ground positions exist to reconcile one party's fervor for complete control with the other party's needs for appropriate and predictable input, checks and balances, without having to rely on the undefined subjective checks of fiduciary duty principles. An approach which moves away from the sole control position on the continuum may constitute the Board with seven members, four from the investors and three from the employees. Employees may provide their input at Board meetings, but ultimate control rests with the investors.

Moving further down the continuum from total one person control, some Board decisions may require the assent of at least five of the seven directors and thereby afford the right of management to block an investor action. The items over which employees would expect to see this type of input are operational issues such as approval over budgets, giving raises and bonuses, and changing operating strategy. Structural issues such as sale, raising of capital and similar items however, would remain in the majority (i.e., investors) of the Board.

Super-majority consent may be further required for major structural decisions such as bank borrowings, major capital spending, raising of additional capital and ultimate sale of the business. A nuance of this approach provides a supermajority requirement in the first few years. After that time, or after the time that certain financial performance goals are not met, however, Board control may revert entirely to the investors.

Continuing down the control spectrum toward employee control is the situation where the budget is devised by the founders and ratified by the Board. Moreover, day-to-day decisions may be made by the founders, subject to the parameters set forth in the operating and capital budgets.

A final stop along the control continuum might be a neutral Board. The family-owned member investors may select three, the employees select three, and a distinguished member of the industry is selected by the six members as the seventh member of the Board. Further, the company's charter may reduce the number of Board seats allocated to an investor as that investor's ownership interest is diluted in subsequent financings. As this percentage is reduced, investors may ask for honorary, advisor or observer seats, which allow them to attend Board meetings and obtain materials circulated to Board members.

Notwithstanding this enlightened approach to sharing power, BSAs will also deal with the right of parties to increase their Board representation in certain circumstances. Venture capital investors, for example, may insist on additional representation, and, at times majority representation, upon the occurrence of certain events. These events may range from a material breach of the stock purchase agreement whereby the investors bought stock, to a material default on a senior loan agreement, or to missing budgets or other projections, or to the departure of key personnel.

ii. Deadlock and Unwinding**.** A critical purpose of BSAs is to provide for means of preventing or breaking deadlocks over major decisions facing the business. BSAs are far preferable to resolving deadlocks than courts, whose remedies may be quite harsh (see sec. (c) below). One of three events typically trigger unwind or deadlock resolution provisions in a BSA.

- First, some BSAs state that after the passage of a certain period of time, any shareholder, or a shareholder exceeding a certain percentage ownership, may elect to trigger the unwind mechanism. These provisions force shareholders to work together for some period of time, but recognize that one or more shareholders may desire an exit mechanism to monetize their ownership interest at some point.

- A second initiating mechanism is at the election of a shareholder after the existence of a deadlock or series of deadlocks over major issues facing the business. While shareholders cannot be expected to agree on every issue, or even every major issue, the chronic and continual failure to agree on major issues impedes the progress of the business as well as the morale of its participants. Some provisions will allow one deadlock over a defined list of major issues to constitute grounds to trigger the unwind clause. Better reasoned provisions, however, will require three or more deadlocks within a defined period, such as twelve to eighteen months, to constitute a deadlock which, in turn, would trigger the unwind provisions. This latter approach prevents an unscrupulous owner from using one issue as a pretext to cause a deadlock to trigger the unwind clause. Obviously, that same owner could perpetrate the same shenanigans by causing three issues to be deadlocked, but the higher number of items reduces such owner's ability to carry off such a scheme without tarnishing that owner's credibility and litigation posture.

- A final triggering event is similar to events discussed above which enable the investor to increase its Board representation. The right to trigger an unwind is the next logical step after increasing Board representation and perhaps taking control of the business.

<u>Consequences Upon Occurrence of a Triggering Event</u>

Upon the occurrence of a triggering event discussed above, one of several consequences could follow.

- On one extreme, many BSAs simply provide no mechanism for solving impasses. The rationale underlying this approach is that the parties should be required to work out their differences to the best of their ability and not have an easy roadmap for unwinding their relationship. Further, one shareholder should not be confronted with a perpetual "sword of Damocles" hovering overhead and threatening the maintenance of the existing business in the event of a disagreement.

- Moving down the continuum of remedies in the event of a deadlock, some BSAs offer arbitration or mediation provisions to solve a deadlock. On the same lines, some will provide for the appointment of a provisional director. These approaches, however, are stopgap in nature since they only address one problem at a time, and not the fundamental cause of the deteriorating relationship between the owners. Further, arbitrators do not always know the business as well as the shareholders, are sometimes expensive, and many times take an expedient compromise approach instead of favoring one side over another.

