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M&A IMPLICATIONS OF CORPORATE GOVERNANCE AND SUCCESSION PLANNING FOR FAMILY-CONTROLLED BUSINESSES

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Family-controlled businesses face unique corporate governance and planning issues with the passage of time as ownership and control is handed down from founders to their successors and heirs. These obstacles are best illustrated by way of example:

> Imagine a successful company founded in 1982 by a charismatic inventor, Margaret. Suppose that Margaret is now in her early seventies but has continued to serve as a very hands-on chief executive officer. Margaret has three children, Sally (an officer and director of the company positioned to succeed Margaret), Sam (a successful investment banker) and Michael (a respected but financially constrained artist), and nearly a dozen grandchildren. Margaret has a very loving relationship with all of her children and grandchildren and, for purposes of estate planning, wants them all to be treated equally as an economic matter.
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> Suppose that Margaret has decided that upon her death a trust will receive all of her shares in the company, and such shares constitute 70% of the company's outstanding equity with 30% held by various third party investors. The beneficiaries of the trust are to be all of Margaret's lineal descendants, and the trust will have three trustees: Sally and two other persons who are of-ficers and directors of the corporation but who are not Margaret's lineal descendants.

There are many important questions that Margaret must face in deciding how to set up a flexible and effective corporate governance structure for her company while simultaneously achieving her estate planning objectives. For instance, given that the company's shares will be held by a trust, how should the governing documents address the duties and obligations of the trustees? How will power in the company be allocated among heirs such as Sally who are actively involved in the business and others who are not but whose inheritance is tied to the company's value? Will the company remain family-controlled even if it needs outside capital? What will happen if Margaret's children or grandchildren have a dispute about the company or finances? What if some of her heirs want to monetize their investment by selling the company or taking it public, but others do not?

Legal advisors must be ready to help navigate such questions. This article sets forth five topics to consider when advising business owners on such planning matters.

Fiduciary Duties of Trustees, Controlling Shareholders and Directors

Frequently, family-controlled businesses are held in trust. The use of trusts has many benefits, including tax benefits, creditor protection, centralization of control, and succession planning. When a trust holds a controlling interest in a business, however, the fiduciary duties the trustee owes to the trust beneficiaries at times may conflict with the duties the trustee as shareholder owes to the company and other shareholders. Frequently, these issues can be managed effectively by careful advance planning.

Fiduciary Duties and Standard of Conduct of Trustee

The primary duty of a trustee is to administer the trust and its assets for the benefit of the trust beneficiaries. A trustee owes fiduciary duties to the trust beneficiaries, and must administer the trust in good faith, in accordance with the terms of the trust's governing instrument and in the interests of the beneficiaries. Notable fiduciary duties include:

- *Duty of Loyalty*: The law imposes on a trustee a duty of undivided loyalty to the beneficiaries for whom the trustee acts. This duty at times may conflict with duties that the directors of a trust-controlled business owe to outside shareholders. In addition, a trustee generally may not deal with the trust assets for the trustee's own benefit.

- *Duty of Impartiality*: A trustee has a duty to administer a trust with due regard to the respective interests of both income beneficiaries and remaindermen. A trustee considering a transaction for a family-controlled business held in the trust must favor neither the interests of current family beneficiaries nor the interests of future (*e.g.*, even unborn) family beneficiaries.

Under state trust law generally, a trustee's standard of care is the "prudent investor" standard. A trustee generally is charged with the exercise of such care and skill in the performance of the trustee's duties as would be exercised by a prudent person of commensurate skill in handling similar matters. The creator of a trust may alter the trustee's standard of care in the trust instrument so long as the standard is not contrary to public policy in the relevant state. The acceptable standard of care varies among the states. Many states allow a trustee generally to be excused from liability except in cases of "willful misconduct" but others have developed a different minimum standard of care and will not excuse liability for "gross negligence." Where a settlor such as Margaret intends to relieve a trustee from liability for particular acts or conduct, the exculpation provision ideally should be as specific as possible.

Addressing Potential Conflict Situations in Advance

When a trust, such as Margaret's, will own voting control of a family business that has non-family member minority owners, there are various potential conflicts of interest that may arise. This is particularly the case where a corporate transaction may disproportionately benefit the trust. Margaret's trust would have trustees who are also company directors and, as such, may owe a corporate law duty to act in the best interests of all shareholders. Further, in some states, the trust itself (as a controlling shareholder of the company) may owe duties to the minority shareholders. Under trust law, however, the trustee's duty is to act in the best interests of the trust beneficiaries.

