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Are your family business ownership documents in order?

Photo 1:

Members of a family business may be tempted to adopt ownership documents (such as shareholder, partnership and LLC agreements) that are less robust than would be the case if the owners were unrelated. The rationale is that "because we're family, we don't need a lot of complicated legal documents." This is a great concept, except when it does not work.

Contracts are critical only when there are disagreements. If the owners of a particular family business can guarantee they will never have a disagreement, then well-prepared legal documents may not be necessary. This, obviously, is not a realistic assumption. In the event of a dispute, it is essential to have a detailed written understanding worked out in advance that will minimize the number of important issues left open for argument.

As part of their planning, family business owners should consider including the following types of provisions in their ownership agreements:

• **Buy-sell:** Triggering event buy-sell agreements provide that an owner's interest may be bought upon his or her death, disability, termination of employment, or divorce. For family business owners who are employed in the business, consider including a call option to buy the employee-owner's interest if the employment is terminated for any reason, with the terminated owner having a put option to sell if the call option is not exercised. These types of buy-sell provisions can help the family business avoid a widely dispersed ownership structure that includes many passive owners who are not involved in the business. They can also provide additional ownership to family members or non-family executives who are essential to the business.

• **Capital calls:** Such provisions clarify the owners' obligations to meet capital calls and guarantee company debt (and the consequences of failing to meet such obligations). If a family business requires a capital call to raise additional cash liquidity, the owners may already be under financial pressure. Having the details of capital calls spelled out in advance in the ownership documents can provide predictability and certainty about the way the process works, reducing one additional source of stress if the business is strapped for cash.

• **Voting trusts:** Voting trusts may grant certain family members (or non-family managers) the power to vote the ownership interests of other family members. Although ownership of a family business may tend to become more dispersed with each generation after the founders, voting trusts make it possible to keep governance and voting rights concentrated in fewer hands if that is preferred.

• **Deadlock resolution:** "Russian roulette" buy-sell provisions typically become operative if there is a voting deadlock on key issues. If the family business owners believe it is critical to avoid deadlocks over major issues, such provisions can provide a mechanism for ending the deadlock. These kinds of buy-sell provisions typically state that, if a deadlock occurs, one owner (or group of owners) may offer to buy out the interests of the other owners. Those other owners must either accept the offer to be bought out or, if not, they must in turn buy out the initiating owners on the same proportionate pricing and terms.

• **"Tag along" and "drag along":** "Tag along" buy-sell provisions protect minority owners, allowing them to "tag along" with majority owners in a sale of a majority interest in the family business. "Drag along" provisions benefit majority owners by allowing them to require minority owners to participate in a sale of all the ownership interests in the company.

• **Supermajority voting:** Under these kinds of provisions, certain key decisions must be approved by more than a simple majority vote of the ownership. This limits the ability of majority owners to force minority owners to accept major decisions.

• **Key man insurance:** Insurance proceeds may fund buy-sell obligations that are effective upon an owner's death or disability. Such insurance can provide a source of liquidity to repurchase a deceased or disabled owner's interest without having to sell or leverage company assets or raise additional equity.

• **Alternative dispute resolution (ADR):** ADR mechanisms, such as mediation and arbitration, make it less likely that a family disagreement will end up in a public litigation situation. With litigation, it can be extremely difficult to maintain personal relationships among the litigants. Use of mediation and arbitration is no guarantee that family members will be able to resolve a business disagreement without permanent relationship damage, but ADR may help reduce such damage.

A key question for a family business is whether its family ownership is more of a critical success factor or a liability. Although the answer will vary from family business to family business, the question underscores how important it is to have thoughtfully prepared ownership documents that include provisions designed to help the business transition from one generation of ownership to the next — if that is the goal — or to be successfully monetized along the way, such as through a sale transaction.

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