CORPORATE GOVERNANCE PRINCIPLES

APPLICABLE TO FAMILY OWNED PRIVATE CORPORATIONS:

A BRIEF OVERVIEW FOR LEGAL PRACTITIONERS

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The bulk of corporations that a non-Bay street lawyer encounters in their daily practice tend to be family owned corporations generally with one controlling shareholder. There may be other minority shareholders, generally family members, for tax purposes or it could be a second generation corporation being run by a family member. For either generation, that same controlling shareholder is generally the only director and officer. Thus, the topic of this paper is ultimately to answer the question of what recommendations of corporate governance should a practitioner make to a closely held privately owned family corporation? To answer this question, resources depicting what corporate governance is have been consulted, although the assumption is that in reading this paper the newly emerging concepts of good corporate governance in relation to (publicly held) corporations is already known to some extent.

The topic is divided into three parts; the first part provides a brief discussion on what incentives family owned private corporations have if any to even begin to address issues of corporate governance. It appears that there are incentives but they rarely come from law, they sometimes come from contract, but the bulk are driven from circumstances particular to that individual corporation. The circumstances include external pressures from audits or financial institutions, external and internal pressures from expansion and growth, and internal pressures arising from succession planning. In the second part, a brief review of some resources that address good corporate governance principles aimed at public companies and their potential implication to private companies has been provided. Included in the second part is an examination of some of the main principles of corporate governance that have been touched upon and will be discussed here as to whether the same principles can in fact be applied to both public and private family corporations, if there is an incentive to apply them. The conclusion is that these principles are not typically able to be applied in the same way to family corporations as can be to public corporations. For the most part, select governance principles must be chosen and then modified to apply properly to family owned companies. Selecting only certain applicable principles to that particular family owned corporation is important because the incentives to devote time and money to corporate governance are few so the practitioner must choose the most important issue germane to that particular corporation. The third part of the paper gives some hypothetical examples of corporate governance issues arising in family owned corporations that include both first generation (which for the purposes of this paper include a sole shareholder, director, and officer, owned corporation) or a second generation family owned corporation. A basic analysis of what if any incentive do these corporations have to focus on corporate governance and what recommendations a practitioner would make to each corporation regarding which governance principles to apply and how to apply them.

Part I-what incentives do a family held private corporations have to focus on corporate governance?

The first question to be asked is what incentive does a closely held private corporation have in improving upon their corporate governance? Secondly, if there are incentives, from where do they come from or which corporations will actually find the incentive to improve upon their corporate governance? The first part of the answer is to look at what is set in law. In Ontario, all corporations are subject to the Ontario *Business Corporations Act*[1] which has a limited amount of regulations and reporting requirements. For example, each corporation must file their Form 1 Notice of Change annually to report on any changes in head office, directors or officers.[2] Privately owned corporations are able to waive the audit requirements but must file income tax returns. Other than any other industry specific reporting requirements, that is pretty much it.

Van Duzer in The Law of Partnerships & Corporations goes even further and states that corporate law is irrelevant for corporations with one shareholder, director and officer because they are in no need of protections for opportunism.[3] Even for publicly owned corporations in Ontario, the reporting requirements are largely flexible being based on disclosure which includes best practices guidelines and

[1] R.S.O. 1990, c. B-16 [*OBA*].
[2] *Corporations Information Act*, R.S.O. 1990, c. C.39.
[3] Van Duzer p.522.

a comply or explain approach.[4] Therefore, other than the *OBA* and its regulations, Ontario family owned corporations are not subject to the National Instruments or National Policies that apply to publicly held corporations. Nor are they subject to the TSX rules and requirements which apply to companies listed on the Toronto Stock Exchange. Secondly, the corporation could be subject to privately contracted incentives which will be touched briefly upon as an incentive only, but other than that is outside the scope of this paper. As such, it appears that statutorily based incentives are almost non-existent for the privately held family corporation.

Despite this lack of mandatory regulation for family held corporations, McCahery and Vermeulen, in their book called <u>Corporate Governance of Non-Listed Companies</u>, have found that there are in fact incentives to non-listed firms to instill principles of good corporate governance and that the benefits can outweigh the cost.[5] They specify the principles that should be focused on by private corporations deriving in fact from the *Sarbanes-Oxley*[6] legislation aimed at good corporate governance that include financial reporting, risk management, performance and inventory tracking.[7] They state that because non listed companies are not subject to market mechanisms to regulate behavior in these areas, nor are they subject to market regulators, they must regulate themselves to prevent opportunistic behaviour.[8] However in regards to the application of these principles and practices in non-listed companies, the adoptions must generally be internally derived and there are few external pressures, such as regulations, on corporations to make these changes.[9] In their book, they devote an entire chapter on contractual provisions that generate a focus on corporate governance for non listed corporations and determine that much prevention can and should be done by contractual provisions which then can become an incentive for the corporation to rectify the applicable corporate governance provisions

[4] Van Duzer p.540-541.
[5] McCahery p. 201.
[6] *Sarbanes-Oxley Act*, Pub. L. No. 107-204, 116 Stat. 745 (2002).
[7] McCahery. P. 201 and Van Duzer p.540.
[8] McCahery p. 144.
[9] McCahery. P. 202

contemplated in the contract.[10] So contracts can become an internally derived external incentive to incorporate principles of corporate governance.

McCahery and Vermeulen come to the conclusion however that the most important incentives for family owned companies are internally derived and include succession planning (within which survival of the business would be essential), family and business led reorganization issues, dealing with familial or closely held personal issues and freeing up managerial resources.[11] They do agree that auditors can be another source of external pressure who tend to put pressure on larger non-listed corporations[12] but for the most part, smaller corporations must find their own incentive to allocate resources to implementing principles of corporate governance. Included in McCahery and Vermeulen's view therefore, is protecting shareholders and creditors[13] which is important for closely held corporations although the incentive may end up being externally driven in those cases.

