Maximising profits by minimising costs: the key legal issues

By Patricia Angus

A family business that is mindful of the need for proper planning, monitoring and maintenance of legal issues will ultimately be more profitable and successful over the long-term

A FAMILY BUSINESS can sometimes feel like a cosy escape from the complexities of a public enterprise. Since family members generally control all decisions, interactions tend to be informal. They can focus their attention on building products, offering services and finding customers, with minimal time spent on theoretical (including legal) problems that may not happen for years, if at all. However, family business profits can be greatly reduced if the legal ramifications of company behaviour are not addressed regularly. Thus, a family business should bear in mind certain key legal issues as they develop and build the business.

Corporate governance issues

The term 'corporate governance' is a popular buzzword in the US and around the world today. Essentially, corporate governance refers to the internal governing rules of a company and the ways in which legal obligations must be upheld by the owners, directors and employees during three key phases: start-up, growth and sale of the business (or going public).

Start-up / initial phase

Proper governing rules should be established from the start, beginning with choosing the proper busines structure. The choice of structure will depend on the type of business and the jurisdiction in which it is established and operates. The family must determine its priorities from a set of factors, including liability, taxation and administration. In certain forms of business like sole proprietorships or general partnerships, the owner(s) are personally liable for all debts of the business. In most other business forms (limited partnerships, limited liability companies, corporations and *société anonymes*) each owner is only liable for their own contribution. In some business forms like sole proprietorships or general partnerships in the US, each owner is taxed on the owner's proportionate share of income earned by the business, regardless of whether they actually receive it. By contrast, a corporation or *société anonymes* is usually a separate taxpayer, and its owners are only taxed on benefits received.

The family should weight these factors to choose a structure. Once a structure is chosen, legal rights and responsibilities of each of the relevant parties must be established. This is generally covered in the 'governing documents' (eg, partnership agreement, articles of organisation, memorandum of association and by-laws). From the start, it is helpful to designate one family member or other key person to oversee legal issues, which will involve developing an ongoing relationship with outside lawyers or hiring an in-house counsel. As soon as possible, the family should learn the parameters in which the business operates. For example, local law will govern their obligations towards employees, taxes, benefits, wages and the work environment that they must provide. The business should have written policies and keep records of important decisions to establish a history for future reference.

Growth phase

As a family business grows, there will be new entrants, both internally and externally. Non-family members may become more active in the management and ownership of the company. There will be increasing numbers of relationships with customers and vendors. Although it is common for these arrangements to be informal, the company should establish the proper terms from the outset. The business should have a clear understanding of its customers and their ability to pay. Terms of payment should be written so that the company does not unintentionally provide credit. Agreements with vendors should include terms for cancellation that provide flexibility for changing needs.

In a family business, a system should be created for succession issues, including contingency planning for the death of the founder or key person, methods of decision making among owners, planning for business growth and inclusion of non-family members. Succession planning should be integrated into the governing documents or a separate agreement. If a family member can transfer their shares, the agreement should state whether family members have a 'right of first refusal' to purchase shares from a withdrawing member using an appropriate valuation method.

Going public / sale of business

If the family considers selling the business or seeking outside investment, each family member should carefully review their objectives prior to initiating the transaction. In most cases, these objectives will go beyond financial goals and include ongoing legal rights and, possibly, control. The governing documents should reflect whether the family (or certain members) wish to remain involved or in control. Securities law requirements and insider trading rules will apply to family members still involved in a public company. The family may need to adjust to these limitations while at the same time being subjected to increased disclosure of personal information.

Local / regulatory requirements

Regardless of the legal form in which it operates, a family business will likely be subject to a variety of local and regulatory requirements specific to the size, type or location of its business. The range of requirements vary and include individual and corporate taxes, employment laws (eg, insurance, benefits, discrimination), pension laws, labour laws and environmental laws. There may be industry-specific regulations, including licensing, inspection and reporting requirements. Also, family businesses should consider industry practice (eg, compensation issues, union involvement).

Risk management issues

Even if the family business has proper corporate governance and complies with all local and regulatory requirements, there is always a risk of unforeseen liability. The risk might come from the inside (an owner, manager or employee might commit a transgression or file suit against the company) or from outside (an injured customer or unrelated third party files a claim against the company).

Risk management takes many forms. At the highest level, it requires proper oversight of business affairs by the directors, including through an audit committee and supervision of compliance functions. In a more general sense, risk management includes avoiding litigation by following proper procedures and efficiently addressing legal issues as they arise. If a lawsuit is filed, or it becomes clear that a suit is possible, the company should seek to minimise the costs and delay in operations that it will entail.

Maintaining awareness

A family business that is mindful of the need for proper planning, monitoring and maintenance of legal issues will ultimately be more profitable and be able to devote its energies more efficiently to ensuring the success of the business over time. Businesses around the world operate in increasingly regulated and litigious environments, so it is more important than ever to maintain an awareness of legal parameters, hot spots, potential traps, pitfalls and opportunities. It will be far more costly and disruptive to respond to and handle the consequences of improper structuring and management than it will be to address the issues on an ongoing basis. ■

Summary of the key legal issues to consider

Start-up phase

- What is the appropriate legal structure for the business, considering tax, liability and administration issues?
- What is the nature of the owner's interests?
- What are the key terms of the governing documents?
- Are there written policies?
- Who will oversee legal issues?
- Have initial members received training on relevant legal issues?
- What system will be used to ensure that proper corporate records are maintained?

Growth phase

- What is the company's succession plan and is it documented?
- Can new owners be admitted and, if so, how? What rights will they have?
- What arrangements should be made for new employees (eg, employment contracts, non-competition and non-solicitation agreements)?
- How will the company's confidential and proprietary information be protected?
- For a sale, transfer or share assignment, how will the business be valued?
- What are the terms of arrangements with customers and vendors?

When going public / selling your business

- What legal rights and responsibilities will apply to owners / directors / employees after the transaction?
- What protection do family members have after the transaction for the value of their shares and their involvement (if any) in the business?
- Have all regulatory filings been made?
- Is the company in compliance with applicable law prior to the transaction?

Regulatory issues

- Is the business subject to special regulations due to its products / services?
- Are owners, directors and employees aware of their rights and responsibilities?
- Are there any labour law restrictions or regulations?
- How will the company ensure that all regulatory requirements are met over time?

Risk management issues

- Are all parties properly informed about potential liability?
- Is there an audit committee? Who is responsible for compliance?
- Have funds been set aside for potential liability?
- Have steps been taken to remedy circumstances that may give rise to a claim?
- If a claim involves the business and one or more of its owners / directors / employees, does each party have independent counsel?

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