



# 111 Governance Best Practices for Family-owned Companies

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## Faculty Biographies

### Philip D. Calderone

Philip D. Calderone is the vice president, general counsel, and secretary of Banfi Vintners, a wine importer and producer headquartered in Old Brookville, New York. He is the solo in-house attorney responsible for contracts, regulatory compliance, real estate, litigation management, and general corporate transactions. Mr. Calderone has been actively involved in the succession planning of this family-owned business from the second to the third generation.

Prior to joining Banfi, Mr. Calderone worked as the first in-house counsel at the New York Institute of Technology, responsible for both business and academic issues. Mr. Calderone began his legal career as an associate at the New York office of Winthrop, Stimson, Putnam & Roberts.

He is active in local community service, although not as a lawyer. Mr. Calderone volunteers as a pianist and organist in his local church and as a music therapist at the VA Hospital in Northport, New York.

Mr. Calderone received his B.A. from the University of Virginia and his J.D. from the Washington and Lee University School of Law.

### Carol D. Miller

Carol D. Miller is general counsel for Restaurants Unlimited, headquartered in Seattle. She is the legal department for the closely held company, which operates 30 full-service restaurants in 13 states under a variety of brands, including Palomino and Kincaid's. She oversees all legal matters for the company, including real estate, corporate, human resources, compliance, and intellectual property.

Prior to joining Restaurants Unlimited, Ms. Miller was a partner in the Seattle law firm Ogden Murphy Wallace, where she was primary counsel for Restaurants Unlimited. Ms. Miller worked with the company as the founder and his family sold their interests in the company to outside investors. Guiding the company through the due diligence process was an enlightening experience that assisted her in preparing the company for future stock sales, increasing the value of the stock and expediting the closing process.

She is a member of ACC and the Academy of Hospitality Industry Attorneys, and is active in restaurant associations both at the national level and in various states, particularly on pertinent legislative matters.

Ms. Miller received a B.A. from Boise State University and is a graduate of University of Puget Sound Law School.

### Michael V. Ward

Michael V. Ward is the general counsel and corporate secretary for Targus Group International, Inc., the largest maker of laptop carrying cases in the world. His responsibilities are for all global compliance and legal matters.

Prior to joining Targus, Mr. Ward spent nearly a decade with a Fortune 100 company in a variety of executive-level and senior counsel roles handling acquisitions, alliances, business development, capital market transactions, compliance, and securities. In addition, he also managed the litigation for the company, which included antitrust, business practices, employment, and securities actions.

Mr. Ward is a graduate of Albion College and Case Western Reserve University School of Law.



## Session 111: Governance Best Practices for Family-Owned Companies

Philip D. Calderone

Vice President, General Counsel and Secretary

Banfi Vintners

*“Closely Held Family Business:  
The Journey From Business Success to  
Succession and Legacy”*



## I. The Ultimate Legal Problem

- A. Defining the Problem: Survival of the business
  - 1. Of the many issues which affect the proper functioning of a family business, continuity of management at the top is critical. Disagreement about whether the business should continue is the “nuclear” question.
  - 2. Confronted with the earmarks of a family business meltdown, a passive approach does not serve your client, the corporation. If you are happy in your work, a primary motivator for digging into these problems is continued employment.
- B. Lack of proper corporate governance, and related succession planning can end a perfectly good company.
  - 1. Failure of top management, at the owner-director and owner-officer level, will produce chaos within the business.
  - 2. The absence of a clear and credible succession plan erodes the confidence of the employees, suppliers and customers of the business.
  - 3. Listen for the warning notes: “I’m not talking with my brother right now. You tell him.....” Or, “I know my Dad built this business with his brains and hard work, but I can’t seem to get him to even listen to some new ideas on taking the business forward.” Or, “They are not ready, and I’m not ready to leave.”



### C. Failure and/or sale of the business achieves narrow goals

1. Stops the fighting
2. Provides cash, which may create opportunities or cause problems
3. Brings closure, end of stress at one level

### D. Perpetuation of the business accomplishes a broader vision

1. Pride of Ownership, especially if the business is the product of entrepreneurial skill
2. An employer in, and perhaps contributor to the community
3. A unique, closely controlled atmosphere for the development and ultimate career satisfaction of owner employees.
4. A well-run business provides dividends to the shareholders, several of whom may not be employees
5. A legacy, inherited from the previous generation and to be passed down to the next.
6. Owning a business can be mostly fun.

### E. Preparedness Inventory

1. Shareholder's/Buy-Sell Agreement?
2. Regular Board Meetings? Minutes?
3. Estate Plan Documents, Voting Trusts, GRATS, Life Insurance?
4. Governance by and for the family, e.g. family council or forum?



### F. Business Owners must declare their vision for the future, and take pro-active steps to achieve that vision.

1. Owners must want perpetuation of the business, the passing of a legacy.
2. Owners must hand off responsibility to their children, nieces, nephews, etc.
3. Owners must work at succession, something different from working on the business.

### G. General Counsel is ideally poised to be the facilitator of this process.

1. You are in a position of trust and confidence.
2. If a successful CG, you have no bias which favors different sides or branches of the family.
3. Much of the architecture for succession planning- shareholders' buy-sell agreement, estate plan, etc. - involves legal drafting and problem-solving.
4. Know your limits, and respect the privacy of the owners on certain topics.



## II. Board of Directors and Board of Advisors

### A. The Difference

1. A Board of Directors has voting authority and runs the company.
2. Board of Advisors has no voting authority, but can have a positive influence on the company if handled properly.

### B. The Informality of the Family Business

1. "Each time Pete and Vinnie went to the Diner for lunch, they had a Board Meeting."
2. As the decision tree spreads across multiple generations, more formality required for better communications and consistent corporate action.
3. From the perspective of Corporate Compliance: Audit Committee, ERISA, Pensions, DOL, etc., formal actions, authorized by the Board of Directors, keeps the Family-owned company on the better side of best practices.
4. **Caveat:** do not lose the nimble quality of Family Business decision-making, which usually contributes to the success of the business.