This coincides with what the authors feel should be an incentive for policy and law makers, in that non-listed companies are essential for job creation and so they require, *"a governance framework that will foster strong decision-making, accountability, transparency, and ultimately firm performance*."[14] Furthermore, McCahery and Vermeulen advise that focusing on the governance of non-listed companies is even more important because of the prevalence of a lack of division between ownership and control in the majority of non-listed companies.[15] These companies are generally more focused on operations and economics.[16] Thus their recommended focus would be on incentives aimed at succession planning and strengthening management to effectively strengthen the business.

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[10] McCahery p. 144.
[11] McCahery p.4.
[12] McCahery, p.202
[13] McCahery p.5.
[14] McCahery p.11.
[15] McCahery pp 11 and 25.
[16] McCahery p.11.

Lipman and Lipman put forward the use of the external audit as incentive in their book called Corporate Governance Best Practices: Strategies for Public, Private, and Not-for-Profit Organizations, in which they advise also that although there is no mandatory requirement stemming from legislation to instill principles of good corporate governance to private family owned corporations, there does exist incentive to do so.[17] They find and it is the author's experience that most private businesses require financing from banks who rely on the corporation's financial statements as well as a personal guarantee from the principal which renders them personally liable.[18] Therefore it is crucial that the financial statements are consistent with proper accounting principles and are accurate in their disclosure and transparency. Lipman and Lipman also advocate for the use of independent directors to form an independent audit committee for this very purpose and seem to come at good corporate governance for private corporations from an audit, independence and risk based perspective.[19] And in the event that the corporation becomes insolvent, having independent directors on the board will assist in protecting transactions surrounding the non-independent directors.[20] Thus their focus is aimed at finding incentives that promote independence and risk management on the board and transparency through audited financial statements.

Lipman and Lipman do agree with the stress on succession planning and family issues stating that many such businesses fail with the second or third generation because of the mix of emotions and business entanglements and so their recommendation to deal with the succession planning aspect is to have an automatic dispute resolution that is engaged upon the death of the founder.[21] This coincides with their focus on independence and audit in what seems to be a risk based focus preference whereas as is set

[17] Lipman chap 17, section 1
[18] Lipman chapter 17, section 1
[19] Lipman chapter 17, section 1
[20] Lipman, chapter 17, section 3, refers to *Pereira v. Cogan*, 2003 WL 21039976 (S.D.N.Y. May 27, 2003) to state that creditors or trustees in an insolvency proceeding can hold directors and officers personally liable.
[21] Lipman, chapter 17, section 2

out below, McCahery and Vermeulen focus more so on succession planning and freeing up management to strengthen the corporation for future generations.

Vermeulen in a separate paper entitled *"The Role of the Law in Developing Efficient Corporate Governance Frameworks"* found in Corporate governance of non-listed companies in emerging markets Organisation for Economic Co-operation and Development, discusses the incentive of globalization where the environment becomes more competitive to the closely held family corporation and so developing good governance practices is an essential tool for ensuring strength, growth and efficiency.[22] The concept of globalization as an incentive could feasibly spill over into the bottom line in a purchase of a family owned private corporation. Ostensibly a strongly governed company would generate a larger purchase price. This seems to be a broad overreaching incentive that coincides with the idea of strengthening and separating out management and therefore strengthening the business but at the same time could be a less feasible sell to a client in that it encompasses too many idealistic goals. It could however be an observation to a client in that all aims at achieving steps to good corporate governance should effectively be realized as being rewarded at the business level.

The highlights of having the incentive to and applying the good corporate governance principles to family owned businesses are that they can be very competitive because of the structure that differs from publicly owned companies in that they can make decisions quickly and effectively, they understand the immediate market, they may have a relationship with regulators and politicians, and *"strong horizontal and vertical relations in the market."*[23] The benefit is that family owned private corporations can pick and choose which principles to incorporate deriving from among their own personal incentives subject to necessity and cost. The drawback to a lack of or a lax regulatory scheme is that many smaller corporations will not have an incentive to do so without external pressures such as a lending institution

[22] Vermeulen p. 94.
[23] McCahery. p.208

insisting upon it, nor will they even know they are lacking in principles of corporate governance. However, because many of the principles being adopted by public companies would be costly without a large benefit to smaller unlisted companies it can be argued that it is in the closely-held corporations' best interest to not be subject to unilateral mandatory corporate governance provisions.

Therefore the answer to the question in Part I of whether there are incentives for family owned private corporations to consider corporate governance is answered in the affirmative however the incentives vary from corporation to corporation. Few incentives are legislated for family owned private corporations, some are found by way of contract, and most come from the particular set of circumstances being currently experienced by that corporation. Particular circumstances giving rise to internally derived incentives include looking to grow the business, requiring loans or desiring outside financing, an owner looking to retire or sell, second generation issues, family issues, or just simply that someone is paying attention to the corporate governance issues that are being highlighted as towards publicly traded corporations and wonder if they need to take notice for their own corporation. Whatever the circumstance, the practitioner must use the incentive provided to begin an analysis of what the bottom line issue is for the client and which principles of corporate governance should be the priority to make the required changes.

Part II-which principles of good governance apply to a family owned private corporation?

