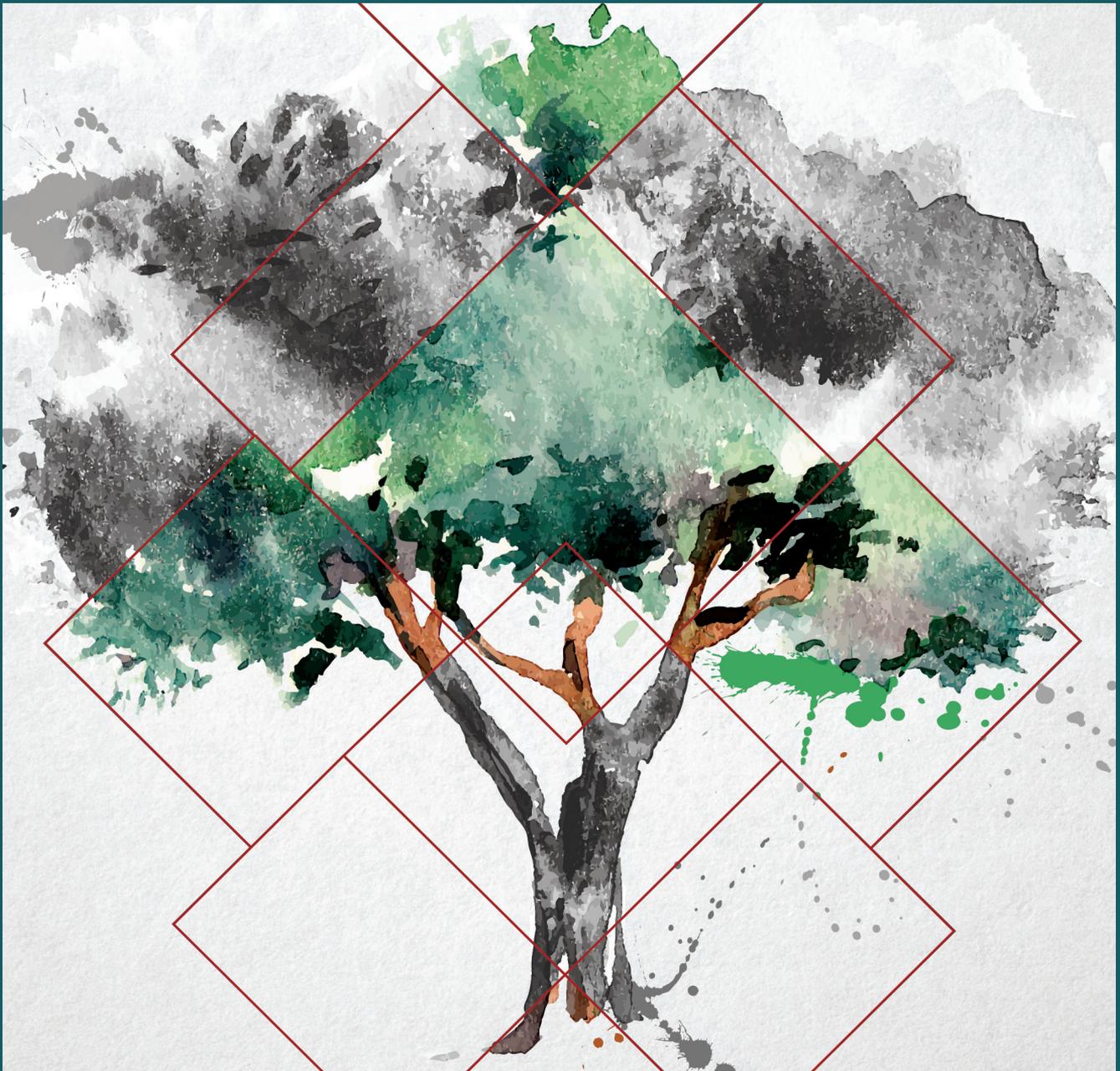

FAMILY BUSINESS

Guide to Governance



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Davis Wright Tremaine LLP is a national, full-service business and litigation law firm representing clients located in the United States and around the world.