### C. Family Owners on the Board of Directors

1. Depending upon maturity cycle of the Family Business, Board of Directors can be equally shared within one generation, or across two generations.
2. If the next generation is still in the development stage, they can certainly attend Board Meetings and debate business issues. Voting reserved to Directors responsible for the business.
3. A discipline of quarterly Board Meetings, with Agenda items suggested and presented by both Director and Non-Director Family members, is a good model for succession training and mentoring across generations.
4. Minutes of Board Meetings, with an "Old Business" and "New Business" format, help focus the meetings and keep responsible managers on task.

### D. Family and Non-family Advisors on a Board of Advisors

1. Within the Family, a Board of Advisors can include the Directors of the Senior Generation, with next generation executives and non-family executives to sit as a Board of Advisors.
  - a) An intra-family Board of Advisors provides a training ground for next-generation directors, and allows for gradual hand off of responsibilities.
  - b) Political lines and alliances become drawn; critical issues surface.



2. For a Family Business on a mature business cycle, an outside Board of Advisors can be an asset to the company.

- a) Shared experiences, new ideas, and a cure for family business myopia all can come from outside advisors.
- b) Senior generation directors can equip their successors in the family with outside professionals, who are trusted and gradually learn the family's business.
- c) Family businesses who are fatigued or deadlocked in certain decision processes can have that cycle broken up with fresh ideas, and the persuasion of respected, independent and objective outsiders.
- d) **Caveat:** carefully control the appointment, and mandate of outside Advisors. The Family needs to retain control, especially voting control, and be able to cycle out Advisors who are not productive or helpful. There should be only one "free lunch".



## E. Relationship with the Shareholders

1. Ultimately, corporations exist to benefit the shareholders.
2. Family-owned companies frequently have silent, or not-so-silent but non- participating shareholders.
3. Some level of regular communication and transparency is appropriate between the Board of Directors and the shareholders.
4. Independence and objectivity go far to provide non-participating shareholders with the perception that there is vigilant attention to their interests.
5. General Counsel can often be a liaison between the Board and the non-participating shareholders. Be careful not to clutter up the operation of the business too much with unproductive shareholder curiosity or comment.



### III. Family Members as Employees

#### Shareholders as Directors and Officers

- A. Mentoring from present to next generation is critical
- B. When the family manages the business, family relationships are studied by employees, suppliers and customers.
- C. Emerging roles in the successor generation should be assigned by skill set and suitability. Neutral assessment tools can help settle family debates about roles and titles.
- D. Communication, Communication, Communication.

#### Non-shareholder family members as employees

- A. Do you know this character?
- B. Family members in the business should add value: best for the business, and best for the Owner-Sponsor of that employee.
- C. Written performance evaluations of family employees are appropriate, and should be conducted with the same frequency and criteria as all employees within the company.
- D. Develop written criteria for future generation new hires within the company. A family employment policy.



### IV. The Buy-Sell Agreement

#### A. Purpose and Goals

- 1. As family business tree branches out, shareholders are scattered, do not see each other at the business, and need to formalize shareholder understandings.
- 2. Opportunity for shareholders to craft their own understandings and structure for future situations, rather than run to outside advisors at a time of crisis.
- 3. Maintain balance among Family Control, Capital Needs of the business and Shareholder Liquidity.
- 4. Create a structure which can allow for the perpetuation of the business into several future generations, while allowing individual shareholders an exit strategy.



## B. Specific Issues

- A. The mechanics of selling company stock: notice, time frame, right of first refusal, appraisal, etc.
- B. Maintenance of Family voting authority, as between branches. Transfers restricted to siblings and lineal descendants.
- C. Voting rights: shareholders in the business, and out of the business.
- D. Valuation of shares, including minority and lack of marketability discount calculations, as well as payout terms.
- E. Specific provisions to balance requests for redemption with capital needs of the business.
- F. Continued "S" corporation status of the company; tax issues related to redemption of shares.
- G. Tag along provision



## V. Outside Help

- A. Recognize need for privacy on certain issues.
- B. Understand that many family business problems are neither legal nor accounting driven. Agreements and spreadsheets are only helpful to record and document negotiated solutions of more fundamental issues.
- C. Neutral outside advisors, neither employees, directors nor vendors of the business, can play a crucial role as sounding boards and mediators of family business deadlocks.
- D. Preferred solution is to have outside advisors "push back" communication skills and problem-solving techniques to the principals, empowering business owners to move forward and "buy in" to organic decisions from within the company.
- E. Useful website resources: [www.efamilybusiness.com](http://www.efamilybusiness.com)  
and [www.afhe.com](http://www.afhe.com)





Helpful articles:

1. Ward, John L., [The Ultimate Vision for Continuity?](#) Families in Business Sept/Oct 2003.
2. Gottlieb, David, [The in-law dilemma.](#) Families in Business Sept/Oct 2003.

## Q & A?

The End.

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### Professional Insight

#### My Personal Piggybank

by Ross W. Nager

When I was growing up, I had a piggybank. Well, actually it was a metal replica of a bank building. But, I called it my "piggybank." I put coins in whenever I could. I rarely took money out, although I could. After all, it was my piggybank. It was my money.

When I got older, I had a real savings account at a bank. My money went in and I could take my money out and buy whatever my heart desired. Although it preferred deposits, the bank expected withdrawals. It didn't really care when I took money out. Other peoples' money just replaced mine, in their own accounts of course.

Some family business owners look at their businesses in the same way. It can start with the founder, who takes money from the till for business (or personal) needs without the proper recordkeeping. The business and the money belong to the founder, so who cares (other than, perhaps, Uncle Sam)?

As the company grows, the owner begins to play more sophisticated tax games, like taking salary and perks that arguably are greater than what a non-owner might receive. Kids' allowances masquerade as tax-deductible salaries for services never rendered.

The kids see all this and learn. After school, one or two come on board, much to their parents' glee. An above-market salary serves as an enticement, although it becomes an entitlement as lifestyles rise to meet it.