- A common approach for resolving deadlocks is the "dynamite" or "candy bar" method. A deadlock will give one party the right for some period of time to offer to buy the other party for a price named by the offering party. The party receiving the offer then has two choices-- it can either accept the offer and sell at that offered price or buy the offeror's shares at the same offered price per share. Theoretically, the offeree's right to buy out the offeror at the same price offered by the offeror will incite the offeror to quote a fair price, for fear that if the price is too low, the offeror will be bought out at that price. In reality, however, the offeror and offeree do not always have the same financial resources, and the offeree's rights to match a low offer by the offeror may be illusory.

- BSAs occasionally provide an exit strategy to large shareholders or management by giving either the right at some point to cause the business to be sold or merged. Investors typically demand this right which they can exercise at any time. The parties may agree that some time should elapse before this right could be triggered in order to give the management team a chance to implement the business plan. In lieu of tying the right to cause a sale to a specific time period, some agreements require the occurrence of some event such as a deadlock on major issues, failure to achieve targeted financial goals, or the departure of a key employee. Sometimes, the parties agree to give either party the right to sell the business at any time, or after a certain time, for a price not less than an appraised or agreed to minimum value. The other party would then have the right to match that price prior to the time the business is marketed for sale, even though this right may be illusory in the case of a management team with few financial resources. While investors desire the flexibility to be able to cause a sale of the stock or assets of the business at any time, the management team will want to limit the periods during which the business is being shopped. This reduces the negative impact on employee and customer morale and uncertainty that naturally occurs during the sale period.

- A final method set forth in BSAs to address the possibility of a deadlock giving one or more parties the right to sell their shares (a "put") and/or the company the right to purchase the shares (a "call") upon the occurrence of a time-based or event-based triggering event. The put price could be either the liquidation value of the preferred equity of the investor or some sort of formula or appraised value for the common equity. While a formula value is sometimes used (e.g., eight times trailing net earnings), this method can be dangerous since fair and appropriate formulas vary over time and the current risk profile of the business. The put is also of questionable value in a real practical sense. If the business is doing well, the investor has other means available to it to liquefy its position. If the business is doing poorly, the business may not have a means of financing the put, and therefore, the impact of the put is to convert the seller's equity to the right of an unsecured creditor. The call right is the logical mirror of a put. The pricing and terms of the call may be the same, except the call right is usually delayed for a year or two after the time that the investor is first able to exercise the put. The value of the put, moreover, may be discounted by a small percentage, say 5%, as the price the investor should be willing to pay to gain cash. Conversely, the call may carry a 5% premium (or perhaps a premium which declines over time) to compensate the investor for having its interest redeemed involuntarily. Investors resist calls since they put a ceiling on price appreciation. The company responds that the call is a last resort after the investor has had the right to put the stock. The call treats the investor fairly, moreover, since the price of the preferred is fixed and the value of the common will be fair market value. In the case of convertible preferred shares held by the investor, the right to call the investor's shares also gives the company the ability to require the investor to "put up or shut up" by causing the investor to decide to either convert its preferred to common or suffer a call.

BSAs assure that the management employee-owners and family-owners will not be able to freely sell their shares in the business. If the employee-owners are financially "joined at the hip" with the family-owned owners, most feel that the employees will stay more focused and motivated. Employee-owners may agree to these restrictions for a certain period of time (three to five years), but after that time elapses, be permitted to sell to any third party. Investors may not want any restrictions on their own ability to sell any shares at any time, but may have to agree not to sell their shares for the same reasons they wish to prevent the employees from selling their interests.

iii. <u>Restrictions on Transfer</u>. To achieve the goal of maintaining continuity of ownership and inter-employee relations, BSAs frequently require one shareholder to give the right of first refusal to the other shareholders prior to the sale of his stock or the sale of the business. This right allows the non-selling party to match a bona fide arm's length offer made by an independent party. Since this offer is from an unrelated third party, it is thought to be for a fair price. If the selling owner is offering an unreasonably low price to the third-party buyer due to the seller's personal circumstances necessitating the sale, the other owners can reap this benefit. If the price the third party is willing to pay is very high, the non-selling owners can avail themselves of a tag along right, or, in some circumstances, cause the conversion of the selling owner's interest to be non-voting. In a family-owned business context, sales or other transfers to family-owned members, for estate planning or other personal motivation reasons, would be excluded from these requirements. This exclusion would therefore enable the family-owned shareholdings to remain in the family.