The firm was founded on a simple guiding principle: to provide clients with high-value legal services customized to their particular needs. Today the firm has grown to include more than 500 attorneys and eight offices, covering a wide range of practice and industry areas.

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Your family's business is more than just a business. It is a daily investment in the people, values and relationships that built the reputation for excellence upon which your business stands.

With decades of experience serving family business clients, the members of the Davis Wright Tremaine Family Business Team understand these dynamics and know how to meet these challenges

Combining family and business affords great advantages but also presents complicated challenges. We take a holistic approach to serving families and their businesses by aligning our business advice with estate and tax planning to ensure that our clients thrive for generations

to come. We are active listeners who provide proactive counsel with a full understanding of the goals of both the family and the business.

This guide focuses on the best practices for governing a family-owned businesses.

For more information, insights and listings of events, check out our website:

www.familyownedbusinessadvisors.com



GOVERNANCE 101

— *By Bill Weigand*

The governance system for a family-owned business provides the structure through which the objectives of the owners and the company are set and the means for monitoring performance against them is established. This system balances the interrelationships among the family, the owners of the company, the company's board of directors, and its management. It allows for the various stakeholders in a family-owned business to participate in a cohesive and constructive manner.

In the beginning—and for smaller, first-generation enterprises—the governance system is usually quite informal: with the same small group of individuals serving as owner, parent, and CEO, with those roles not clearly delineated. The founder may rely upon friends and close family members for informal guidance with the business. Informal groups of family members may provide input, whether solicited or not, on how the family relates to the business.

As the enterprise grows and ownership becomes more diverse (such as when siblings or cousins become owners), a more formal and robust governance structure can be a great benefit. Below is a fully developed governance structure suited for a large family-owned business with multiple owners. As you read this, please remember—there is no one-size-fits-all solution.

FAMILY ASSEMBLY

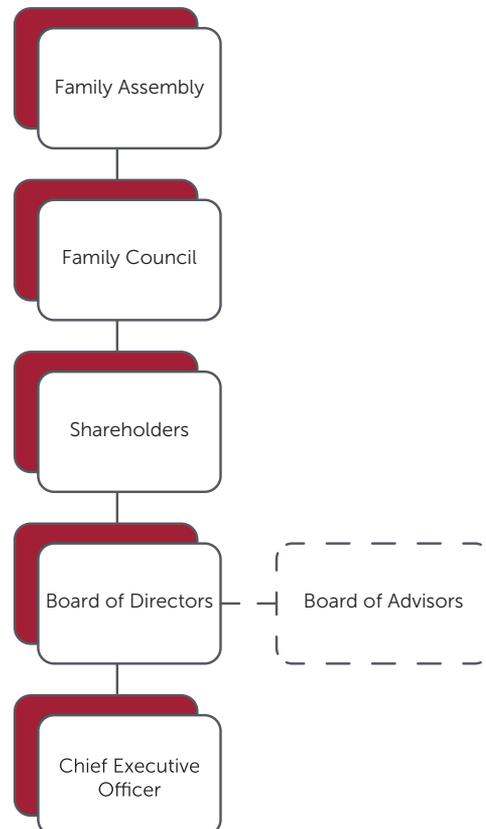
When we refer to a family assembly, we are talking about the entire group of family members, whether or not they are directly involved in the business as a manager, owner, or otherwise. A family assembly is an open forum for all family members to connect as family and learn about the business. A family assembly allows the family to discuss family values and align on major issues. Typically, a family assembly meeting consists of equal parts fun family activities, education, and time to talk about the family business. Often, there is a presentation by the company's chief executive officer or the chairman of the board on current developments in the business. A family assembly can have committees comprised of smaller groups of individuals focused on key areas of the family and the business.

FAMILY COUNCIL

A family council is a subgroup of the family assembly. It is the governing body for the family, and its representatives are elected by family members. The family council develops the family's vision for the business, aligns family values, and serves as the communication link between the family and the business.