Fast forward. Some kids are in, some are out. All own stock. "I need a new house!" says one. "I need more income to help put my kids through private school!" says another. "But, the business needs the money to grow," says a third. "I think that your proposed new strategy and related capital investments stink!" says the first. "It's our business, too, and we deserve to share in the rewards of ownership, says the second.

Sometimes the disputes are honest disagreements over vision and risk tolerance. It could be an inadequate analysis of a business proposition or a lack of communication about it. Other times, it's a lack of understanding of how a business needs capital to operate.

Joint ownership of the piggybank is tough, they all agree. Some want to keep the money in and others want to take it out. But, it's not that simple. A bank may be ambivalent about money going in and out. But, a business cannot function that way. Shareholders can't simply cash in their chips whenever they want some spending money. They are owners, not depositors or lenders.

My premise has always been that unwilling shareholders should not be held hostage. If they really want out, let them sell if at all possible. But, everyone should consider the consequences of selling. Where should the line be drawn? Should "dribbling" redemptions, meaning a little here for a car and a little there for a vacation, be permitted? Probably not, especially when you consider all of the implications. That's the piggybank mentality at work.

Think twice before you decide to buy that new house by redeeming some shares. Unlike cashing in some Intel stock, you probably can't replace the family business shares you sell. You may be permanently affecting your and your descendants' future rights and involvement in your heritage. It can have a serious impact on business operations. It can create resentment and alter voting relationships within the family. And, high-priced redemptions can set a bad valuation precedent for future gift and estate tax purposes.

Even if you are the sole owner, it's not just *your* piggybank. The livelihoods of your employees, customers and others can be affected if the demands are too high.

Raiding the piggybank was no big deal when you were a kid. The stakes are much higher when you consider a raid on the family business. Approach the issue with care, good advice and a very long-term perspective. Make sure that you truly understand the real reasons you want to sell shares. If you must, you must. But, trading your heritage for short-term lifestyle benefits may not be the right decision.

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Professional Insight

Shareholder Redemption Traps

**All Gains Are Not Equal: Part 1**

by Ross W. Nager

Inevitably, there may come a day when it is necessary for your company to buy back (redeem) some of its shares. Perhaps your sibling will want money to start her own business or your parent decides to retire and cash in his chips.

Shareholder agreements typically specify the terms by which family members can or must transfer their stock. Some provisions may force shares to be sold back to the corporation if they are transferred to "prohibited parties" (i.e., ex-spouses and creditors). Others may give shareholders the option to redeem part or all of their shares. In fact, prearranged terms to allow dissatisfied or cash-needy owners to redeem all or part of their shares can be the ultimate relief valve to avoid major family discord.

Unfortunately, a couple of obscure income tax traps can create major migraines for *both* the redeeming and non-redeeming shareholders. And, the traps can exist when the company buys back stock even if there is no written shareholder agreement.

**Ordinary income or capital gain?**

Suppose you want to sell part of your stock to get funds to buy that nice house. Shouldn't your tax be the same regardless of whether you sell stock back to the corporation, to a family member or to some unrelated person? Most people would expect a maximum 20% capital gains tax regardless of who buys their stock. Unfortunately, a sale to the corporation typically will be taxed as a dividend at ordinary income rates as high as 39.6%.

Why? Suppose you and I each own 50 shares, representing 100% of our corporation's stock. Instead of paying ourselves a \$10,000 dividend subject to ordinary income tax rates, we each redeem 10 of our shares for \$10,000. We would like to treat the redemption as a sale taxed as a capital gain. However, if you think about it, turning in the 10 shares was meaningless because we each own half of the outstanding stock both before and after the redemption. The relative percentage ownership, not the number of shares, is what's important.

Decades ago, Congress discovered this gambit. So, the law would treat our redemption as a dividend. IRS collects a higher tax rate. *Plus, we cannot reduce the proceeds by the basis in our stock.* That basis simply "floats" over and adds to the basis in our remaining 40 shares.

#### **Qualifying for capital gain**

A redemption is treated as a sale if it is "substantially disproportionate," which requires:

- the shareholder to own less than half the voting stock after the redemption; and
- the shareholder's percentage of both voting and nonvoting stock to be reduced by more than 20%.

Alternatively, a complete redemption of all of a person's shares can qualify as a sale.

Unfortunately, both alternatives are complicated for family owned businesses because of another set of arcane rules called "family attribution." These rules treat you as owning stock that is actually owned by your spouse, children, grandchildren and parents. Your stock ownership may not go down enough to meet the percentage tests, or your stock will not be considered redeemed in its entirety, because you are deemed to own these relatives' stock holdings.

#### **Redeeming All Your Stock**

One way out of the quagmire is for you to redeem all of your stock and "waive" the ownership attribution rules. However, Congress extracts a huge pound of flesh for this privilege. Specifically, you must:

- Have no interest in the corporation immediately after the redemption other than as a creditor, meaning that you may not own stock or serve as a director, officer or employee;
- Not acquire any interest (other than by gift or inheritance) within 10 years after the redemption; and
- File an agreement with the IRS and meet some additional technical requirements.
- Obviously, this exception has limited application, but it does work when a shareholder wants out "for good."

It's one thing for a redeeming shareholder to pay ordinary income tax on the redemption proceeds. However, in my opening paragraph, I said that redemptions can create major headaches for non-redeeming shareholders. Tune in next month to hear how even non-redeeming shareholders can be stung with an unexpected tax.

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## PROFESSIONAL INSIGHT

Shareholder Redemption Traps**All Gains Are Not Equal: Part 2**

by Ross W. Nager

Last month, I explained how a partial redemption of a family member's stock typically is taxed as ordinary dividend income, not capital gain. To add insult to injury, the income can't be reduced by the cost basis in the stock. What could be worse? Well, could the law tax the non-redeeming shareholders, too? Shocking though it may seem, a little understood and often overlooked law can do exactly that!