Margaret and her advisors should consider what would happen if a large competitor proposed to acquire the company after ownership of her shares pass to the trust. In exercising a trustee's duty of care in accordance with the prudent investor rule, a trustee generally has a duty to diversify the trust's assets. A trustee may incur liability to the beneficiaries for failing to diversify the trust's investments if the failure to diversify is shown to cause a loss to the trust. A trustee's presumptive duty to diversify may require the trustee to consider this proposed sale of Margaret's company if the business constitutes a significant holding of the trust, even if a sale of the business at that time may not be in the best interests of the other shareholders.

To minimize the potential conflict, the governing instrument of Margaret's trust may contain terms authorizing or directing the trustee to hold a particular business interest even though holding such interest otherwise would violate the prudent investor rule, thereby relieving the trustee from the duty to diversify with respect to a particular holding of the trust.

Similarly, a provision in a trust instrument prohibiting a sale or limiting the authority of a trustee to sell a business holding may create a conflict with the other shareholders. Such a provision could require a trustee to reject a purchase offer even if it is in the best economic interests of the shareholders, including the trust. As a general matter, such provisions should be avoided.

Other potential conflicts should be considered and addressed in advance. For example, under applicable trust law, an individual's potential conflict as a result of acting as an officer or director of a trust-controlled business may *per se* disqualify the individual from acting as trustee. A trustee's duty of loyalty also could prohibit an individual acting as trustee from receiving a personal benefit from a trust-controlled business, which would include compensation as an officer or director of the company.

To avoid such problems, the governing instrument of Margaret's trust may authorize each of the trustees

(i) to act as trustee even if the trustee also is an officer or director of the company and (ii) to receive compensation and other benefits from the business in the trustee's capacity as an officer or director. An alternative approach to managing potential conflict situations is to provide a mechanism in the trust's governing instrument for the appointment of an independent special trustee to act when the trustee has a conflict.

Finally, conflicting fiduciary duties can be mitigated by a thoughtful choice of entity. The state laws governing limited liability companies may be more flexible than those governing corporations with respect to fiduciary duties. In Delaware, corporate directors and officers are subject to non-waivable fiduciary duties, while a limited liability company agreement can limit or eliminate most duties of a member or manager of the limited liability company. Accordingly, in a trust-controlled entity formed as a limited liability company, the issue of potential conflicting fiduciary duties can be addressed up front as a contractual matter.

Potential Conflict Situations That Cannot Be Managed Effectively in Advance

Although a trust's governing instrument may contain general waivers of conflicts, some conflicts are not waivable. This is particularly the case where a trustee is an "insider" of a company in which the trust holds a controlling interest and a transaction the trustee must approve or permit could be construed as unduly benefiting the trustee in a personal capacity.

Imagine that the proposed sale of Margaret's company would also result in Sally receiving a significant change in control payment from the company as a result of early vesting of equity awards she holds. Sally could be liable to the trust beneficiaries if she approves or permits this transaction. Exculpatory clauses and conflict waivers in the trust's governing instrument and reliance on an independent advisor's fairness opinion alone may not provide sufficient protection for such conflicts. In this sort of situation, a trustee may wish to obtain the trust beneficiaries' consent to the proposed transaction.

A trustee will be protected from liability for the trustee's actions if such actions are consented to by the beneficiaries, so long as such consent is fully informed and not improperly induced by the trustee and the consenting beneficiaries are of age and otherwise have capacity to provide consent. Adult beneficiaries who have capacity generally may provide effective consent. In addition, under "virtual representation" statutes and similar provisions in a trust's governing instrument, the adult beneficiaries may represent and bind other trust beneficiaries, including charities and those who are minors, unborn or under a disability, with respect to trust matters.

For large trusts with many beneficiaries, however, obtaining effective consents from the beneficiaries may present practical difficulties. In order for the beneficiaries' consents to be fully informed, the beneficiaries generally should be independently represented by advisors who can assist them in evaluating a proposed transaction. In addition, the beneficiaries and their advisors would need access to confidential information at the company level, which likely would necessitate entering into nondisclosure agreements.

In the M&A context, consideration would need to be given as to whether the trustees would receive a disclosure document that is separate from what is provided to other shareholders, and, if so, what the company's role (if any) would be in preparing and filing such a document. In addition, the parties to the M&A transaction would need to agree as to whether the transaction would be conditioned on the consent of the beneficiaries or whether that consent could be obtained pre-signing.

Liquidity and Third-Party Investments

When relatives co-own a business they often face some of the same challenges and obstacles that present themselves to parties pursuing a joint venture.