Once the incentive is there, and keeping in mind the general recommended priorities of risk management, independence and succession planning, the practitioner must ask the question, which principles of good corporate governance can apply to a closely held family owned private corporation? According to the authors McCahery and Vermeulen, the principles, or here what will be called goals of

Corporate Governance, are to, "(*1)ensure the basis for an effective corporate governance framework; (2) define the rights of shareholders and the responsibilities of management; and (3) set out the guidelines for enhanced disclosure and transparency.*"[24] These goals seem to be overarching and broad enough to cover both public and private corporations however it is the implementation and focus of the following non-exhaustive criteria that must be changed for closely held family corporations. Vermeulen in his paper categorizes family owned corporations as being along side with group-owned companies, private-investor-owned companies and joint-ventures who are all characterized as having a smaller number of shareholders, no ready market for corporate stock, and substantial (majority) shareholder participation in the management, direction and operation of the company.[25] Ironically, the characteristics thus described are completely opposite to those in publicly traded corporations which means that any corporate governance principles aimed at those categories will either not be relevant to family owned private corporations or they will usually not apply in the same way.

In McCahery and Vermeulen's joint work, they have done an excellent job of creating a table that clearly sets out the differences between public corporations and family owned firms that need to be taken into account for the interpretation and application of guidelines for corporate governance:

Table 7.2. The anatomy of corporate governance: listed versus non-listed companies[26]

Governance in typical public companies	Additional governance challenges for family-owned firms
Board composition	
Board members are not employed by shareholders; represent interest of all shareholders equally. Independent directors are key to proper governance.	Board members are typically family members. Better model: include outside directors to obtain a mixture of family views and strategic perspectives.
Board roles	

[24] McCahery p. 207 and Vermeulen p.93
[25] Vermeulen p. 95
[26] McCahery.p.206

Board focuses on approval of major strategic decisions, CEO succession, risk management.	Boards must set the strategies and goals, while taking the special interest of the family into account.
Decision-making	
Investors unite in desire to maximize shareholder returns, manage risks.	Key decisions require the involvement of family members. It is important that all generations are directly or indirectly involved in the decision-making process. A family forum could serve as a platform for communication and consultation.
Management team	
Management team members are accountable to CEO and board.	Key members are often family members who are accountable to the board—which preferably consists of family members and outsiders.
Resource flows	
Venture does not depend on shareholders for any operational inputs.	Venture depends largely on bank and internal (family) financing.
Ownership structure	
Market model of corporate governance: widely dispersed shareholders.	Family members directly or indirectly hold most or all of the shares.
Control model of corporate governance: concentrated ownership.	The challenge is succession planning and keeping the next generations involved.
Shareholders can dispose of their shares in the stock market.	
Shareholder activism	
Measures are advanced to encourage shareholder activism—electronic voting, proxy voting, active institutional investors.	Corporate governance should create awareness among members of different generations. Its main objective is to supply incentives to educate family members about the ins and outs of the family business.
Deadlock and other conflicts	
Board members owe fiduciary duties. Derivative and class actions.	Business conflicts are magnified by emotionally charged familial relationships. A family forum (and outside mediator) could be used as a bonding place which would help resolve conflicts in its initial stages.

Source: Adapted from a Table published in Bamford and Ernst (2005).

This table illustrates some of the key differences broken down by category between a publicly traded corporation and a family held private corporation. For the family held private corporations, it is recognized that at the board composition level, the board members are usually family members and the recommendation is to have independent directors on the board. For both the board roles and decision making process, the uniqueness of the family setting must be taken into account and preferably dealt with by way of family council. Family members are often involved at the management level but again the recommendation is to have some independent players as well. In these types of corporations, financing and shareholdings all directly involve the family members. Succession planning including education and incentives are crucial and emotions can run high leading to a difficulty in impartial decision making. One can see that the common thread running through the family side of the chart is that family's involvement completely alters the traditional aspects of each of the corporate governance principles aimed at public corporations. These considerations are important to keep in mind when coming up with a corporate governance strategy either to address a particular issue or to generally clean up the corporate governance of a family held private corporation.

Lipman and Lipman have provided a list that takes into account this focus on independence and a recognition of the unique issues faced by a family held private corporation which they have narrowed or simplified the issues somewhat to provide overarching considerations of what can be used as a good start when considering best practice tips for family owned private corporations. Their three preferred good governance principles to consider and upon which to base recommendations are:

1. Independent directors or an independent board of directors[27]

[27] Lipman, chapter 17, section 1

2. Dispute resolution mechanisms in the charter of family-owned businesses that are effective automatically once the founder dies or retires and preferably uses independent directors to resolve the dispute after the death of the founder[28]
3. When the organization is in the "vicinity of insolvency, "independent directors should hire their own independent counsel to assist them in performing their potential fiduciary duties to creditors.[29]

In other words, Lipman and Lipman seem to prefer a strong focus on independent directors for risk management and so looking into this possibility would be high on their list of priorities. In considering dispute resolution mechanisms, they are recommending that family owned businesses should focus firstly on their brand or technology and secondly on strong corporate governance to 1) free up management to run the business, 2) focus on long-term survival, and 3) deal with family issues.[30] Crucial to the strong corporate governance are the factors that will enable decision making, accountability, transparency and performance which all contribute to the potential of investment and expansion and linked to that the likelihood of receiving private equity and venture capital investments.[31] Lastly, they wish the client to remain aware of the implications of insolvency and the associated risk management.

