

Family Affair: Potential Problems with Family-Owned Businesses

Written By **Merrill G. Jones, II** (mgj@wardandsmith.com) and
Zachary F. Lamb (zflamb@wardandsmith.com)

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Some of the most heartbreaking situations we see in our closely-held business and estate practices are families torn apart over differences in dealing with family-owned businesses.

When there are problems with family-owned businesses, people tend to think with their hearts, rather than their brains, and often take unreasonable positions that are counterproductive to reaching a satisfactory resolution. Often, the personal relationships among the family members continue to suffer until the business issues have been resolved, and even for a long time afterwards.

Almost invariably we find that careful planning and documentation could have led to a quick solution to the business problem. However, we find that families are less likely than unrelated parties to have carefully documented processes for dealing with problems. The closeness of family members makes many of them think that their family members will always act fairly and that problems will be resolved without resorting to written agreements. Failing to properly document the intent of family members in businesses while everyone is in agreement and not fighting can be a devastating mistake.

Consider the following scenarios:

Scenario 1: Jody 'Retires' Without Telling Buffy.

Buffy and her brother, Jody, created a line of doll clothing designed to be worn by Mrs. Beasley dolls. They formed a corporation called "Mrs. B's Bureau, Inc.," filed a Subchapter S election, and started a successful small business manufacturing the doll clothes and selling them on the Internet to the masses.

Buffy and Jody owned the stock of Mrs. B's Bureau in equal shares and they were the only two directors on the corporation's board of directors. Against their lawyer's advice, they chose to save on legal fees and did not enter into a buy-sell agreement to govern transfers of the corporation's stock.

In common with owners of most small Subchapter S-corporations, Buffy and Jody worked as employees of Mrs. B's Bureau and received modest, but reasonable salaries for their roles as chief executive officer and chief operating officer, respectively.

After setting aside a reasonable reserve of the corporation's profits for operations and capital improvements each year, Buffy and Jody would vote as directors to issue a distribution of the corporation's remaining profits to themselves in the form of

large dividends.

Relying heavily on the large distributions from the corporation, Buffy and Jody lived very well, building nice homes and buying even nicer vacation homes. Everything worked very well for a period of time. Buffy and Jody worked very hard in the business. They were making plenty of money and enjoying their lives.

However, Jody began to enjoy his vacation home a bit too much. Gradually, he began to spend more and more time there and started neglecting his duties at Mrs. B's Bureau. Ultimately, Jody was spending very little time at work.

Buffy, having a great work ethic, covered for Jody for a while. She took over some of his duties and shifted some to other employees, but eventually got fed up with Jody's laziness. Jody was making the same salary as Buffy and, when it was time for distributions, got the same amount as Buffy since they owned their stock in equal amounts. Buffy tried to get Jody reengaged in the business, but could not get him to come back to work.

At her wits' end, Buffy hired a personal attorney to advise her on what to do about Jody. She really would have liked to just buy his stock and move on without him, but quickly found there was very little she could do unilaterally to get what she wanted.

Jody was not interested in selling his stock. In order for Buffy to get her distributions from the corporation, which she needed to support her lifestyle, Jody had to receive equal distributions. Why would he give up that arrangement? Jody no longer worked, but continued to receive the same salary and large cash distributions. Due to Buffy's hard work, the company still thrived and grew in value each year. Buffy had no way to force Jody to sell his stock in the company.

As CEO of the company, Buffy used her authority to fire Jody for failing to show up to work. However, losing the relatively small salary was not a big deal to Jody. He still served on the board of directors and there was nothing Buffy could do about that. Owning half of the stock of the corporation gave Jody the right to elect himself as one of the two directors.

Buffy could not raise her salary without a vote of both board members, something Jody was unwilling to do. Buffy still needed the cash distributions and Jody was always willing to vote for those since he would get the same distribution as Buffy.

Buffy became very frustrated with the situation and eventually came to despise her lazy brother for being willing to take half of the fruits of her considerable labor.