The family council may oversee committees of the family assembly. Often the chairperson of the family council serves on the company's board of directors. Members of the family council can be compensated for their services, whereas the members of the family assembly are typically not compensated, other than for having their expenses covered for attending family assembly gatherings.

Model Family-Business Governance Structure



SHAREHOLDERS

A company's shareholders elect its board of directors. The shareholders make major decisions on behalf of the business, including whether the business is to be sold or whether the company will grow by acquiring other businesses. The shareholders set long-term objectives for the business and guide and inform the board of directors.

BOARD OF DIRECTORS

The board of directors sits between the owners and management of a business. Its members are elected by the shareholders, make decisions on behalf of the company, and direct the chief executive officer and management of the company's implementation of such decisions. The members of a board of directors owe fiduciary duties to the company and its shareholders. Directors are legally bound to the business and may be held liable for the consequences of the business's actions or inaction.

Often, as a precursor to a fiduciary board of directors that includes "outside directors"—those with no pre-existing relationship with a company's owners or management—a company establishes a board of advisors. The members of the board of advisors do not have decision-making authority on behalf of the company. A board of advisors provides nonbinding, strategic advice to the management team of a business. Businesses generally choose to have a board of advisors so they can benefit from the knowledge and advice of experienced outside professionals.

CEO/MANAGEMENT

A company's CEO and management team run the business based on direction and guidance from the board of directors. They handle the day-to-day operations of the business. They implement the desires of the owners and the board under the board's direction.

Governance of a family business is an evolving process. The governance structure will and should change over time. The proper governance structure for a family business must be commensurate with the needs of the family and the business and with their mission and their vision.





FAMILY COUNCILS: WHAT YOU NEED TO KNOW

— *By Pat Green*

What is a family council, and why would owners of a family business find the effort and time to form, organize, and operate one worthwhile? To explain how a family council can operate and how it could be beneficial, this short article presents an example from a recent engagement with a client (identities changed to protect confidentiality).

First of all, we should explain that the governance of a family business is prescribed by the type of entity in which the business operates. For example, in a corporation, shareholders own stock and elect directors who represent the shareholders in setting policy and direction for the business. In turn, directors elect officers to administer and carry out those policies in the day-to-day operation of the business. In a limited liability company (LLC), the owners are members who either operate like directors and/or officers or who appoint a manager or managers to run the business. In a family partnership (general or limited), owners are partners who may also serve like shareholders, directors, officers, or managers. In most family businesses, family members often serve in one or more capacities.

A family council offers an opportunity for the family business to engage all family members regardless of whether those family members serve in one or more of the formal roles.

The family business in our story involved two branches of the original family founders of a now fifth-generation corporation, each branch owning 50 percent of the voting stock. The C-suite (i.e., president, chief financial officer, and all vice presidents) are all nonfamily members. For the past 35 years, the shareholders have elected directors, the majority of which were nonfamily. To avoid deadlocks, the shareholders placed their stock into a voting trust where a trustee from each of the two family branches and a nonfamily director voted the shares for directors and for other major shareholder decisions.

While this governance structure served the business and family well over the years through

growth and regular dividend distributions, new generations acquired stock through gifts and inheritance, and nonfamily directors and the nonfamily trustee retired. The growing number of multigeneration shareholders felt that they had lost touch with the business, which resulted in some disagreement regarding their desire to continue or to sell the business. Directors and management sensed a lack of clear direction from the owners, which resulted in indecision regarding the direction for future investment for growth and expansion.

To help capture a vision for the future from the owners, the directors recommended that the shareholders engage a family business facilitator. This experienced individual conducted a confidential survey of the stakeholders (i.e., shareholders, directors, officers and key employees) regarding their views on whether to buy, sell, hold, or expand. With the survey results in hand, he facilitated a family retreat to open the discussion among the multiple generations of shareholders and their other family members. This process involved a number of meetings resulting in a more detailed and comprehensive report prioritizing and balancing the varying interests of the owners. Of course, dividend distributions remained important although most of the shareholders were willing to reduce them to invest in the future of the business. Each family elected a representative to report to the board and management regarding their progress. Although this process stretched over 18 months, here were the takeaways and outcomes:

- The two family branches united in agreement to continue the business, with one family group changing their minds regarding selling.