Many object to the concept of a right of first refusal on the grounds that it may have a chilling effect on would-be purchasers. The third-party offeror's enthusiasm is repressed by not knowing whether its deal will be consummated. Third-party offerors also resist acting as the stalking horse to set the price that someone else can match.

To address the concerns that rights of first refusal may have the practical impact of reducing the universe and attractiveness of potential buyers of privately held stock, some BSAs provide for rights of first offer and first negotiation. A right of first offer essentially requires the selling shareholder to first make an offer to the non-selling shareholder at which price the selling shareholder would be willing to sell its shares or the entire business. If the non-selling shareholder does not wish to pursue this opportunity on these terms, then the selling shareholder would have a finite period of time to market the shares or business. If the selling shareholder found a buyer within this time period for a price equal to or above the offered price, then the sale could go through. This approach enables the non-selling shareholder to assure that the price is fair and that it has had an opportunity to participate in the purchase. It also allows the selling shareholder to pursue the sale without the specter that the would-be buyer will be discouraged by the existence of the right of first refusal. The time period during which the shares or the business must be sold at or above the offered price should be kept relatively short (e.g., not more than six months). This minimizes the psychological and logistical impact of having the business or large block of stock being perpetually up for sale. The right of first offer should also adjust for the circumstance where the buyer's price is ultimately reduced below the offer price (e.g., due to a purchase price adjustment between signing and closing caused by losses or declining levels of working capital). A modest, let's say 5% reduction, below the offer price is generally accepted as reflecting the realities that the business can deteriorate by some amount without starting the entire right of first offer process over again from scratch.

Some investors believe that a right of first offer also has a chilling effect on would be purchasers due to the many timing and price caveats contained in first offer provisions. For example, the possibility that the value of the business may decline and thus reduce the sale price below the offer price, or the closing may be delayed due to financing or regulatory reasons and, therefore, the process must be re-commenced, may serve to dissuade many buyers from trying to buy the shares or business. Therefore, some agreements only require the parties to negotiate in good faith for a finite period. If the right of first negotiation does not result in a binding agreement within a finite period, then the selling party is free to sell for any price, even a price below the previous negotiated price. This approach provides the selling shareholder with the most certainty that the sales efforts will not be impeded by the other shareholders' rights. Considerable subjectivity, however, regarding the standards of good faith negotiation abound and the threat of litigation over this issue could loom large. The ability to negotiate in good faith with parties with whom distrust or antagonism may be present is also difficult.

<u>Drag Alongs/Tag Alongs</u>

After the expiration of any holding period which prohibits a shareholder from transferring its shares, sales within an investor group, family-owned group or employee group are typically offered to the other members of the group first and then offered to the other groups or the business itself. Employee-shareholders may claim that their ability to purchase the investor's or other family's shares is illusory since the employee-shareholders do not have a realistic access to capital to acquire the funds. The investors reply that this fact should not preclude their ability to sell and should not harm the employee-shareholders, since in substance one investor is merely being replaced by another. Whether this view is true depends in part on the degree the selling investor participates in or actually controls the business.

Since one family-owned or group of investors may not own all of the business' securities, their efforts to sell the business may be thwarted if the third-party buyer desires to purchase the entire business. Therefore, investors or one family-owned group typically require the right to cause the other family-owned group or employee-owners' shares to be "dragged along" and sold to the buyer at the same price if either the buyer requests or the selling owner believes that the sale of all of the stock will enhance the prospects for sale of the business. Employee-shareholders or one family-owned group, on the other hand, may desire to sell their shares to the buyer at the same time and price as the selling group. An employee-shareholder's rights to "tag along" is generally acceptable to investors on two conditions. First, the tag along (or piggyback) right is not considered if the buyer genuinely would not buy the business unless the employees maintained their same ownership interest and the same motivation inherent in ownership of a business. This concern is only rarely voiced by a buyer and many avenues pave the way to address this concern, including selling some of the employee's stock and rolling the balance over on a tax deferred basis into the buyer's entity, giving options to founders to buy stock in buyer's company, or selling them some stock in the buyer's company. A second issue arises in poorly drafted "tag along" clauses. Frequently, these clauses simply allow the employee-owners to sell on the same basis as the investor. If the investor desires to sell all of its stock, which represents 80% of the business' stock, does this tag-along right therefore mean that the investor can still sell all of its stock and the employees also have the right to sell all of their stock? Or does this mean that the investors may now only sell 80% of their shares (64% of the business total outstanding shares) and the employees may only sell 80% of their shares (16% of the total shares) to give the buyer the desired 80% of the total stock in the business? These clauses frequently do not address the ramifications of the buyer refusing to proceed with the transaction if, in the first scenario, the buyer is forced to buy all of the business' shares and aborts the transaction as a result.