**Stock Split? Tax-Free**

The culprit is Internal Revenue Code Section 305. (Yes, for the first time in a long time I put a citation in this column. Yawn. Sorry.) It starts out friendly enough by saying that a corporation's distribution of stock to its shareholders is not taxable income to them. That is why an Internet company can do a two-for-one stock split every few months, doubling the number of shares owned by each shareholder. After the flurry of new stock certificates is distributed, everyone owns exactly the same percentage of the company as they did before the split.

**Bottom line:** No tax because nothing really changed other than a few trees were killed. No shareholder got cash and everyone kept the same relative percentage ownership.

**Cash or Stock – Taxable**

Let's suppose we change the facts a little bit. Instead of distributing additional stock certificates proportionally to each shareholder, the Internet company offers the shareholders a choice: a \$10 dividend per share payable in cash or in additional shares. Obviously, the shareholders taking cash are taxed on the dividend.

What about the ones who take stock? Section 305 starts to turn nasty. It taxes the stock-takers on the value of the stock they receive in lieu of the cash dividend. In a way, that's fair. They could have opted to take cash, pay tax, and then turn around and buy additional shares. Section 305 just treats them like they took that more circuitous route.

Section 305 says that shareholders receiving stock are taxed if the distribution (or a series of distributions) has the effect of some shareholders receiving cash and other shareholders receiving an increase in their proportionate interests in the corporation.

**Bottom line:** The ones who take additional stock now own a higher percentage of the company than the ones who take cash. Some get cash and some get stock. Everyone gets taxed.

**Redemption of Shares**

Change the facts again. Suppose that the company redeems some shareholders' stock for cash. Because there are fewer shares outstanding, the shareholders who did not redeem wind up owning a larger percentage of the company. Isn't that the same end result as the "cash or stock" deal above?

In fact, it is. Some shareholders received cash in exchange for shares. Although the others did not actually receive additional stock certificates, their ownership percentage increased due to fewer shares outstanding.

That is the core of the problem. When the dust settles, issuing new shares to Shareholder A and cash to Shareholder B is the same as taking shares away from Shareholder B in exchange for cash. Either way, Shareholder A's percentage interest in the corporation increases and B gets cash.

The regulations say that an "isolated" redemption will not trigger Section 305's wrath. Unfortunately, they stop short of guidance in defining what is isolated and what is not. Advisors tend to be very comfortable with the redemption of a single shareholder. But, when another shareholder seeks to redeem some stock, even within a few years of the first, they get nervous. Your lawyer and accountant will break into a sweat when a third one wants to cash in some chips within a few-year time period.

**Family Business Impact**

From a non-tax standpoint, family businesses are well advised to create a shareholder agreement that allows shareholders to cash-in stock when they desire (subject to the business' capital needs). Why? It's not wise to hold unwilling owners hostage. They can create major problems. Unfortunately, Uncle Sam disagrees because, if more than one exercise their rights, it could cause unexpected taxation to those who remain behind.

Unfortunately, there's no real solution other than discouraging the need for frequent redemptions. Perhaps shareholders' cash requirements can be handled in other ways. From a financial planning standpoint, cashing in shares is not a very sensible way to handle normal living expenses anyway.

Now that I think of it, maybe Uncle Sam is on to something. Perhaps the moral to the story is that it is in the best interests of those who want to keep their stock to do what's necessary to keep the others happily on board. Enough said?

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**Session 111**  
**Governance Best Practices**  
**for Family-Owned Companies**

**Carol D. Miller**  
**Vice President, General Counsel**  
**RUI One Corp.**

**Closely Held Family Business**

**Preparing For The Day**

**The Family Wants Cash For Its Investment**



**The Reasons**

- Next generation doesn't want to operate the business or doesn't have the talent
- Next generation is too expansive or diverse to have a clean succession
- Desire to receive return on the value created by developing the business
- Securing funds for business expansion by selling shares to outside investor
- Other?



## Form Of Transaction

- Owner may sell stock or assets outright and withdraw from the business
- Owner may retain some ownership interest, but sell a controlling interest to an investment group
- Franchising or sale of expansion rights
- Other?



## Counsel Can Prepare For The Day

- By previewing the due diligence process and identifying potential issues
- By resolving matters that would affect value or raise concerns by the buyer *before* the buyer starts reviewing the company assets and liabilities
- By adding value through asset creation and protection





## The Due Diligence List

- Sample due diligence request that a selling company will likely be required to complete
- Complete an internal response in advance of soliciting purchase offers to identify issues and opportunities



## Unique Issues For A Family Business

- Casual business approach may lead to
  - Incomplete corporate documents
  - Oral agreements that are essential to business operations and value
  - Arrangements with long-term vendors that are no longer competitive
  - Preferential benefit and other arrangements that could expose the company to claims of discrimination or force the offering of expensive benefits



## Unique Issues For A Family Business

- Insider business arrangements that would be objectionable to outside investors
  - Unsecured loans to shareholders and family members
  - Leases and other agreements with provisions favoring insiders over corporate interests
  - Family/friends as employees who aren't the best talent
  - Co-mingled businesses that might be more attractive if split in separate entities (Supplier combined with business contracting for third parties; distinct concepts)



## Interview Operations Staff

(not PHBs)

This process provides a unique opportunity to interview the individuals handling day-to-day operations and may lead to early identification of potential issues:

- Regulatory violations that have not been resolved
- HR issues (numerous EEOC claims at one location may highlight a practice that needs to be rectified)
- Purchasing or operating practices that should be modified
- Contracts that are not being followed or properly utilized



## Contract Review

- Use this as an opportunity
  - to collect and summarize critical agreements
  - identify situations where contracts can be improved or should be required
  - implement a contract execution policy
  - terminate automatically renewing contracts with long-term extensions



## Personnel Review

- Review any employment contracts for golden parachutes and other items that may raise concerns for a buyer
- Consider whether successor management has been trained so that all value is not lost when ownership withdraws
- Consider whether non-compete, nondisclosure, trade secret agreements would enhance the value of the business



## Build Asset Value

- Implementing intellectual property protections
- Documenting oral agreements essential to business operations
- Extend valuable contracts and leases
- Terminate contracts and leases with unfavorable terms



## Make Due Diligence During Closing A Non-Event

If not prepared:

- Due diligence can bog down the sale process
- Surprises first unearthed during the process can result in price reductions or the end of a deal
- Full consideration may not be paid for undocumented or unprotected “value”
- A complete, attractive due diligence report can be provided in advance of a request from the buyer – simplifying the process and controlling the review



## Controlling the Due Diligence Process

- In-House Counsel should control the due diligence process
- Mark all drafts “Confidential Attorney-Client Privileged Communication”
- Take other appropriate steps to protect the review process and drafts
- No guarantee that the documents will be protected, but supports the position
- Carefully consider the message the review process will portray to staff – provide an explanation that doesn’t make staff worry that their jobs are disappearing

### SAMPLE

#### RESPONSE TO DUE DILIGENCE REQUEST

Draft Provided July 10, 2005

General Comments and Definitions

The following is the Company's response to due diligence requests submitted by counsel for Purchaser. The following individuals are responsible for verifying the responses which will be certified accurate by the President at Closing. Additions and corrections to the responses must be provided to General Counsel within 3 business days of receipt.

Updated information will be provided as it becomes available. Additions from prior versions of this response will be double underscored the first time they appear and deletions will be lined through. For ease of reference, the original request is shown in bold.

**1. Corporate Records of Each Company.** *Review these in advance to ensure they are complete, up to date and authorize or ratify all significant actions of the corporation and any subsidiaries. Secure good standing certificates to ensure authority is secured in each state in which business is conducted.*

- a. **Articles of incorporation and all amendments.**
- b. **Bylaws and all amendments.**
- c. **Minute books (including minutes of directors, committees, stockholders).**
- d. **Stock records (do stock check memo).**
- e. **Warrant, option, and other agreements relating to securities of the Seller, and related cancellation agreements.**
- f. **Good standing and tax certificates.**
- g. **List of states in which Seller owns or leases real property, has employees, or otherwise is doing, or proposes to do, business.**

**2. Financing.**

- a. **Documents and agreements evidencing borrowings (both senior and subordinated), including loan and credit agreements, promissory notes and debentures, and agreements evidencing assets pledged to secure such borrowings.**
- b. **Bank letters of credit or agreements confirming lines of credit, including performance bonds and guarantees.**
- c. **Documents and agreements evidencing other material financing agreements, including repurchase agreements, sale and lease-back**

## SAMPLE

agreements, installment purchases, capital leases, and informal banking arrangements.

- d. **Material correspondence with lenders for last three years, including any compliance reports submitted by the Seller or its auditors (including borrowing base reports).**
- e. **UCC tax, and judgment lien searches, state and county.** *Conduct a UCC search in advance so any exception can be cleared before searches to be produced to Purchaser are run.*
- f. **Guaranties and agreements obligating the Seller to extend credit.** *Be aware of any guaranties granted for obligations of related entities and shareholders.*

## 3. Tax Matters.

- a. **Copies of all tax returns for last three years (federal, state or local).**
- b. **Audit and revenue agents' reports (federal, state, or local).**
- c. **Settlement documents and correspondence.**
- d. **Agreements waiving statute of limitations or extending time.**
- e. **Deficiency notices.**

## 4. Governmental Regulations and Filings.

- a. **Material reports and documents that have been filed as required by federal or state agencies.**
- b. **Governmental agreements, contracts, permits, licenses, authorizations, inspections, reports, etc. (e.g., EPA, OSHA, EEOC).**
- c. **Environmental reports (federal and state) and related licenses and permits.**
- d. **Correspondence relating to each of the above.**

5. Employees, Benefit Plans and Salaries, Labor Disputes. *There can be surprises here that a purchaser will demand be terminated as a condition to closing. Early identification and a proposed resolution can avoid uncomfortable discussions and reductions in sale price.*

- a. **Compensation or bonus plans and outstanding employee or director loans.**
- b. **Pension, retirement, stock option, stock appreciation, savings, and profit sharing plans.**
- c. **Employment agreements, including indemnification agreements, golden-parachute and any secrecy, confidentiality, technology assignment, or noncompete agreements with management.**

## SAMPLE

- d. **Employee disputes, requests for arbitration, and grievance proceedings.**
- e. **The actuarial unfunded liability of all benefit plans.**

6. **Litigation.** *Having a good tracking system in place is essential to being able to provide accurate information on historical claims.*

- a. **Pending or threatened litigation and claims, including governmental administrative proceedings or inquiries (e.g., EEOC, EPA, and OSHA), and proceedings involving environmental matters.**
- b. **Any consent decrees or injunctions currently in effect or in effect at any time during the past three years.**
- c. **Settlements, judgments, decrees, or injunctions within the last three years of actual or threatened litigation or claims.**
- d. **Auditor's inquiry letters to attorneys and replies for the last three years.**

## 7. Insurance.

- a. **All material insurance contracts, including general liability, key-man insurance, director and officer insurance, worker's compensation arrangements, and business interruption insurance.**
- b. **Self-insurance, reinsurance, and coinsurance programs.**
- c. **Product liability risks.**

8. **Material Agreements.** *Having a good tracking system in place is essential to being able to provide accurate information on historical claims.*

- a. **Leases, subleases, and amendments (other than real property leases for Seller's manufacturing, warehouse and office locations).**
- b. **Material agency and distribution contracts and third-party warehouse contracts or agreements.**
- c. **Contracts or other business arrangements with insiders, shareholders, affiliates, or other related parties.** *Review these carefully in advance to ensure they will withstand the purchasers review. Consider renewing any that are going to expire. Look for "unwritten" contracts that can be reduced to writing in advance of a potential sale to avoid disagreements over the arrangements with an eventual purchaser.*
- d. **Partnership and joint venture affiliations and agreements.**
- e. **Guaranty, surety, or indemnity agreements.** *Consider inter-company cross-guarantees. Also general statements about contractual indemnifications contained in most real property leases and service contracts are appropriate.*

## SAMPLE

- f. Shareholder agreements, including restrictive transfer agreements and voting arrangements, if any, and preemptive rights.
- g. Agreements related to the purchase or sale by RUI One Corp. of business units or assets, including original purchase agreement, if applicable, and schedules and exhibits thereto.
- h. Brokers or finders agreements.
- i. Licenses of intellectual property rights.
- j. Any and all agreements restricting the Seller from borrowing money or issuing the Seller's capital stock or securities convertible into the Seller's capital stock.