Lipman and Lipman's three principles are a good place to start an initial examination however the principle of independent directors or an independent board of directors will not always be applicable to small family corporations and may actually be a discussion to be touched upon but then left until another time unless there are issues directly requiring independence on the board such as audits or risk

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[28] Lipman, chapter 17, section 2-gives an example of a dispute resolution mechanism upheld by the Pennsylvania Supreme Court whereby in the event of a dispute, the independent directors were able to cast approximately 80 percent of the votes of all Class B shareholders which left the decision in their hands unless the remaining shareholders voted unanimously on either side. See *Warehime v. Warehime,* 563 Pa 400, 761 A.2d 1138 (2000); *Warehime v. Warehime*, 860 A.2d 41 (Pa.2004).
[29] Lipman, Chapter 17, section 3.
[30] McCahery. p.208
[31] McCahery. p.208

management. A dispute resolution mechanism can be related to the independent principle as Lipman and Lipman would like to see independent directors resolving the dispute but again this principle is not always applicable unless there are more than one family member who have equal power and decision making levels and usually comes into play once the first generation is making succession plans. Their third area of focus which is on having independent counsel during insolvency proceedings is also an excellent recommendation but again is specific to a client going through insolvency proceedings and may not be a relevant discussion to have at the outset.

As such, McCahery and Vermeulen have set out the principles to which it is suggested that a closer in depth analysis would be a good initial approach for the practitioner while simultaneouslys keeping in mind Lipman and Lipman's focus as stated above. These principles are not exhaustive but have been chosen as a starting point because they may sound familiar to both practitioner and client as they have been recently the more generally focused upon corporate governance principles in relation to publicly held corporations.   They are also the main overarching principles of corporate governance. The idea here is thus to start with these somewhat familiar principles and then analyze their applicability in general to family held private corporations at which point they are then modified to apply specifically to family held private corporations. The practitioner's job at that point is to in discussion with their client pick and choose which of these principles apply to their particular client's corporation and which of their issues takes priority.   A client may also have heard about these corporate governance principles and wonder about their applicability to their own corporation. Sample questions to be asked by the practitioner are set out below each principle.

Separation of ownership and control

Traditionally and in conjunction with remuneration (see below), the focus of the more recent concerns with respect to publicly traded corporations in relation to corporate governance has mainly been focused on the separation of ownership and control. Problems for publicly traded corporations ran into issues for example where management is on the board tied into the fact that their remuneration is contingent on short-term goals and that the shareholder structure in a publicly held company is not able to effectively deal with these types of scenarios. This type of concern is typically of less importance in a closely held family corporation because although there are generally situations where shareholder(s) run the business, they normally have the expertise to understand and run the business as well as the incentive to run it sustainably with long-term goals. Thus the concern that shareholders are disinterested and unknowledgeable with respect to the business is usually irrelevant with respect to family held corporations.[32] This applies to majority shareholder control issues as well, generally they are not as problematic because they too are focused on the future of the corporation.[33] As the corporation gets bigger however the separation of ownership and control can become an issue if those running the business do not have proper management skills or lack much needed independence. At the initial stage, however, the focus in this category for a family held corporation should be whether management is free to put its attention to managing the business or whether they are tied down in director and shareholder type decisions and concerns.

Questions for the practitioner to ask therefore include:

1. What decisions in the corporation are being made at a shareholder level?
2. What decisions in the corporation are being made at a director level?
3. What decisions in the corporation are being made at a management level?
4. Are any of the three levels of decision making intertwined?
5. Would there be a difference in efficiency if the proper decisions were delegated to the proper decision making level?

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[32] McCahery. P. 167
[33] McCahery. P. 168

6. And then, should the family members acting as management have the proper skill set to properly manage as the business grows?
7. Is it feasible to instill one or more independent directors on the board?
8. Is it feasible to instill one or more independent persons in management?

Shareholder Identity

Included under the heading of separation of ownership and control but yet a separate heading in its own right is that of shareholder identity. It stands that the general corporate form aimed at public companies does not take into account the importance of the identity of shareholders in a closely held corporation.[34] The identity of shareholders is important because of what was previously discussed with respect to the smaller number of shareholders, the lack of a ready market for the corporate stock, and the large role in which the majority shareholder and other shareholders play in the management of the company, all of which contrast deeply with the scheme of a publicly traded corporation. Succession planning therefore becomes an issue under this category because in many situations there is one shareholder and it is not always a simple task to find a buyer with a good price. Emotions often come into play here for various reasons. The owner may feel the business is worth much more than what it can realistically be sold for, the owner may not want the business to be bought out by a larger company who intends to manage from afar, who intends to let employees go, or who intends simply to buy out the competition or liquefy the assets. There may be emotional factors tied into the fact that the owner wasn't able to convince their children to buy them out or take over the business. Or even worse, there may not be a buyer period.

Other issues within shareholder identity can include problems with majority rule. Because of the lack of division between management and ownership, the centralized management form of a corporation

[34] McCahery. 24-25

becomes somewhat irrelevant for the family held corporation and majority rule can become an issue.[35] In addition to issues with protecting minority shareholders, many judicial decisions interpret closely held corporations to be an extension of a partnership type arrangement that includes limited liability and tax benefits.[36] Questions to ask under this heading include:

1. Who are the shareholders?
2. Is there a family council set up to deal with shareholder, who are family, issues?
3. Are there any minority shareholder issues or the potential of same?
4. Is there any protection for minority shareholders?
5. Has any thought been put into a succession plan?
6. What is a realistic succession plan for this particular business?
7. Is the share structure consistent with other protections so that it won't be characterized solely as a tax avoidance scheme?

<u>Shareholder participation and dividends</u>

Problems can often arise in closely held corporations when there is a disagreement between the majority shareholder and the minority shareholders. The minority shareholder who generally is employed in the corporation may get terminated leaving them with no dividend in the event that they retain their shares or they may get bought out by the majority shareholder who then sets the price.[37] In family owned corporations generally the minority shareholders consist of family members for tax purposes and succession planning purposes. They usually have little or no say in corporate decisions nor is there a proper board to which they can elect representatives. The issues then to discuss with a client for good corporate governance in relation to shareholders include structuring proper classes of shares that are designed to represent the purpose, role and protections required for the specific shareholder.