- The process provided the directors, officers, and key employees with a clear direction regarding the family's desire for moderate and measured growth.
- The owners agreed to terminate the voting trust and to restate the buy-sell agreement so that a "super majority" vote would be required for major decisions such as selling the business and electing directors, which worked to avoid deadlock between the two groups of family shareholders.
- The owners gained significant mutual trust as longstanding issues were discussed and addressed in an open and safe forum.
- The owners re-engaged with each other, the directors and management and then decided to formalize an ongoing family council where each family line elected a representative

to communicate with the directors and management resulting in better mutual understanding among all stakeholders as to where the business should head.

A family council can facilitate education, discussion, and engagement leading to clarity in the mission of the business. Input from the family council can provide the board and management with clarity and direction for the future of the business, which provides the board and management with guidelines for addressing both threats and opportunities. Starting with a facilitator, a survey, a retreat, and a fresh look at the business's governing documents are often the beginning steps to engaging family in the future of their family business. If you would like further information or would like to discuss action steps to consider a family council for your business, please contact one of our attorneys in our Family Business Practice Group.





FIVE TIPS FOR EFFECTIVE ADVISORY BOARDS

— *By Bill Weigand*

If you are looking for a fresh perspective on family business matters but not ready to be bound to follow the recommendations of outsiders, an advisory board may be the perfect vehicle. Unlike a fiduciary board of directors, members of an advisory board have no decision-making authority. Their role is to provide nonbinding, strategic advice to the company's owners and management team. This independent insight can be critical when confronting difficult decisions around succession, growth, diversification, and other significant challenges.

When forming an advisory board, be careful, proactive, and well-organized.

SELECT ADVISORS CAREFULLY.

Be diligent in selecting appropriate candidates for your advisory board. This is your chance to expand your circle of influencers. Consider avoiding those you already know well or with whom you work professionally; you are already benefiting from their insight. Ask a lot of questions and check references. Look for those with a skill set or experience that your organization may be lacking. Do they have contacts that may be helpful to your business? Do they have conflicts of interest that outweigh any benefit that they may bring to the table? Think about what the ideal number of advisors is and how the members will get along with each other.

SET CLEAR EXPECTATIONS.

Use a written Advisory Board Agreement to detail the roles and responsibilities of advisory board members. Include your expectations around time commitments and effort. Spell out the compensation arrangement; virtually all advisory boards pay their members, but the compensation can vary widely based upon the anticipated level of involvement and the necessary level of expertise. The most common compensation arrangement is to pay a per-meeting fee and reimburse reasonable expenses. Include broad confidentiality protections.

EDUCATE YOUR ADVISORS.

Be intentional when onboarding your advisors. Prepare a notebook with key information about

the business and its owners. Spend time with advisors to bring them up to speed on the nature and history of the business, its special advantages, and its unique challenges.

CONTROL THE AGENDA AND MEETINGS.

Proactively frame the specific issues that you want your advisors to focus on. Be laser-focused and realistic. Many advisory boards fail due to the lack of advance planning and a “shotgun” approach to the issues facing the business. Keep control of the advisor meetings. These are talented individuals with a lot to contribute, but don’t let one advisor dominate the discussion or shift focus elsewhere.

GIVE AND REQUEST FEEDBACK.

Much can be gained through open communication and constructive criticism. Evaluate the performance of the board and its members each year. Let members know what they are doing well and which areas need improvement. Solicit ideas on how you can improve the board’s efficiency and effectiveness and how you can do a better job. Set new goals for the coming year.