## 9. Assets and Properties.

- a. Schedule of all real property owned or leased, including environmental reports and to the extent owned, deeds and title policies. *Would extending leases, negotiating modified terms increase the value of the business?*
- b. Schedule of all significant facilities and equipment indicating the Seller's interest in each item.
- c. Schedule of all material intangible property and investments and, if applicable, information related to liquidity or transfer restrictions.
- d. Computer system and data processing and software licensing contracts.
- e. Patents, copyrights, trademarks, service marks, and trade names and all applications in respect thereof, including information regarding threatened or pending claims of infringement and registration thereof. *This may be an overlooked asset. Consider whether value can be created by registering trademarks, implementing proprietary property agreements with employees and vendors and taking other steps to ensure ownership and protection of valuable intellectual property rights.*
- f. List of location of all assets, including consigned assets or assets used by a person other than the Seller. *Are there "corporate assets" that are being used exclusively by family members or are perceived to be personal benefits (vacation property, suites at sports facilities, etc.). Does an agreement about use/ownership need to be reached?*

## 10. Miscellaneous inquiries.

- a. A complete list of each corporation, partnership or other entity in which the Company or a control person has a debt or equity interest.
- b. Safety and quality control and performance procedures, timing, and expenses.

## SAMPLE

- c. Nature of temporary investments of working capital.
- d. Asset valuation reports or appraisals.
- e. Outstanding service commitments.
- f. Prior safety problems.
- g. Environmental risks of the business or any owned or leased real estate; disposal of hazardous waste since organization of the Company and investigation of integrity and financial condition of third party's engaged to dispose of subwaste.
- h. Purchase commitments.
- i. Customer lists, including family connections, and other special relationships.
- j. Prior safety problems.
- k. Compliance lists, including family connections, and other special relationships.
- l. Worker's compensation and unemployment ratings.
- m. List of deposit accounts and signatories thereto.
- n. Unusual or nonrecurring transactions.



**Session 111**  
**Governance Best Practices**  
**for Family-Owned Companies**

**Michael V. Ward**  
**Vice President, General Counsel, and Corporate Secretary**  
**Targus Group International, Inc.**

**GC: General Counsel as**  
**Governance Consigliore**



**Who Is the Client?**

- **The Company**
  - ➔ **THE SHAREHOLDERS!**
    - Not the management
    - Not the family
    - Not the founders
    - Not any individual shareholder, but all shareholders collectively
- **Wearing different hats**
  - “As General Counsel I would say..., but as CFO...”
- **Conflicts of Interest**





## Family Businesses Are Different

### ● Corporate Governance:

#### *Market Model vs. Control Model*

- The Market Model works well for large public companies because:
  - Corporate control is decentralized
  - Shareholders' interests are purely financial
- American corporate law reflects the Market Model.



## Family Businesses Are Different

- The Market Model can create tension in a family-owned business.
  - Family Control vs. “Agents”
  - Shareholders and management overlap.
  - Particularized family goals and values.
- A square peg in a round hole.



## **Sitting on a Fault Line**

- Family Conflicts Affecting the Business
- Business Affecting the Family
- Straying from Founders' Goals and Values
- Doing v. Planning: The One-Man-Band
- Abuses of Power
- Informality
- Oppression of Minority Shareholders



## ***Family Conflicts Affecting the Business (dissolution, deadlock)***

A genie says to a man, "You can have whatever you want, provided that your mother-in-law gets double."

The man thinks for a moment and then says, "OK, give me a million dollars and beat me half to death."

- *Unknown*



*Family Conflicts Affecting the Business  
(dissolution, deadlock)*

- Unwelcome Family Roles
- Sibling Rivalry
- It's the perceptions that count.



*Family Conflicts Affecting the Business*  
**DIVORCE**

After a quarrel, a wife said to her husband, "You know, I was a fool when I married you." The husband replied, "Yes, dear, but I was in love and didn't notice."

- *Unknown*



*Family Conflicts Affecting the Business*  
**DIVORCE**

● In-laws and Divorce:

*Opening a Closed Corporation*

- In-laws are just difficult.
- Keeping the shares within the family.
- Be sensitive!



*Business Affecting the Family*

- Founders' Goal: Business relationships will unite the family.
- As General Counsel, you need to anticipate:
  - Disharmony
  - Power struggles
  - Compensation disagreements




### *Straying from Founders' Goals and Values*

- The founders of a family business may be concerned that future shareholders' goals and values may differ from their own.
- Founders are often reluctant to hand over the company to the next generation.



### *Doing v. Planning: The One-Man-Band*

- Young family businesses are often run by a single founder who does everything alone and has little or no time to plan for the mid- or long-term.




*Abuses of power*

All I've ever wanted was an honest  
week's pay for an honest day's work.  
- *Steve Martin*



*Abuses of power*

- Some family members might assume greater authority than is appropriate.
  - Company finances
    - Taking from the cash register or petty cash
    - Withdrawing from company accounts
    - Overcompensation
  - Unprofessional conduct
    - Sexual harassment



### *Abuses of power*

You moon the wrong person at an office party and suddenly you're not "professional" any more.

- *Jeff Foxworthy*



### *Informality*

- Payroll Taxes
  - Civil and criminal liability
  - Officers' liability
- Piercing the Corporate Veil



### *Oppression of minority shareholders*

- Minority shareholders within the family.
- Outside investors.
- Most states impose a higher fiduciary duty for shareholders in a close corporation.
  - Especially, between majority and minority shareholders.
- There is still some danger of oppression and poor representation of minority shareholders.