Jody could not believe that his sister fired him and could not stand her self-righteous attitude about her role in their company. No amount of counseling from their big sister, Sissy, could repair the damaged relationship.

What Could Buffy and Jody Have Done Differently?

The simplest thing Buffy and Jody could have done was to have followed the advice of their lawyer and entered into a buy-sell agreement with respect to their stock.

Owners of small businesses which rely on the efforts of the owners, whether they are family members or not, should have agreements providing that if an owner quits working full time in the business, the other owners have the right to cause the owner who quit working to sell that owner's stock. The buy-out should be at fair value to be fair to the owner being bought out. The buy-out may be structured with payments made over time so that the company or remaining owners are not put in a bind to come up with a large single cash payment to buy the stock.

Similarly, a buy-sell agreement can contain a compulsory provision whereby an owner (the "Offering Owner") has the right to trigger a buy-out of one or more of the other owners for any reason. Compulsory buy-sell agreements often provide that the Offering Owner can make an offer to either buy another owner's stock or sell the Offering Owner's stock to one or more of the other owners at a price stated in the offer.

The other owner or owners get to decide whether to be a buyer or a seller. If the other owner or owners do not respond to the Offering Owner's offer to sell or buy within a given time, the Offering Owner gets to choose whether to be the buyer or seller.

Assuming both or all owners have the same ability to fund the purchase of the other owner's stock, this type of provision is fair because it provides for a fair price. The Offering Owner will not set the price too low or too high, because the Offering Owner will not want to be bought out at a low value and will not want to be a buyer for a price that is too high.

Another thing Buffy and Jody could have done was include a provision in the Bylaws of the corporation that required a third, independent director. While they were getting along, Buffy and Jody could have agreed upon a third director who would only consider the best interests of the corporation, without a personal stake in it.

An independent director could have made it easier to fire Jody, giving Buffy cover in her decision to terminate her brother. The independent director also could have helped Buffy vote to increase Buffy's salary and award bonuses to recognize her outstanding efforts for the corporation. This would have made her less dependent on the distributions, which could then be lowered simply by the vote of Buffy and the independent director without the necessity of getting consent from Jody.

Some simple planning in the beginning, when Buffy and Jody were aligned and happy with one another, could have provided a quick resolution when Jody decided to retire without telling anyone.

Scenario 2: Uncle Bill Gets Married

Imagine if, instead of Buffy and Jody creating their own business, they worked for Uncle Bill, who became their guardian when their parents died in a tragic automobile accident.

Uncle Bill loved Buffy and Jody as if they were his own children. Uncle Bill involved Buffy and Jody in his successful import business in Raleigh, "Mr. French's Imports, Inc.," as soon as they were old enough to understand its workings. Both kids joined the business when they graduated from college. Buffy and Jody's older sister, Sissy, whom Uncle Bill also loved as if she were his own, was not interested in the business and became a school teacher.

Buffy and Jody became an integral part of the operation of Mr. French's Imports and eventually took over the management of the company when Uncle Bill stepped back from his responsibilities. Uncle Bill, a confirmed bachelor for many years, eventually fell in love and married a woman named Edith. Uncle Bill and Edith lived together in wedded bliss for a little over 15 years when tragedy struck again. Uncle Bill was also killed in a car accident.

After the funeral, when all of the family came together to read Uncle Bill's will, they were in for a big surprise. Uncle Bill did not own anything of value, except for his stock in Mr. French's Imports. His luxury apartment was leased, as was his car. He spent the money distributed to him from Mr. French's Imports supporting his and Edith's lifestyle.

Edith had inherited money from her family and had enough to take care of herself without getting anything from Uncle Bill's estate. Because he knew about Edith's inheritance, but without discussing his wishes with Edith, Uncle Bill had decided that there was no need for him to leave her anything. He considered her to be self-sufficient, but she did not know that he had made that determination.