Done right, an advisory board can be wonderful, mutually beneficial experience. It can be a precursor to adding nonfamily members to your fiduciary board of directors or other improvements to your governance structure. Like all things, you will get back what you put into it. Expect to work hard, hear things that you won’t necessarily like, and gain invaluable insight.



TOP TEN PITFALLS UNDER BUY-SELL AGREEMENTS

— *By Bill Weigand*

If your family business has or anticipates having more than one owner, you need a buy sell agreement. A buy-sell agreement governs the terms and conditions under which ownership interests in the enterprise may be transferred.

It can take the form of a standalone buy-sell agreement, a shareholders' agreement, or detailed provisions within a limited liability company's operating agreement or a partnership's partnership agreement. Without a current, well-thought-out buy-sell agreement, business and family relations could be in great jeopardy.

Done right, buy-sell agreements provide a path for transitions of ownership that is orderly and predictable. Here are 10 of the most common pitfalls under buy-sell agreements:

1. Lack of a Buy-Sell Agreement.

An unfortunately large number of family enterprises simply do not have any written agreement governing the purchase and sale of ownership interests. This leaves everything to chance and the good graces of the current owners.

2. An Outdated Buy-Sell Agreement.

Just because you entered into a buy-sell agreement when the business was formed or several years ago, don't expect it to serve its purpose now and in the future. No family or family business is the same as it was five years ago. Business, economic, and interpersonal relations have all changed. Don't expect your agreement to automatically keep pace. Plan on undertaking periodic reviews of your agreement, and expect to make changes to address new developments.

3. One Size Does Not Fit All.

The best buy-sell agreements are carefully tailored to the business and its owners. Spend time discussing the unique features of your business and its owners with your legal counsel. Do not accept the first draft. Work through various scenarios with your lawyer, accountant, wealth manager, and other advisors to guarantee proper results. This also allows for broad input from various angles and is a good test of whether the agreement is accurate, precise, and understandable.

4. Burdensome Transfer Restrictions.

No one wants to be forced to be a co-owner with a competitor or someone he or she finds

unacceptable. That is exactly what could happen if there are no restrictions on the transfer of ownership interests. But are the restrictions too burdensome? Do they cause unintended consequences? Often, families wish to retain ownership within familial blood lines by prohibiting transfers to spouses. This, however, prevents the owner from obtaining a marital deduction at death, thus accelerating the payment of estate tax, which could have been delayed until the death of surviving spouse. One workaround is for the buy-sell agreement to permit transfers to a qualified terminable interest property (QTIP) trust for the benefit of the surviving spouse during his or her lifetime.

5. Missing Trigger Events.

Trigger events are the factual events that give rise to the company's and other owners' rights or obligations to purchase ownership interests. Common trigger events are death, disability, retirement/termination, bankruptcy, divorce, and an attempted impermissible transfer. Does your buy-sell agreement cover all of these events? Are there other events that would be appropriate trigger events for your business?

6. Death as a Trigger Event.

Should the death of a family shareholder create an obligation to sell ownership interests back to the company or to other owners? That may make sense for the owner of a small interest, but should it apply if a major owner dies? Instead, should an owner be able to pass ownership to his or her heirs, thus preserving that particular family branch's ownership interest in the enterprise?

7. Divorce as a Trigger Event.

No one wants to be forced to be a co-owner with the ex-spouse of a former owner, but that is exactly

what could happen in a divorce proceeding. The award of an ownership interest to an ex-spouse is typically an event triggering the right or obligation of the company and/or its owners to acquire that ownership interest. Is this the correct result? Or should the divorced former owner be given the first right to reacquire his or her former ownership interest?

8. No Path to Liquidity.

What if a shareholder would like to reduce his or her ownership interest? Many buy-sell agreements provide no clear path to accomplish this, leaving shareholders effectively “stuck” if a separate deal cannot be negotiated. Uncertainty in a family business does no one any good. Perhaps a better route is to spell out a path whereby owners may reduce their ownership interests over an extended period of time under clearly expressed terms and conditions.