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[35] McCahery. p.24-25.
[36] McCahery p.26.
[37] McCahery p.45-46.

1. Are there minority shareholders?
2. Are there any protections for minority shareholders?
3. If so is a separate class of shares appropriate for dividends and minority protection?
4. Do the minority shareholders employed in the company have an employment contract?
5. Do the minority shareholders have a mechanism through which to dispense with their shares if they so choose?
6. Do the minority shareholders employed in the company have a contract pertaining to dividends or share sales?
7. Is there a communications mechanism or family council through which minority shareholders can voice their concerns?
8. Is there a proper board through which minority shareholders can elect representatives?

Contractual provisions

Issues can arise with closely held corporations being subject to the same type of structure of publicly held corporations when attempts are made to contract around the publicly held structure oriented legal rules.[38] However the fact that closely held family companies can contract in or out of certain decisions is actually an excellent tool for the good corporate governance of such corporations. McCahery and Vermeulen advise that the most successful family owned corporations generally contract many decisions relating to potential relationship breakdown as well as succession planning, buy-out options (or lack thereof).[39] Contractual provisions relating to the structure and organization of governance are also crucial for factors such as each family member's level of involvement in decision making, control, accountability and entitlement to dividends.[40] Contracting such often provisioned oral arrangements ensures communication and understanding. Furthermore, regular informal meetings or establishing a

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[38] McCahery p.27.
[39] McCahery. P. 152
[40] McCahery.p.154

family council in addition to the corporate governance scheme will ensure open lines of communication.[41] Questions to ask are:

1. Has the corporation made attempts to contract in or out of certain decisions?
2. Have there been any attempts to contract around the publicly held structured legal rules?
3. If so are they able to be upheld?
4. Have any decisions been made with respect to succession planning, buy-out options (or lack thereof), structure and organization of governance etc. that would be strengthened by a written contract?

Disclosure and Transparency

The principles of disclosure and transparency generally tend to be overlooked in closely held corporations as reporting requirements and accounting principles such as audits because they are felt to be a different standard than that applicable to listed companies. However, McCahery and Vermeulen argue that these principles of disclosure and transparency should be given more weight and attention by closely held corporations for the purpose of being more attractive to investors and financing for purposes of growth.[42] As such, McCahery and Vermeulen advise that closely held corporations should be in a position to provide information about their objectives, principal changes, balance sheet and off-balance sheet items, financial positions of the firm and its capital needs, board composition and company policy for appointments and remuneration, forward looking expectations, and profits and dividends.[43] For practitioners therefore, this is a discussion for a client who has incentives deriving from looking to expand by attracting investors, for a client requiring loans from a financial institution or it could be included in the discussion on succession planning if attracting investors or funding is not the current focus of the corporation. Therefore applicable questions may include:

[41] McCahery p.154
[42] McCahery p.45.
[43] McCahery p.45

1. Does the corporation require outside funding?
2. In the future could the corporation require outside financing?
3. Are the financial statements transparent?
4. Have the financial statements been audited?
5. Has the corporation articulated its objectives regarding growth and finances?
6. Has the corporation articulated its policies regarding appointments, remunerations and dividends?

Remuneration or "Say on Pay"

According to McCahery and Vermeulen, remuneration should not be a large concern for family corporations because the focus should be elsewhere such as in succession planning. [44] Generally in closely held corporations, the shareholders who may also be directors and management are closely involved and making the decisions on a regular basis[45] and oftentimes, the salary taken is tax driven. The questions therefore to ask in this situation might be:

1. Is a forum for say-on-pay required?
2. Who sets the salaries of management?
3. Are the salaries pursuant to employment contracts?
4. Do minority shareholders have any input into salaries of management?
5. Is a family council established who can deal with remuneration issues?

Therefore the over-arching principles stemming from corporate governance practices aimed at public corporations can and do apply to family owned private corporations to some extent and are a good place for the practitioner to start because they address the typical main issues germane to these client corporations. Through the use of the types of questions that have been set out and the use of the over-

[44] McCahery. P. 156
[45] McCahery. P.203

arching principles as a guide the practitioner can make a start when planning out a corporate governance restructuring for a client or when simply making recommendations.

Once the practitioner has a general understanding of the over-arching principles of corporate governance that are generally the focus for publicly traded corporations and how they can be modified to apply to family held private corporations or how they might not apply at all, the practitioner can then begin to break them down into factors to consider. Therefore, to go further in depth, the practitioner can review the following non-exhaustive list of governance factors which has been adapted from corporate governance lists compiled from various countries looked at by McCahery and Vermeulen.[46] These factors can then be examined and can be used to formulate further discussion questions for the client's corporate governance analysis. The headings are taken from the groups of related factors and are not derived specifically from corporate governance headings however the factors can all be applicable to principles of corporate governance for family held private corporations and the practitioner must choose which ones are relevant for each particular corporation if the incentive is there. The factors include:

[46] McCahery. p.213

Audit

Judicious use of outside

advisors

External audit

Auditing and related aspects of corporate transparency

Internal control and risk management

The board of directors

An active board of directors

Outside directors or board of advisors

Number of board meetings

The managing director

Board of directors, structures, responsibilities and prerogatives

Governance of family-owned enterprises

The board committees

Directors' charter and duties

Management

A high-performance management

Compensation systems

The relationship with personnel

The government as partner

The articles of association

Redemption and approval clauses

Communication and information

Related party transactions

Shareholders

Involved shareholders

The Shareholders' agreement

General meeting of shareholders

Shareholders' rights and obligations

List of shareholders' rights

Shareholders' rights to information

The rights of shareholders with regard to shareholders' meetings

Board composition and minority shareholders

Family

The family forum

The family charter

Consultation with the shareholders

Information and communication

Succession

Resolving conflicts

Change of generation in family enterprises

Relationships

banks and financial

institutions

suppliers

customers

Investors

Partners

Government

employees

Other general Corporate governance principles

Structure and organization

Culture and incentives

Key persons

Succession

Publication of the corporate governance rule

This list of factors can be used as a quasi-checklist for the practitioner when discussing corporate governance objectives with the family held corporate client. Again there are similar categories to those applicable to public corporations with the exception of the family category. As the factors within each category are applied, special attention must be given to the fact that the factors are usually not to be given the same treatment as what are being aimed at and addressed to public corporations. Furthermore, not all principles may apply to family owned private corporations and therefore flexibility is crucial as most of the items on the list are not mandatory and those that do apply may not apply equally or in the same manner to all clients.

Thus the answer to the question posed in Part II of which principles of corporate governance apply to family held private corporations is that most principles apply but some are more important to these types of corporations and need to be emphasized in particular. The three overarching goals of corporate governance need to be kept in mind when analyzing the categories under which the principles and factors into which to take consideration fall. Furthermore the way in which the principles of corporate governance are applied to family owned private corporations differs almost completely than the application to publicly traded companies. It is also important to note that the feasibility of a family owned private corporation incorporating each and every principle of good corporate governance is not strong for reasons of resources and cost. As such, the practitioner would be well counseled to focus on making recommendations to the client aimed at the most crucial areas of corporate governance that are lacking to that particular corporation and that simultaneously focus on its particular pressing issue(s) that will result in the most effective result or “bang for your buck.” The other factors should be set aside until such time as the client may want to look further into corporate governance as they garner incentive to do so. This is important so that the client does not become overwhelmed and decides instead to dispense with the entire exercise. However leaving the client with the key recommendation of starting to think about succession planning if it hasn’t already been addressed would probably be a prudent practice. The next section provides some real examples of issues that have been encountered in practice. Some have been encountered first hand, some not, and where facts are unknown they have been hypothesized.

Part III- a few hypothetical examples of putting the principles in practice

Applying the theoretical principles in practice is always a challenge and so the author has chosen some examples, generalizations and conclusions stemming from her own practice and experience only in which to analyze the applicable principles and to see how they apply and whether there is an incentive for the client. This is no doubt an extremely small cross-section of what a practitioner would encounter in a small town practice and the author does not intend this to be proper empirical evidence but rather a simplistic attempt to provide a simplistic guide as to what have been found to be some common issues and the resulting applicable good corporate governance principles to those issues.

The examples include a manufacturing corporation who is focusing on succession planning, somewhat late, but better late than never, but who could stand some improvement in corporate governance if the price of sale is to be driven up; a construction corporation who has not yet officially begun to think about succession planning and whose succession planning when started may require strategies to deal with familial issues; an owner who was able to sell his manufacturing corporation upon retirement having instilled principles of good corporate governance but most likely could have driven up the price with an even more thorough focus on such principles; a corporation who was forced to change its name as it grew for a lack of initial risk management; and finally a corporation that grew without corporate governance which is now facing a large lawsuit because of large conflicts in management. These examples give a depiction of the sorts of businesses and their particular issues that can be encountered by a practitioner and can be used as an exercise to decipher the best applicable corporate governance principle(s) to recommend or to come up with an action to improve upon their practices or lack thereof.

Again, the idea is to choose the most relevant principles germane to the largest corporate governance issue that is currently being experienced by the corporation and to put in place some changes that will have the most effective result without completely overwhelming the client. Incentives are a large factor to take into account when deciding what is the most important issue of corporate governance for that particular corporation because the incentives are why the client has no doubt come to the practitioner for assistance and recommendations in the first place.

The first example is the more easy one in terms of what recommendations to make to a client when you find yourself in a situation like the following because there is a large incentive as well as many corporate governance issues from which to chose. In this situation, the client bought her father's manufacturing business for a million dollars several years ago. The loan was set off by a key man insurance policy on the father but the loan is in the business' name with a personal guarantee by the client. The premium is being paid by the business. When the business was bought from her father, the client incorporated a holding company to own Ontco, USco, Ontpropertyco and USpropertyco. Ontco owns the insurance policy and pays the escalating premiums. Ontco is the Canadian factory, USco is the American distribution centre which leases its property, USpropertyco owns a residence, and Ontpropertyco owns vacant land. The client is the sole shareholder, sole director and sole officer. Ontco has loans in addition to the purchase loan with the bank in the amount of 500,000 that are guaranteed by the client and USpropertyco and USco. The client is approaching retirement age and has been approached by a potential purchaser who wishes to purchase Ontco but does not want the insurance policy, Ontpropertyco's vacant land or USpropertyco's residence. The economy is low in the U.S. and the U.S. residence has lost substantial value from when it was first purchased. The potential purchaser is offering to purchase the holding company, to credit back the value of the insurance policy and the value of the U.S. residence, to offer a three year consultant fee to the client, and to take on the guarantee for the business loans excluding the loan for the original purchase from the client's father.