c. Judicial Remedies if Parties Cannot Govern Effectively. Hopefully, the shareholder or other contractual or personal relations among shareholders will cause the corporation to be governed efficiently and properly. The judiciary, however, is the court of last resort when persuasion, prudence and contract fail to forge agreement. Most statutes are designed to allow courts to exercise a broad range of remedies from the draconian and last resort liquidation of the corporation to more targeted and narrow remedies to break the deadlock at issue and to prevent future disputes. Courts have wide discretion and latitude in exercising their equitable powers to fashion well balanced and appropriate remedies. Some remedies may be appropriate in some cases and not appropriate in others based on the varying facts, circumstances, nuances and personalities of each case.

Delaware law, and the law of many states, allows any shareholder to seek that the court appoint a custodian of the corporation when the shareholders are so divided that they cannot appoint directors or cannot otherwise govern the corporation (if it is a close corporation). The court may also appoint a provisional director if at least half the directors or one-third of the shareholders (by ownership percentage) so request and the court deems equitable to prevent irreparable harm to the corporation. Delaware also permits a close corporation to have a provision in its certificate granting any stockholder or specified ownership percentage to have the corporation dissolved upon their will or the occurrence of a specific event.

Illinois courts also permit a court to compel dissolution or the repurchase of a complaining shareholder's stock in the corporation. The Illinois statute requires the complaining party to show either that (1) the shareholders of a close corporation are deadlocked in voting power, (2) the directors have acted illegally, oppressively or fraudulently or (3) corporate waste or mismanagement have occurred. Illinois also permits other alternative judicial remedies such as prohibition or compelled performance of an action, removal of an officer or director, canceling or altering any article or by-law provision, paying dividends, paying damages, or appointing a custodian or provisional director. These remedies are designed to eliminate shareholder self-help remedies and lower the cost and delays of protracted litigation.

7. Board Structure.

Since state law vests in the board of directors the power and authority to manage the business of the corporation, and since the board and its members need to function efficiently and properly to carry out the goals of corporate governance and the responsibilities of directors discussed above, the optimal structure of the board is key to accomplishing these results. This section discusses various components to consider in establishing and managing a board.

a. Composition. It is self evident that the board should be comprised of a broad spectrum of educated, experienced and deliberate people with vast and diverse business and problem solving skills, as well as independence. The composition of the board to implement that bromide has evolved over the past decade or two. Before the plethora of takeover and other shareholder driven litigation challenging and, at times, seeking to micromanage the decisions of the board, its typical composition was senior management, maybe an outside investor, banker, community representative and customer, and then the corporation's outside legal counsel and perhaps accountant.

In today's corporate climate, most boards of public corporations have a majority of independent directors and many have at least two outside directors for each inside director. Family-owned businesses remain, and will likely remain, dominated by family-owned members and active senior management. Legal counsel and other service providers are gravitating toward playing less of a role on the board.

The composition of boards in family-owned businesses are perhaps anathema to the principles set forth above. Rarely are the members of the board independent. Many times the board members have family-owned considerations, and not just business considerations, in mind when making a decision. Many members of the board may have resumes which may be limited to the family-owned business without a broad and diverse background of varied experiences.

The role of the Chairman and Chief Executive Officer has become more bifurcated over this time frame. As discussed in section 5, while only one-sixth of the survey respondents have actually formally separated these roles, the trend is definitely in this direction. Other studies have estimated that only 5% of public corporations have outside directors as Chairman, although 35% indicated they were receptive to this change.

b. Size and Term of Board Members. Most state laws require at least one director. Many family-owned businesses follow that approach or have a small board comprised solely of family-owned members, even those who have never participated in the business. Corporations should consider drafting in their certificate of incorporation or by-laws a minimum and maximum number. Certainly there should be a minimum number of directors necessary to handle the function of the board in proportion to the size and complexity of the business of the corporation. A maximum number will give the corporation the flexibility to increase and decrease the size of the board, without shareholder approval, as and when the corporation expands or appropriate candidates emerge. Ideally, the board should be small enough to function smoothly, efficiently and without bureaucracy, yet large enough to have a diverse and talented group of participants. Many commentators have suggested that smaller boards act more cohesively and increase the opportunity for each director's voice to be heard and provide meaningful input. The board, in general, should be as big as it needs to be, to relate to its constituencies and perform its function effectively.