9. Valuation Surprises.

Vague, confusing, or outdated valuation processes create great risk of unpredictable and unfair valuation results. The approach to valuing ownership interests is key. Is it clear and precise? Does it provide a fair result? Buy-sell agreements typically use fixed prices, formulas, or appraisals to establish a sales price. Often the approach chosen at the onset of the agreement no longer results in a fair and predictable valuation, given changes to the

business and its ownership. Setting an initial value by appraisal and then providing for periodic appraisals may be the best approach. While this approach is not the cheapest one, it does ensure that all owners have greater clarity around what their ownership interests may be worth.

10. Unrealistic Payment Terms.

Does the agreement require payment in full upon the occurrence of a trigger event, or does it allow for a down payment and payment over time? Given the varying size of ownership interests typically found in family-owned enterprises, are the payment terms workable for both the purchaser and the seller? The purchaser, whether it be the company or another owner, may have cash-flow restraints. The seller will have his or her own cash needs, whether it be to fund tax payments or other obligations. These competing interests need to be carefully balanced to result in a “fair” outcome that does not jeopardize the financial existence of either one.

Now is a great time to review your buy-sell agreement and to test it against present circumstances. We are certain that you will find ways to update and improve it. You and your family will be thankful when the time comes to apply its provisions for real.

For more information, insights and listings of events,
check out our website:

www.familyownedbusinessadvisors.com



ADVICE FOR BOARDS OF DIRECTORS

— *By Drew Steen*

Most advisors recommend that a family business have and use a board of directors. A corporation is legally required to have a board of directors, although it can frequently be a single person and there are very few actions that actually require board approval.

With other sorts of entities (e.g., LLCs) a board of directors is not legally required. So there is always a temptation in a closely held business to avoid the hassle and complications of appointing a group of individuals to govern the business, calling meetings, taking input from those not intimately involved in the business, etc. Nevertheless, it is common wisdom that a functional board of directors, including some independent voices, can be a valuable asset to a company. A board can offer an objective and higher-level perspective. It can be a decision-making body without blind loyalty to a particular family member or family branch. And because the directors on the board are each subject to the fiduciary duties that go along with such role, there is a real comfort that they take the position seriously.

What frequently goes unsaid, however, is that a company should not just rush out and pull together a board of directors based on this advice. The composition of the board is key. The selection of individual directors should be a careful and thorough process. In selecting a director, the owners of a company should consider each potential director's skill set and sophistication, his or her familiarity with the business or the industry, his or her independence and any inherent conflicts of interest he or she might have with what would otherwise be in the best interests of the company. The owners should be aware that a director cannot be "handled". A director is entitled to effectively all company information she requests and cannot be removed or excluded from board meetings. This makes sense because a director has to comply with his or her fiduciary duties. Therefore, the law is very

clear that he or she should be entitled to all the relevant information necessary to make tough, strategic decisions for the company.

In some family-owned businesses, owners will sometimes try to place individuals from the family on the board of directors to make them feel included in the business, even when they have limited involvement otherwise.

Be warned that this puts an individual in a place of significant power and influence in a company. It is unlikely that such a single director could unilaterally direct policy or force certain actions on the company, but he or she could upset a productive decision-making dynamic in the board room. The whole value of a functional board of directors is its ability to operate collectively. And it only takes one person in the room to dramatically change the dynamic.

Closely held companies should consider the advantages of a functional board of directors, but they should also be very careful about selecting the individuals to participate. It is a grant of substantial authority and trust, but it is not hard to imagine how a dysfunctional board of directors could be worse than none at all.



SURVEY SAYS: GOOD GOVERNANCE PAYS BIG DIVIDENDS

— *By Bill Weigand*

The Pacific Family Business Institute (PFBI) has just released the results of its 2018 survey. With support from Cascadia Capital, Moss Adams, and Davis Wright Tremaine, PFBI interviewed 81 family businesses in Washington state and Oregon, focusing on their governance and compensation practices. This was the first regional survey on these topics.

Here are some of the key takeaways:

GOOD GOVERNANCE IS WORTH THE EFFORT.