Over time, just as with a joint venture, the circumstances of the co-owners or the underlying business might change, creating additional challenges. For instance, Michael, the artist, may have a growing need for liquidity to fund his children's education, or the company might reach a stage in its life cycle where it needs to grow by acquisition but requires external investment to do so.

There is an inherent tension between granting heirs liquidity or allowing outside investment and ensuring that a family continues to control the company. The right balance depends on personal preferences and the needs of the parties in question. But estate planning that assumes that the needs of the company and heirs will remain static could lead to conflict among heirs or underinvestment in the company. Accordingly, a flexible framework is best.

Some of the devices that traditionally are used in joint ventures can be used to give family businesses and their owners the flexibility they need to navigate unforeseen developments. The following devices can be calibrated to strike the right balance:

- *Options*: Call options can give a company or its shareholders the ability to purchase the interest of other shareholders while put options can give a shareholder the right to force a company or other shareholders to purchase their shares, in each case, pursuant to specified formulas and processes. Options can satisfy the needs of those who desire liquidity while ensuring that ownership stays with the existing shareholders. Options also can facilitate a clean exit if a dispute is festering between co-owners.

- *Transfer Restrictions Coupled with Rights of First Refusal or Rights of First Offer*: Transfer restrictions limit the universe of transferees to a specific set of persons, unless the person who desires to sell their shares complied with the requirements of a ROFR or ROFO. This allows a sale to or an investment by third parties while giving other heirs the opportunity to preserve family control.

- *Preemptive Rights*: Before a company can issue new equity, existing owners are given the opportunity to subscribe to the new shares in order to maintain their proportionate ownership. This creates a framework for private placements to third parties subject to existing family members having the opportunity to invest the capital the company needs.

- *Tag- and Drag-Along Rights*: Such rights help facilitate the sale of a whole company while ensuring that all shareholders are treated fairly and that no shareholder can extract hold-up value.

The facts and circumstances will determine which, if any, of these tools are appropriate, and how to fine-tune the mechanical details. Particular pressure points for consideration include timing of potential exits, the valuation of shares and the liquidity of the parties. Some of the devices (for example, options and transfer restrictions) can have an impact on the valuation of the affected interest in the company for estate and gift tax purposes, and accordingly the design and crafting of such provisions by the M&A lawyer should be coordinated with the client's estate planning attorney.

Balancing the Needs of Active and Passive Owners

It is common in family-controlled business that over time some family members will be actively involved in the business while others will be passive owners. This can create a host of problems or incite conflict as the interests of active and passive owners diverge.

With respect to Margaret's company, it is easy to see how her children might have different views regarding what is best for the company. Sally, as a company insider, may prefer that more returns are reinvested in the company rather than distributed.

There is also a risk that she might engage in transactions that are self-enriching—whether it be setting a favorable salary for herself or giving other insiders equity compensation to increase the power or benefits of management. At the other end of the spectrum, Michael, given his financial constraints, might be more likely to prefer that the company sell itself, or that dividends be maximized at the expense of reinvestment. Alternatively, Sam's independent banking experience might lead him to second-guess Sally's leadership or have strong preferences regarding the company's capital allocation strategy.

Ultimately, corporate and estate planners need to create a framework under which passive shareholders are treated fairly and not abused, but do not have undue rights to impact the management of the company. The exact solution can vary. One approach is to give passive shareholders who own a specified threshold proportion of the company's equity veto rights over certain significant transactions including initial public offerings, amendments to the company's organizational documents and a sale of the whole company, as well as any transaction that could impair their economic or governance rights in a manner disproportionate to other shareholders. Sometimes combining veto rights with a put right, a call right or another exit mechanism for minority shareholders who feel disenfranchised can prevent discord from bringing the enterprise to a standstill.

The rules governing the appointment of directors or the ability of shareholders to directly influence company policy can be another means for calibrating the balance of power. In families where there are well-defined factions and groups of family members, each faction can be given the ability to appoint directors. For instance, each faction of Sally, Sam and Michael could have the right to appoint a portion of the board. In large, multi-generational families where there can be dozens of stakeholders, a more democratic, inclusive model can be used whereby decisions about material company policies are made at family meetings.

Family-Controlled Companies with Publicly-Traded Equity

It is possible for a company to have public shareholders while still remaining firmly controlled by a founder and her heirs. Public equity ownership under the stewardship of family control raises a host of issues ranging from how to achieve such a structure to considering the public disclosure requirements imposed by federal securities laws. While a family-controlled public company may be able to take advantage of controlled-company exceptions to stock exchange listing rules, the company likely still will be subject to other restrictions and requirements that should be considered in connection with the decision to take the company public.