Uncle Bill had always told Buffy and Jody that if they stuck with him in the business, he would leave it to them. Therefore, everyone was shocked when they discovered that, in his Will, Uncle Bill had left his stock in equal shares to Buffy, Jody, and Sissy. Buffy and Jody were extremely disappointed that they would have to share the business with their sister who had never worked in it and knew nothing about how it operated. Additionally, Edith was extremely hurt to find out that Bill had left her nothing despite their happy marriage. Sissy, living on a teacher's salary, was delighted to learn that she was going to receive a windfall from Uncle Bill's estate.

After hiring her own attorney, Edith learned that no matter what Uncle Bill's Will said, she was entitled, by law, to roughly 50 percent of his assets under North Carolina's surviving spouse elective share statute. When Uncle Bill's estate was probated, Edith got 50 percent of the stock in Mr. French's Imports, and each of Buffy, Jody, and Sissy got one-sixth of the stock. The only person who was happy was Sissy.

Buffy and Jody were fully capable of running the company, but really resented having to work for a collective one-third of the value and profits of the company. Edith was happy to get her share of the stock, but really did not want her inheritance from Uncle Bill tied up in a closely-held company whose operations were unfamiliar to her, and about which she was not inclined to learn at her age.

After a lot of negotiations and some very sore feelings, Buffy and Jody struck a deal to buy out Edith. They didn't want to pay for something they thought they already had earned, but had no choice. Edith was willing to finance the purchase of her stock, and Buffy and Jody determined that they would be able to make payments to Edith with the profits of the company. Buffy and Jody tried to buy out their sister, but Sissy was determined to hang on to the gift her Uncle Bill had given her and would not sell.

Buffy and Jody never got over Sissy's refusal to sell and, ultimately, Sissy became very distrustful of her brother and sister's operation of the company and the large amounts of money they paid themselves to run it. As a minority shareholder in the company, there was little Sissy could do. The siblings, who had been very close, now barely speak to one another.

What Could Uncle Bill Have Done Differently?

Uncle Bill wanted to leave Mr. French's Imports to Buffy and Jody and also wanted to take care of his other niece, Sissy. He realized that he did not have other assets to give to Sissy, so, thinking he had no alternative, he settled for giving her a third of his company. Uncle Bill didn't realize the effect of the surviving spouse elective share statute and never anticipated that Edith would get half of his company. He also assumed that Buffy and Jody would figure out a way to buy out Sissy, so they would get the company and Sissy would get money.

In order to fund an inheritance for Sissy, Uncle Bill could have considered buying life insurance on his life when he was younger and the premiums were much lower. He could have set up a life insurance trust to own the policy, with Sissy named as the beneficiary, and could have used his ability to make tax-exempt annual gifts to pay for the premiums.

If the life insurance solution was not available, Uncle Bill could have left the stock to the three siblings but made them sign a buy-sell agreement while he was alive that would govern any shares of the company which they may receive in the future. The buy-sell agreement could have given Buffy and Jody an option to buy out Sissy at any time. Correspondingly, the buy-sell agreement could have given Sissy the right to force Buffy and Jody to buy her out. The agreement also could have provided a mechanism for determining the value of the stock and it could have provided that Buffy and Jody could pay for the stock over time at an appropriate interest rate.

With respect to Edith, Uncle Bill could have insisted upon a premarital agreement in which Edith would waive her right to claim her statutory elective share of his estate. Even without a premarital agreement, Uncle Bill could have recognized the fact that Edith was entitled to a share of his estate and could have funded that share by purchasing life insurance. He also could have asked her to sign a buy-sell agreement which gave Buffy and Jody the right to buy her out, similar to the one described above with Sissy.

With careful planning and proper communication, Uncle Bill could have left a legacy to each of his loved ones without generating the hurt feelings that would forever taint their lives and their memories of him.

Conclusion

A family fight over a company is a terrible thing to witness, and even worse to experience. Family relationships are much more important than assets. With careful planning and communication while family members are happy and cooperating, most family business disputes can be avoided or minimized. The time to plan is now.

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