Eighty percent of the respondents consider the contributions of its board of directors to be “valuable” or “very valuable.” They recognize and appreciate the value of having a formal board of directors with regular meetings, defined processes, committees, compensation, and independent (non-family) directors. The value provided by a functioning board heavily outweighs the time and expense involved.

TYPES OF GOVERNANCE STRUCTURES.

Sixty-one percent of respondents have only a board of directors. Eighteen percent have both a board of directors and a family council (the governing body of the family, with its representatives elected by family members). The remaining 21 percent have a board of advisors (providing nonbinding, strategic advice to the company).

BOARD MEMBER COMPENSATION.

Sixty-seven percent of respondents pay their directors. Independent directors are the most likely to be paid, while family members who work in the business are the least likely to be paid for the service on the board. Compensation for board members ranges from \$4,500 to \$78,000 per year, often with other perks and reimbursement of expenses. Some boards are paid through an annual retainer, others offer a per-meeting fee ranging from \$300 to \$6,500, which may or may not be on top of the retainer. Some companies offer compensation based on company performance, earnings, or profits, while others provide restricted stock,

phantom stock, or options. One respondent makes a charitable donation in the name of each board member.

BOARD COMPOSITION AND RECRUITMENT.

On average, a board of directors has seven members, four of which are family members and three of which are independent. More than 60 percent of boards have independent directors. Only half of the respondents have formal written policies or guidelines for board membership. “Specific expertise” and “trust by the extended family” were the most sought-after qualities for independent board members.

BOARD RETENTION.

Most respondents indicated that it was easy to recruit and retain board members. Most boards have little turnover and do not have term limits. The average board member serves for 15.6 years(!), leaving only upon retirement. Families should consider instituting term limits that will give them flexibility to renew their boards as governance and other needs of the business change over time.

BOARD TIME COMMITMENT.

On average, a board of directors meets 3.6 times per year. Boards of directors typically spend 20 hours every year in formal meetings (and a like number of hours in preparation for such meetings), with additional time for special meetings and projects common. Board chairs typically spend an additional 75 hours or more on their leadership role. A typical board focuses on internal issues in meetings 60 percent of the time, tends to operate with standing compensation and

“As a family business grows in size and complexity, so does its need to develop a robust governance system. The rewards in doing so will be well worth the effort.”



audit committees, and provides developmental opportunities for its directors. The meeting frequency for boards tends to be greater for older, larger, and more complex organizations.

FAMILY COUNCIL.

The average family council meets 3.3 times per year for a total of 21 hours. Preparation time is typically one-half of the meeting time. The council chair typically spends another 20 hours in leadership and planning functions. Just over a third of the respondents pay family council members who are not employed by the business. On average, compensation consists of an annual retainer of \$1,500 (\$3,500 for the council chair) plus a per-meeting fee of \$700 to \$900 (\$200 if meeting is attended by phone). Businesses that have both a board of directors and a family council are more likely to have independent directors.

RURAL VS. URBAN PRACTICES.

Rural respondents are more likely than their urban counterparts to have an active board of directors, and those boards are generally smaller. Rural companies also tend to report greater satisfaction with their governance structures and are more likely to emphasize the need to mentor family members regarding their roles in the family business and its governance.

As a family business grows in size and complexity, so does its need to develop a robust governance system. The rewards in doing so will be well worth the effort.



We are committed to helping family businesses learn and grow.

DWT helps family businesses connect with each other and give back to the greater community through our Family Business Resource Center at <https://www.familyownedbusinessadvisors.com/>. We host events like the Family Business Legacy Series, which is limited to owners and managers of family businesses and provides a safe and confidential forum to exchange best practices, and the Family Business Study Group, which is designed to inform professionals who serve family businesses on the latest developments and best practices.

SOME OF THE ISSUES FACING FAMILY BUSINESSES:

- Succession planning and implementation
- Estate planning
- Governance
- Business transactions
- Tax
- Real estate
- Land use
- Employment
- Philanthropy

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