The first question is to figure out what is the client looking to achieve from coming to the practitioner. In this case she has a potential buyer for her business. The next question that can be asked is whether there any incentives to look to principles good corporate governance in this situation and if so, what are they? In this scenario, both McCahery and Vermeulen as well as Lipman and Lipman's overlapping priorities are important. Firstly, there is a large incentive for the client to address some of the corporate governance issues because she wishes to sell the business. As to the larger principles of corporate governance upon which to focus, one might begin to assess that this situation is within that of the principles under the family heading, but in actuality this situation is inherently succession planning as the client is looking for a potential arm's length purchaser and seemingly does not wish to pass it on to her children or to remain involved in the business. This client is looking to maximize her selling price and is willing to ignore any emotional attachments she may have. In the event the current offer for which the client has come to see the practitioner does not pan out, the practitioner can discuss further succession planning including whether or not a family member or an employee might wish to buy out the client with a consulting package for the client. Furthermore, for the current potential purchaser or to attempt to attract other potential purchasers, additional corporate governance principles may need to be discussed.

Under the heading of the principle "audit" the practitioner should stress that the financial statements need to be clear and transparent and preferably independently audited. This is also important because there are banks and financing involved, the client must focus on those relationships also to ensure the loans are not called. Risk management is also under the same heading in the above list, and for that all liabilities or potential liabilities of the corporation need to be fully and over-disclosed to the purchaser. Because in this scenario, the client is selling the business at an arm's length price to an arm's length purchaser and will have no further involvement, there is not much point in focusing on issues of independent directors, management, shareholders and family relations. Most likely the potential purchaser will be setting up their own scheme for the board of directors and management. The convoluted structure of the business is typical of a family owned corporation that has grown from entrepreneurs starting from scratch and will have to ultimately be sorted out by the accountants and lawyers working on the logistics of the closing. However in the event the sale does not go through, cleaning up the disorganization would most likely increase the chances of selling and simultaneously increasing the purchase price if the market is conducive. Thus the corporate governance principles upon which attention should be focused in this type of situation are succession planning (in the event the potential sale to the first purchaser does not go through) and the audit principle with a focus on transparency and disclosure of both a financial and liability aspects of the business. If these principles are not managed properly, the client is at risk at having a difficult time getting out of the business and also at risk of being sued in the future for an undisclosed known liability or risk.

The second example is of a corporation that is an Ontario corporation where the primary business is infrastructure construction. In this corporation, it has been set up mainly by accountants, other than the initial incorporation, that the father is the sole shareholder, director, and is the CEO. One son is the sole shareholder, director and officer of a related corporation which is a second division. The other son has recently taken on a larger role in a supervisory position in the company and is just starting to become more involved. The mother and sister also work in the business (encompassing both corporations) but as can be typical in male dominated industries are not shareholders or directors or officers and do not have any say in the management of the corporation. There is a newly appointed CFO for the group of companies. Current issues are health and safety and insurance as well as the constant pressure of bidding on projects but business is going well. It does not appear that any real thought has been given to succession planning at this time. There are no outside sources of funding or loans.

In this case, the client is somewhat familiar with risk management as they are aware that they have health and safety and insurance issues. The practitioner must therefore provide the incentive by stressing that succession planning is a part of risk management and needs to be done early. Thus, in this scenario, the approach should be on McCahery and Vermeulen's recommended focus of succession planning and freeing up management to run the business. In this case, the family already works in the business but questions to ask are whether any of them intend to take over the business, whether they have the skill set and the personality to take over and run the business or whether further training needs to be done. The practitioner could recommend that the pieces be put in place early on to develop the family member's experience. Placing the son or whoever wishes to take over in a major management role such as President while the father takes on an advisory position while he is still active in the corporation would be beneficial. This would serve the dual purpose of succession planning as well as freeing up management to concentrate on running the business. An alternate solution would be for the son to become vice-president with increasing delegation of management responsibilities and doing any required training.

In the event that the other family members wish to be placed in director roles, or the two sons wish to take over the company together, a dispute resolution mechanism should be put in place and regular board meetings and separate regular family council meetings should be held. The client must also begin to think about whether there will be an eventual purchase price by the family member(s) and how that price will be determined. This should be regularly discussed so that there are no last minute surprises. Should it be determined that none of the family members have the skill set or the desire to take over the business, the owner must look to an alternative succession plan. Selling to a competitor or an employee or group of employees might be an option and so plans should be put in place to investigate alternative options if need be.

This same corporation also needs to be directed to focusing on risk management. They have a health and safety officer but because this is such a huge issue as is a large number of insurance issue, a committee of board members dedicated to risk management would be a huge asset for this company. Unfortunately, even establishing a board of directors would probably be a tough sell to this client because of the uniqueness of the competitiveness aspect of the industry-a lot of decisions must be made quickly and based on one's knowledge of the industry alone by the president which means that he would most likely be worried about relinquishing control. However the practitioner should point out that not only will a strong board of directors assist in succession planning because more people are privy to decision making, he as sole shareholder still retains that aspect of control over the board of directors. Having independent directors on the board to focus on risk management would also bring credibility to health and safety audits as well as to insurance issues. Furthermore, having those decisions be made at a board level will free up management to focus on running the company and those decisions are an item of control over which the client might feel comfortable in delegating while still having a say. Having a CFO is a good step for financial transparency and later on attention should be given to an independent auditor and perhaps an audit committee.