### **Planning for Earthquakes**

- You can't prevent or even predict earthquakes, *but* you can prepare in advance.
- Understand the Client's Goals.
  - Current income or accumulation of wealth
  - Financial freedom for future generations
  - A personal or family legacy
  - Fun (something to do; a challenge)
  - Family harmony





## The Tools

- Authority Matrix
- Code of Conduct / Code of Ethics
- Prenuptial Agreements
- Board of Directors / Board of Advisors
- Voting
  - Buy-Sell Agreements
  - Articles of Incorporation, Shareholders' Agreements, Bylaws, & Operating Agreements
- EDUCATE!



## *Authority Matrix*

- Protecting shareholders' interests against individual family members who might abuse their power.
- Ensuring compliance with certain formalities required by law.



### Authority Matrix

Responsibility	BOD or BD Committee	President	CFO	General Counsel
<b>GENERAL CORPORATE MATTERS</b>				
Appointment of Legal Counsel:	Approve	Recommend	Recommend	Recommend
Appointment of Outside Consultants	Unlimited	< \$250k	< \$100k	-
Disposition of Assets	> \$500k	< \$500k	<\$250k	-
<b>TREASURY ARRANGEMENTS</b>				
Open and Close Bank Accounts (Requires 2 Authorized Signatures if > \$100k)	-	-	Approve	-
Execute, Modify or Renew Loan Agreements	Approve	Recommend	Recommend	Review
<b>COMPENSATION CHANGES</b>				
Executive Level (Director Level & above)	Approve Comp. Committee	Recommend	Review	-
Salary Level (All Others)	-	Approve	Review	-

### Code of Conduct / Code of Ethics

- A code of conduct can help prevent shareholders and employees from confusing work with home or otherwise acting inappropriately at work.



## Code of Conduct / Code of Ethics

- **BUSINESS ACTIVITIES**
- a. Conflicts of Interest
- b. Confidential Information
- c. Sales & Marketing Conduct
- d. Procurement Practices
- **RELATED ACTIVITIES**
- a. Employment and Work Environment
- b. Political Activities
- c. Media Relations
- **CODE ENFORCEMENT**
- a. Reporting Violations
- b. Discipline and Sanctions
- c. Non-Retaliation
- d. Internal Audit



## Code of Conduct / Code of Ethics

<p><b>BUSINESS ACTIVITIES</b></p> <p><b>a. Conflicts of Interest</b></p> <p><i>Financial and Other Conflicts</i></p> <p>Associates must avoid conflicts of interest. Such a conflict occurs when any transaction, investment, relationship or other involvement interferes with or influences the exercise of an associate's independent judgment in the best interests of The Company. Associates must also avoid any involvement that could even appear to create a conflict of interest.</p> <p><i>For example, neither an associate nor his or her immediate family may have, directly or indirectly, any financial interest in a customer, competitor or supplier if the associate influences or appears to influence The Company's business decisions regarding that entity. Also, an associate may not occupy a position such as member of the board of directors (unless previously authorized by The Company's General Counsel), officer, associate, agent or consultant of a customer, competitor or supplier. An associate should remain vigilant as to potential conflicts of interest if an immediate family member or friend is an associate of one of The Company's customers, competitors or suppliers.</i></p> <p>...</p> <p><b>b. Confidential Information</b></p> <p>...</p> <p><b>c. Sales &amp; Marketing Conduct</b></p> <p>...</p> <p><b>d. Procurement Practices</b></p>
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### *Prenuptial Agreements*

My husband and I didn't sign a pre-nuptial agreement. We signed a mutual suicide pact.

- *Roseanne Barr*



### *Prenuptial Agreements*

- Nobody wants a prenup until they get divorced.
- Shareholders' Agreements could require shareholders to have prenups.
  - This would make them less personal and, therefore, less objectionable at the time of marriage.
- *Note:* Each state has different rules.



## *Board of Directors / Board of Advisors*

- A great way to protect minority shareholders.
- ***Board of Directors v. Board of Advisors***
  - A Board of Directors has more power to protect the shareholders, ***but*** it may slow decision-making and become too involved in family affairs.
  - Also, shareholders may prefer to be directly involved.
- ***Insiders v. Outsiders***
  - Outsiders provide a connection to industry standards, bring views from other related industries, and may be more objective than insiders, ***but*** they may not gain shareholder trust or represent particularized family interests as well as insiders.



## ***VOTING***

- Buy-Sell Agreements
  - Keeping a Closed Corporation Closed
- Articles of Incorporation, Shareholders' Agreements, Bylaws, & Operating Agreements
  - Voting Pools
  - Super-Majority or Unanimous Votes
  - Cumulative Voting
  - Class Voting
  - Veto Rights
  - The Right to Unilaterally Elect a Director
  - Clauses Designating Directors



## EDUCATE!

- Be aware of *all* relevant parties, including—
  - Current shareholders
  - Potential future shareholders
  - Current (and future) employees
  - Family members with unofficial relationships with the business
- Educate the shareholders on the potential risks, the available solutions, and the costs associated with each.



Grant of Authority Matrix  
Authority Policy

Appendix A

Responsibility	Compensation Committee	CEO	CFO	General Counsel	Corp. Controller	Corp. Treasurer	CIO	Op. Co. President/GM	Op. Co. Controller	
<b>GENERAL CORPORATE MATTERS:</b>										
Appointment of Legal Counsel:										
- Lead Counsel										
- Credit Agreement matters										
- Patent Counsel										
- Litigation matters										
- HR Matters										
- Subsidiary legal representation										
Initiate Litigation or settle a claim:										
(Subsidiaries - report all claims or litigation immediately, via fax and/or phone, to Mgr of Legal Services)										
- Patent infringement										
- Contractual violations										
Appointment of Independent Accounting Firm										
Appointment of Other O/S Consultants:										
- On Strategic planning and organizational matters										
- Personnel and benefit matters										
- Audit and accounting matters										
- Tax and finance matters										
- MIS - business systems										
Formation of Subsidiaries, branches and other operations:										
- Domestic										
- Foreign										
- Declaration of dividends by subsidiaries										
Legal Entity Reorganization										
Acquisition of Business(es)/Investments in Joint Ventures										
Disposition of Business(es):										
- > \$750k										
- < \$750k										
Disposition of assets not comprising a business:										
- Operating assets which are fully depreciated or reserved and FMV \$										
- Operating assets with NBV or FMV \$										
- Intangible assets:										
- Intellectual Property rights, Trademarks, Patents, etc.										