The average size of the board of a publicly-traded corporation is believed to be 12 members whereas the average size of a family-owned business is not known but is certainly much smaller. The trend in the business community over the past decade has been to reduce the size of public company boards to make them function more cohesively and better focused. Many directors selected for diversity or "window dressing" purposes or who have outlived their contribution and participation have tended to be the targets of the reduction in board size.

Directors are typically elected to one year terms. Every state except California allows directors to be elected to staggered terms. Typically a staggered board will have a multiple of three directors (e.g. nine), each of whom will serve for three year terms (unless removed for cause or due to death, disability or resignation) and only one-third of whose terms will expire in any given year. Staggered boards help thwart hostile takeovers since the removal of directors is made more difficult. Staggered boards also provide for greater continuity and more stability of directors since the term of each director is typically more than one year and since all directors' terms do not expire at the same time.

c. Time Commitment. Quantification is difficult since the required effort will vary with the corporation and circumstances confronted. Surveys indicate that directors of public corporations devote about 100 hour per year to board service. This equates roughly to six full day meetings and six full days of preparation. Directors should assess the time commitment expected of them prior to becoming directors and not over-commit themselves to too many boards. Likewise, director search committees should try to evaluate the potential of other time demands that may divert the attention of a director.

d. Compensation. Directors deserve to be fairly compensated to reflect their fair contribution to the corporation and lost opportunities. The forms of compensation are many and varied, from all cash to all stock and stock options and to hybrids of both. Many public corporations are now requiring directors to receive at least a part of their compensation in stock and to invest some minimal level of personal funds in the stock of the corporation. Independent stock ownership is not an issue in family-owned businesses since most directors tend to be insiders and either directly or indirectly own the majority of the business.

Significant conflicts of interest arise when directors set their own compensation. The level of compensation and the types of perquisites need to be carefully scrutinized to assure that the board remains truly independent and objective. Boards should conduct surveys of compensation levels of boards of comparable firms and obtain other salient information to gather objective evidence of the appearance of fairness of their compensation.

e. Quality of and Access to Information. The old adage "garbage in garbage out" is equally relevant in encouraging management to provide quality, timely and organized information to directors. Senior management should also make themselves available on a reasonable basis to answer director questions outside of the structure of the boardroom. This information will enhance directors' performance, as well as enable them to better discharge their fiduciary duty of care. In family-owned businesses, the free flow of information is sometimes restrained. The patriarch or others controlling the day to day operations sometimes restrict the information flow due to their desire to reduce or minimize family-owned tensions or jealousies.

f. Meetings. The boards of public companies typically meet every two months (barring a major event or transaction). Directors should receive agendas and information packages for the meetings as far in advance as possible to enable them to review the information and come prepared. Senior management should also invite directors to propose items for the agenda. Meetings should be properly balanced between the time allocated to senior management presentations, special committee reports and the time for directors to ask questions and raise other issues. The conduct of meetings should veer between military precision and a free-for-all.

g. Committees. The boards of most public corporations have created committees to oversee specific functions such as compensation and audit. Special committees may from time to time be established to handle specific matters such as evaluating an acquisition or takeover overture or an investigation. The New York Stock Exchange rules require listed companies to have an audit committee and the SEC proxy rules mandate reports from a compensation committee (if one exists) and strongly discourage management directors from serving on that committee. The Model Act, as well as many state statutes, allow a director who is not serving on a committee to rely upon the reports and recommendations of such committee.

8. Liability of Directors and Officers.

Many directors consider board service to be an honor, obligation and/or source of great pride and achievement. As with any virtue, directors should analyze the potential considerable personal liability to which service exposes them.

a. Damages and Personal Liability. Directors may be personally liable for breaches of the duties discussed in parts 3 and 4 of this article. State laws establish the prerequisites for the liability for damages arising from the breach of conduct described in that section. State law also imposes potential liability on directors for approving dividends or other distributions from the corporation which would render the corporation insolvent or is otherwise "unlawful" or in violation of the corporation's charter. Delaware law, for example, imposes liability on directors to the corporation and, if the corporation is insolvent, to its creditors, for six years following the date the unlawful dividend was paid. This liability extends even if the director was merely negligent and not grossly negligent (which is the standard for imposing most other non-willful liability for breach of the duty of care). In deciding whether to declare or pay a dividend, directors are allowed to rely on the financial books and records of the corporation as well as the opinions of experts.