As an aside, a lack of succession planning seems to be a major issue for those in the construction industry. Many small to large construction firms seem to be family firms (in which for the purposes of this paper includes one shareholder firms) and most of which are first generation run. The skill set of understanding the bidding process and knowing how to be competitive in addition to running the business makes succession planning seem even more difficult-which could be true in other industries as well. These corporations similarly tend to have the same shareholder, director and officer-"the owner", partially no doubt because of the narrow skill set required. The author has recently encountered the owner of a paving company who passed away due to illness and it is unknown as to the status of his business and who is running it. An owner of another successful construction company as well as an owner of an electrical company recently encountered are both at ages of retirement and do not appear to be in great health. When questioned about their succession plans, they advised the author that they had none. The smaller corporations in the industry will no doubt disband if there are no children or employees willing to continue, thereby losing goodwill and a purchase price, however it becomes even a more germane issue to the corporations who employ a number of employees who are left jobless.

The next two examples are not first hand information but are known of by the author of this paper who has hypothesized the theories behind them. The first being that of a family owned plastics corporation that became very large during the first generation and allegedly through instilling corporate governance practices[47], was able to package and sell the business when the owner wanted to retire. Approximately eight years later, allegedly with the addition of further corporate governance practices[48], the buyer was able to sell it for twice the price. The largest most effective (and ironically seemingly simplest in conception) original corporate governance practice instilled was that of having a proper board of directors with independent directors who had regular meetings which seems to be an anomaly in family owned corporations that do not have an eye on future expansion or who are at the small or medium levels.

Another practical corporate governance issue that seems to arise is that of the name of the corporation. The problem with not properly registering the corporate name (of which the strongest protection is most likely trademarking which is outside the scope of this paper) right from the beginning is that as the corporation grows bigger they may end up having to change it. Again this would come under the heading of risk management and generally clients are willing to go along with the recommendation to incorporate but protecting the name at the outset is usually not in the budget. Once the business is established however it is a good recommendation to consider protecting the name. An example of this

[47] Author's hypothesis
[48] Author's hypothesis

being problematic is of a fairly well established vegetarian restaurant in Toronto that changed its name in mid-swing, most likely the reason was that they had started without doing the proper trademark searches and hadn't taken any steps to protect it[49]. Otherwise the reason could be that once they grew and wanted to look to establishing corporate governance, they weren't able to trademark the name.[50]

The last example is of an Ontario family held private franchise corporation that grew very large within Canada but had very few principles of good governance, the main issue becoming a lack of independence. There was a very conflict ridden board and management and as the corporation became bigger and more successful they had more and more of a need for good corporate governance which they largely ignored. It seems likely that the family members, or some of them, had a disincentive to instill good corporate governance procedures at the time because they were benefitting personally from their conflicts and at the same time the business continued to grow and profit. They did bring in an attempt of an independent in high up management and possibly to be on the board, but not only had he previously been the independent counsel for the company, he also was a franchisor at various material times and seemed to be himself conflict ridden and profiting on a personal level. The bigger problem is that all those types of alleged conflicts and the alleged lack of corporate governance is completely legal within corporate law in Ontario. The corporation is currently facing a lawsuit from a franchisor with issues that ultimately arose because of the lack of independence and good corporate governance but whether it will be successful or whether any judgment made against them will be anything more than a cost of doing business will remain to be seen.

The examples looked at set forth in Part III demonstrate the types of issues that can arise for the practitioner. The corporate governance principles that arose and were important factors in just these few examples cited are those of succession planning, independent audit, independent directors, a

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[49] Author's hypothesis
[50] Author's hypothesis

separation of ownership and control for the sole purpose of freeing up management, family planning including contractual dispute resolution, risk management, and corporate governance practices in general to increase the sale price or to grow the business properly. The incentives to the clients were there for a variety of reasons, with the recurring incentive being that of succession planning whether it be by sale or by second generation, which coincides with McCahery and Vermeulen's thesis. The second strongest incentive also followed their and to some extent Lipman and Lipman's conclusions as they related to the running and improving upon the business. That is not to diminish Lipman and Lipman's preferred areas of focus being that of independent audit, dispute resolution mechanism for family governance and independent counsel during insolvency proceedings, because those are also important areas of concern, however the incentive to the client probably needs encouragement from the practitioner in those areas once the immediate common more pressing concerns are dealt with properly. It is interesting to note however that the crucial corporate governance principles that were easily highlighted in such a non in-depth analysis which will no doubt assist the practitioner in rendering a preliminary opinion for the client.

Conclusion

Corporate governance for family owned corporations therefore has serious implications and the lawyer practitioner should encourage their clients to review their current practice or lack thereof. The incentives for family owned private corporations are not statutorily based and so the corporation must find its own incentives with the practitioner's assistance. The corporate governance principles aimed at publicly traded corporations that have received publicity as of late such as say-on-pay are generally not the same principles upon which a family held private corporation should focus. Furthermore, the corporate governance principles that can and do apply to family held private corporations should be applied in a manner that addresses the particular nature of private corporations. The practitioner should not initially aim to perfect each principle of corporate governance for their client but rather should focus on the immediate needs of that particular corporation.

Although many of the corporate governance principles touched upon in this paper can and do apply to family owned private corporations there are a number of principles that tend to be of more importance to such corporations. Generally succession planning tops the list in order of importance as well as transparency of financial statements and audits for corporations who require financing or are looking towards growth. Having a board of directors with properly constituted meetings assists in freeing up management to run the business as well as creates a body to deal with risk management. Lastly, a family forum and a mechanism for family dispute resolution is a great tool for corporate governance when there are more than one family members involved in the business.

The greater broader question that remains is that whether the lack of mandatory corporate governance requirements for family owned private corporations will consistently become a large liability for both the corporation itself and innocent third parties as the corporation gets bigger and more successful but is ultimately run by those who become inexperienced to run corporations as they increase to that level no matter how well they know the business itself. Whether that happens or not, there will no doubt be a large role for the lawyer practitioner to counsel on corporate governance either to assist with proper growth or to assist in the rectification after improper growth.

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