Appendix A

Grant of Authority Matrix  
Authority Policy

Responsibility	Compensation Committee	CEO	CFO	General Counsel	Corp. Controller	Corp. Treasurer	CIO	Op. Co. President/GM	Op. Co. Controller
<b>TAX MATTERS:</b>									
- Sign Fed and State Income & Franchise Tax returns (foreign equivalents).									
- Approve estimated tax payments									
- Sign Sales & Use Tax and VAT returns									
- Sign Property Tax returns									
- Sign Bus Privilege & Municipal returns									
- Sign payroll tax returns									
- Agree to settlements upon audit by tax authorities									
- Authorize the extension/waiver of the statute of Limitations regarding tax matters									
- Contract for outside tax projects									
- Approve invoices for outside tax professional services									
- Establish transfer pricing policies									
<b>BANKING ARRANGEMENTS:</b>									
- Open and close bank accounts/approve authorized signatures (2 Sig's Required > \$100k)									
- Execute/modify/renew all loan agreements, including all short-term borrowing arrangements									
- Guarantee Corporate/Subsidiary obligations									
- Borrow funds under existing arrangements, not included in Annual Plan									
- Authorize repayment without prepayment penalty									
- Authorize repayment with prepayment penalty, not included in Annual Plan									
- Execute Officer Certificates for Bank Compliance									
- Opening Letters of Credit									
<b>INSURANCE</b>									
- Negotiate & execute coverage									
- Process Claim									
- Approve premium									
- Accept claim settlement									
- Authorize limits of coverage & new forms of coverage									

Appendix A

Grant of Authority Matrix  
Authority Policy

Responsibility	Compensation Committee	CEO	CFO	General Counsel	Corp. Controller	Corp. Treasurer	CIO	Op. Co. President/GM	Op. Co. Controller
<b>HUMAN RESOURCE ISSUES:</b>									
<b>REQUISITIONS FOR NEW STAFF:</b>									
- Vice President level, if not in Annual Plan									
- Director level									
- Manager level, in Incentive Plan									
- Employment Contracts									
- Other Staff, not in Incentive Plan									
<b>BENEFIT PLANS:</b>									
- Implementation of new plans									
- Annual Mgmt Incentive Plan Targets									
- Modification of existing plans for:									
- Benefit changes									
- Statutory compliance									
<b>PROMOTIONS OF STAFF:</b>									
- To VP level									
- To Director level									
- Up to Manager level, in incentive plan									
- Up to Manager level, not in incentive plan									
<b>COMPENSATION CHANGES:</b>									
<b>Exec. Incent. Comp. Plan Participants:</b>									
- Salary level - Sr Mgmt, Div Presidents									
- Salary level, All others									
- Incentive comp. % participation/achievement/payout									
<b>All Other Employees:</b>									
- Annual merit increase guidelines									
- Merit increases, within guidelines									
- Merit increases, outside of guidelines									
- Equity increases									
- Promotions									
- Separation Agreements - Sr Mgmt, Div Presidents									
- Separation Agreements - All others									
- Termination for cause									

Appendix A

Grant of Authority Matrix  
Authority Policy

Responsibility	Compensation Committee	CEO	CFO	General Counsel	Corp. Controller	Corp. Treasurer	CIO	Op. Co. President/GM	Op. Co. Controller
<b>CAPITAL SPENDING</b>									
- Annual Capital Spending Plan									
- Capital expenditures in Approved Capital Budget									
- < \$50k									
- > \$50k									
- Capital expenditures NOT in Approved Capital Budget									
- < \$25k if total spending below total Capital Budget									
- > 25k or if total spending above Capital Budget									
(Note: All facilities expansion programs require CEO approval)									
<b>CAPITAL AND OPERATING LEASES:</b>									
- Facilities - new (requires Legal review)									
- Renewal of existing lease, at market rates									
- Equipment, excluding computer equipment									
- < 12 months: \$1K/mo									
- > 12 months: \$1K/mo									
<b>EXPENSE APPROVAL LEVELS:</b>									
- General expense approval authority (covered under separate policy)									
<b>CONTRACTUAL ARRANGEMENTS:</b>									
- Third party guarantees									
- Commitments for materials purchases for quantities greater than 3 mos. forecast demand and involving a cancellation clause									
- Other contracts for goods or services involving total annual payments									
<b>SALES/CUSTOMER ISSUES:</b>									
- Sales Compensation Plans									
- Sales Incentive Payments within plan									
- Rep/Distribution Agreements									
- Rep/Distribution Commission payments									
- Customer Quote / Purchase Agreements w/ fixed prices									

Appendix A

Grant of Authority Matrix  
Authority Policy

Responsibility	Compensation Committee	CEO	CFO	General Counsel	Corp. Controller	Corp. Treasurer	CIO	Op. Co. President/GM	Op. Co. Controller
<b>ACCOUNTS RECEIVABLE</b>									
- Establish Credit Limits									
- Customer Sales Order Approvals									
- Credit Holds									
- Extended Payment Terms									
- Increase Credit Limit									
- Increase Bad Debt Reserve									
- Write accounts off against Reserve									
<b>Approve Credit Memo's</b>									
- Limit Dependent on Reason:									
- Warranty									
- Customer satisfaction									
- Sale re-negotiated; over \$250K, CEO approval required.									
- Parts returned for rework; credit memo only upon receipt/inspection of returned parts									



**Legend**

**Purpose:**

To clearly establish responsibilities and limits of authority granted to the members of management of the Company.

**General:**

- A) The provisions of this policy are applicable to the Company and all of its domestic and international subsidiaries and operations.
- B) These guidelines are general in nature; individuals may delegate to subordinates up to XX% of their authorized limits. Such delegation must be documented in writing
- C) This grant is subject to all applicable policies and procedures.