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Smart Governance Structures: The Keys to Success in Shared Ownership

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When a family business is owned in substantial amounts by two or more family members (i.e., shared ownership), a smart governance structure can help the owners remain cohesive and enjoy the economic rewards of a successful business.

Smart governance structures are transparent and open to owner participation. They are well-defined and operate objectively. They allocate input and authority in ways that encourage consensus and collaboration—and avoid deadlock. They do not permit arbitrary or abusive application. They are tailored to meet the owners' reasonable perceptions of what is fair and equitable. They incorporate checks and balances.

Four Levels Of Governance Authority And Oversight

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

A graphic representation of authority:

Share Voting
Elects the directors and holds them accountable through removal

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Board Authority
Appoints officers/executives, directs and oversees their performance, and holds them accountable through removal

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Executive Management Authority
Exercises powers of day-to-day management that determine return available to beneficial interests

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Beneficial Interests
Benefit from exercise of authority of all above levels, but has no authority

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

A graphic illustration of economic interests:

Beneficial Interest Holders
Holders of debt entitled to priority repayment; holders of equity entitled to unlimited economic enjoyment of profits or net proceeds

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Executive Management
Executives entitled to reasonable compensation and benefits for services

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Board Members
Directors receive board fees for limited time commitment

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Holders of Share Votes
Holders of votes have no direct economic interest by reason of voting rights, but might receive fee if voting as a fiduciary

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

Allocating Ownership Rights And Governance Authority

A smart governance structure for a family business with shared ownership is one in which everyone is accountable to someone else, including an independent presence who can "arbitrate" owner deadlocks or act in matters of owner conflicts of interest.

Building a smart governance structure involves defining what specific powers can be exercised at each level of authority and then creating an equitable system for determining who will serve at each level.

1. Executive Management

The executives will run the day-to-day operations of the business. Executive hierarchy and each executive's authority can be set forth in the By-Laws (or LLC agreement), or be left to the discretion of the Board of Directors to be set forth in resolutions that the Board may issue from time to time. The authority of even the top executive can be limited by the Board, which may require some actions of the executives to be specifically approved in advance by the Board. The Board will also determine compensation of the top executives. Usually, the By-Laws (or LLC agreement) will provide the executives serve at the pleasure of the Board, and thus can be removed with or without cause. However, the Board can approve an employment contract that provides severance benefits for an executive who is terminated without cause.

In the context of shared ownership, the fact that one owner has been appointed to serve as chief executive can be easier for the other owners to accept if the Board maintains enforceable oversight of the chief executive's activities and if the other owners sit on the Board or have a meaningful influence over who sits on the Board.

2. Governing Board

In a shared ownership family business, it is likely (and usually appropriate) that each owner who holds a substantial amount of stock will have a seat on the Board. However, a smart governance structure for a shared ownership family business will also include a meaningful number of independent directors on the Board.

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

The Articles of Incorporation or By-Laws should set forth the number of independent directors required, their terms and how they are elected. It may be advisable to stagger the independent directors' terms to provide stability on the Board from year to year. It may be desirable to classify Board seats so that different lines of family owners are each represented on the Board by at least one independent director, or it may be desirable to adopt cumulative voting so that minority owners can pool their votes to elect at least one director, notwithstanding the voting of owners who hold more stock.

Regardless of who sits on the Board or how they are elected or appointed, the company's governing documents should explicitly state that each director owes the same fiduciary duties to the company and to the owners as a class. Directors, acting as directors, cannot pursue their own interests (or the interests of the constituency that elected them) contrary to the interests of the company or its other owners.

3. Voting Owners or Powerholders

The preceding section discusses some mechanisms to help allocate representation on the Board of Directors among the owners, such as classification of Board seats or cumulative voting. In some cases, however, the family members who own the company may be too inexperienced, uninformed or contentious to responsibly exercise shareholders' rights to vote for directors or hold the Board accountable. Also, in most cases, owners have no fiduciary duty to the company or the other owners with respect to how they exercise their voting rights. In such cases, it may be necessary to insulate the company from the beneficial owners of stock by granting voting rights to a fiduciary or some other powerholder who is more likely to responsibly exercise the stock voting rights.

This issue can be addressed through trust ownership of the company stock (or LLC units). A key step in planning for such trusts is determining who will have authority to vote the ownership interests and who will have authority to appoint, remove and replace such powerholders. Often, corporate trustees may be best at the ministerial duties of a trustee, but may be inadequate to exercise an owner's voting rights in a family business. In such cases, a "directed trust" may be more appropriate. Under a "directed trust," the trustee's authority and discretion with respect to ownership in the family business is delegated to a special trustee or board of advisors who exercise the right to vote for the stock held in trust.

Other means of allocating voting rights or discretion away from the beneficial owners include a voting trust, a voting agreement or the use of voting and nonvoting stock to select which owners can vote and which cannot.

4. The Voice of Beneficial Owners

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

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

Smart governance structures in shared ownership family businesses should lead to better decision making, positive owner attitudes and sharpen everyone's focus on the collective success of the business.

About Reinhart's Family Office Services

With the increasing value in and complexity of our clients' estates and financial holdings, which oftentimes includes one or more operating businesses, an increasing number of wealthy families are creating or utilizing the services of family offices. With the growing number of options available to such clients, Reinhart attorneys work with our clients to assess their needs, the options available, and then work with our clients to select or custom-design the best solution.

We listen to our clients, to gain a complete understanding of their goals and desires. This understanding of how our clients' business and financial goals intersect with their family's personal planning needs allows us to help guide them through their most important transactions, and to maintain a long-term course for future generations.

We undertake strategic counseling and planning roles as needed to assist the client, particularly when the client does not have a family office, serving in many of the capacities that they might look to a family office to provide, including helping to select and coordinate complimentary services for the family.

We assist families in designing and creating their family office, tailored to the unique needs of the family, its goals and unique assets. We also serve families who have a family office, when the family office itself needs specialized skills or guidance, whether long-range planning, crisis management, or a transaction involving family wealth.

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