Federal law also imposes statutory liability on directors for violation of various statutes. The inter-workings and nuances of these and other statutes are far beyond the scope of this article, but the following lists certain statutes of which a director should be aware. The federal securities laws, for example, impose liability on directors in several areas. The statutes include violations of ERISA, prohibitions on insider trading, short-swing profits, sales by reporting persons, faulty registration statements, failure to comply with SEC reporting requirements, and false and misleading proxy statements. While these statutes do not directly apply to directors and other fiduciaries of family-owned businesses, sensitivity is needed. For example, the director of a family-owned business could still be potentially liable for insider trading if he buys the stock of a public company who is possibly going to buy the director's corporation or otherwise enter into a material agreement with that corporation.

b. Indemnification, Exculpation and Insurance. No director in his right mind would serve unless there was broad indemnification and exoneration for their good faith conduct. State law as well as private contract typically grant directors broad indemnification protection. Delaware law, for example, has a broad indemnification statute which over half of the states follow. Delaware law gives every corporation the right to indemnify "any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation…" This statute forms a non-exclusive basis for indemnification. Contractual, charter and by-laws of a corporation may broaden the indemnification rights of those owing a duty to the corporation, subject to limits imposed by public policy. These provisions may even make indemnification mandatory, as long as it is not against public policy, and include an advance of expenses through final appeal.

Indemnification protection for shareholders of the corporation does not appear to be covered by this statute. This is surprising since, as discussed previously, since some and perhaps all shareholders of family-owned businesses and other close corporations owe a fiduciary duty to the corporation and other shareholders. Shareholders of family-owned business should consider contractual or other forms of indemnification from the corporation.

The corporation may advance defense and other litigation expenses to those covered persons, even if their lack of culpability has not yet been determined. If the recipient of the advance does, in fact, turn out to be culpable, then the corporation would be entitled to reimbursement.

Delaware law imposes three prerequisites to indemnification. First, the person seeking indemnification has to be a member of the covered class entitled to indemnification. Second, the person must have acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation…" The term "good faith" is not defined in the Delaware statute. The Model Act suggests that this term is subjective, and includes "a mistake in judgment" even if a reasonable person would not have made such a decision. A mistake in judgment is not broad enough, however, to entitle a director to indemnification for reckless or intentional bad acts or breaches of the duty of care. Finally, the person seeking indemnification must have "reasonably believed" that he or she acted in a manner either in or not opposed to the corporation's best interests.

In addition to indemnification, the corporation may exculpate a covered person. The Delaware statute, which most states have adopted, provides that a corporation's certificate of incorporation may limit or eliminate the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. This statute only covers directors, and not shareholders, officers or other employees and agents. The exculpation provision does not eliminate or limit a director's liability for any breach of his duty of loyalty, acts or omissions involving intentional bad acts, willful or negligent authorization of the payment of dividends or stock repurchases or any transaction from which the director derives a personal benefit.

In family-owned businesses, the corporation's indemnification and exculpation obligations are typically self-funded, i.e. the covered party may only seek protection from the assets of the corporation. Most publicly traded corporations, and some large or venture capital driven private corporations, purchase directors and officers liability insurance ("DOI"). DOI fills in the gaps where the corporation may not have the resources to provide indemnification, and provides psychological solace to a covered person that funds will likely be available. DOI may also provide funds where indemnification is not applicable, such as in a shareholders derivative suit or due to violations of federal securities laws and for other situations in which the covered person cannot satisfy the requirement that he acted in "good faith" or with a "reasonable belief."

DOI policies tend to have many exclusions from coverage and these will vary with the carrier. Typical exclusions are for deliberate dishonesty, personal gain, bodily injury or property damage, violation of the securities act prohibition against short-swing profits, liability under the ERISA statute and illegal payments.

Fred D. Tannenbaum is a partner with Gould & Ratner LLP in Chicago and is Chairman of LawExchange International. Mr. Tannenbaum can be reached at ftannenbaum@gouldratner.com.