Dual-Class Equity Structure

A common method for tapping public equity markets without relinquishing control is to employ dual-class common stock featuring one class with special voting and governance rights that is held by a select group of shareholders (*e.g.*, founding shareholders and their heirs) and another class that is sold to the public but has limited voting and governance rights. Dual-class structures are not new but they have continued to proliferate with the IPOs of companies such as Facebook, Google, Shake Shack and Fitbit.

The apparent convenience of a dual-class structure comes with long-term costs. It might make sense for uniquely gifted founders such as Margaret to maintain special control over an enterprise even if it has public shareholders. But such arrangements could be subject to long-term problems as control is retained over multiple generations. Even if second-generation leaders such as Sally are well suited to lead, someone in Margaret's position may not know whether third- or fourth-generation heirs will continue to have the desire or ability to lead the company. Management of the company's affairs might suffer and the risk of scrutiny for such failures is greater in a public company. And, of course, if the family's fortunes are tied to the company, third- and fourth-generation heirs might be worse off than if the family's wealth were originally invested in a diversified portfolio of assets.

The liquidity concerns that plague privately held family businesses can still apply in dual-class companies. This is an obvious issue if the special voting class of stock is not itself publicly traded. But even if both the high-vote and low-vote classes of stock are publicly listed and freely transferable, the market for the more widely held shares is likely to be deeper and more liquid. This can create an unusual outcome whereby shares with special governance powers trade at a discount to the more widely held shares Many dual-class company charters seek to address these issues by including "sunset" provisions that automatically cause high-vote shares to convert into low-vote shares if transferred to third parties.

Of course, one reasonable response to the above concerns could be that, as time passes and circumstances change, the company and its controlling family could simply restructure the company's capital structure to do away with the dual-class structure.

In order to facilitate such flexibility, legal advisors need to carefully craft the relative rights of the two classes in anticipation of such a recapitalization. Margaret would need to address whether her descendants should be able to extract a premium for relinquishing control to public shareholders through a recapitalization. Additionally, attention should be given to antitakeover laws of a particular jurisdiction and how they might apply to a recapitalization involving a controlling shareholder.

Federal Securities Laws and Public Disclosure

Another important consideration for a family-controlled business looking to tap public equity markets is that the company will be accountable to its public shareholders and regulators. In particular, federal securities laws will require a myriad of public disclosures.

Periodic reports will require the company to disclose information about its financial condition. Such disclosures would make significant details about the finances of a controlling family public knowledge. Not only are the finances of a public company subject to disclosure, but controlling shareholders are personally subject to significant disclosure obligations. Rule 13d-1 of the Securities Exchange Act of 1934 requires that certain beneficial owners of more than five percent of a class of equity securities file reports with the Securities Exchange Commission on Schedule 13D. Most notably, Schedule 13D requires such shareholders to disclose their plans or proposals for the company on an ongoing basis. In addition, the proxy rules will require disclosure of related party transactions involving controlling shareholders.

Public disclosure can become an even bigger concern if there is a dispute among family members. For instance, if there is conflict that escalates into a contest for control of the company, a public proxy fight would necessitate extensive public disclosures. The prospect of a family feud is only made all the more troubling if it is to play out on a public stage.

Dispute Resolution

The risk of a family feud is something that must be taken into consideration. Simmering sibling rivalries can escalate when money and power are thrown into the cauldron. Disputes in family-controlled companies can garner a lot of press attention even if a company is private because the combination of wealth and the appearance of family dysfunction makes for an easy story for the press. Not only could publicity embarrass the family but it also could harm a company's relationship with suppliers, customers and distributors, who might be alarmed by the uncertainty surrounding the company's direction.

Although a private company is better positioned than a public company to maintain confidentiality in the midst of a dispute, public scrutiny of private companies is still possible through court filings made in the course of litigation or through voluntary disclosures by indiscreet stakeholders. Various tools can be employed to maintain privacy. For instance, mandatory arbitration provisions, confidentiality agreements and the inclusion of non-disparagement clauses in shareholder agreements and other instruments can limit the ability of dissident family members to damage the company with negative publicity.

Conclusion

Family-controlled companies present many interesting issues at the intersection of estate planning and M&A. It is critical that a family's estate planning advisors coordinate closely with the company's M&A advisors to ensure a consistent and workable approach across both aspects of the company's future.