

Resolving Disputes in Family Owned Businesses - A Lawyer's Approach for Achieving Happy Endings For Unhappy Families

by Maureen T. McKay and Murray Gottheil

"Happy families are all alike; every unhappy family is unhappy in its own way."
Leo Tolstoy, Anna Karenina

Introduction

Resolving a dispute among shareholders of a family owned corporation is entirely different from resolving a dispute among shareholders who are not related. Professional advisors who want to help resolve disputes in a family-owned business must understand not only that a family owned business is different and how it is different, but more importantly, must adjust their approach to take those differences into account.

The Battle Ground Is Different

To a lawyer, the corporate battle ground is defined largely by the written agreements which govern the relationship among shareholders. The most relevant agreement is usually a shareholders agreement, but there are often other agreements which define the battleground as well, such as employment contracts, consulting agreements and non-competition agreements.

When the shareholders are closely related, there are often no written agreements in place at all, because the family members simply do not see the need to document their expectations. Even if the need is foreseen, the people involved may not want to offend each other by suggesting that they need to have written agreements to govern their relationship. As well, in some families, family members are not willing to share the type of information that is required in order to settle the terms of a legal agreement.

For instance, when speaking to spouses who are involved in business together, we often ask them whether they would insist on having a shareholder agreement if we could tell them that there is a fifty per cent chance that they will have a bitter and emotional break-up with their partner. With odds like that, they all agree that it would be important to have a comprehensive shareholders agreement in place. Nevertheless, despite the current divorce rate, these same shareholders almost always decide that they do not need a shareholders agreement.

The following is just one example of how the informal approach to documenting legal relationships among family members sometimes leads to unforeseen complications.

It is common for shareholders to enter into rollover agreements with their corporation which contain price adjustment clauses. In some circumstances, other shareholders of the corporation will not have entered into similar agreements. In the event of a tax reassessment, this could result in the corporation becoming subject to an obligation to issue more shares to a shareholder, thus changing the relative financial interest of the shareholders, or even the manner in which the corporation is controlled. In an arm's length scenario, a well-drafted shareholders agreement would address this possibility.

Another feature of the battleground is the share structure of the corporation. When family is involved, the share structure often looks very different than the share structure of a corporation owned by unrelated parties. For example, there may be a succession plan which has left a parent with voting control and a "child" with equity shares. The child may have an expectation as to how the voting shares will be dealt with by the parent which may be frustrated by a change of heart, the influence of another family member, the mental illness of the parent, or a transfer of the voting shares to an unexpected party following the parent's death, which may result from the parent having had an out of date, invalid or a poorly written will.

Financing arrangements constitute another element of the legal battleground. Where shareholders are family members, they may not be as diligent as unrelated shareholders would be to ensure that each shareholder advances his or her proportionate share of the working capital of the corporation and guarantees his or her proportionate share of the liabilities of the corporation. In the event of a dispute, this can impact the parties' respective exposure to risk and thus their bargaining position.

Finally, there may be documents and legal obligations in place which you would not typically find among unrelated shareholders. In employment arrangements, for instance, where a number of siblings work in different capacities for the business, you may find that all draw precisely the same salary. Alternatively, you may find one sibling receiving excessive bonuses because a parent with voting control might feel the need to take special care of that "child".

It is also far less likely that there will be a written non-competition agreement to bind any of the siblings, no matter how significant their roles in the business. Should a sibling who is critical to the success of the business decide that drawing a salary equal to that of another whose contribution is less valuable quit to earn more elsewhere, the departure could be disruptive and damaging both to the business and to family relationships.

Agreements of a personal nature may also impact the dynamics of the business situation. For example, a parent may have granted a power of attorney to a trusted child permitting the child to make legally binding decisions in the name of the parent in the event of the parent's physical or mental incapacity. Such powers of attorney can often be invoked without any proof being required that the parent is indeed physically or mentally incapable. This could result in a child who is a shareholder having a powerful instrument of control that an arm's length partner would rarely be given.

The Combatants are Different

In a family business, the combatants may not be people who you would ordinarily expect to see involved with the business. There may be a parent who is a shareholder although not active in the business; there may be a sibling whose ownership of shares (or the extent of his or her ownership of shares) can only be justified by an accident of birth; there may be a spouse of a shareholder or other family member who is not officially involved in the dispute at all, but whose absence from the negotiating table may doom any attempt to resolve a dispute.

It is therefore essential to fully understand personal dynamics and family history in order to determine not only the identity and predispositions of the combatants, but potential allies, adversaries, mediators and decision makers.

The Motivation of the Combatants May Be Different

In arm's length situations, we sometimes see shareholders act irrationally. There are times when people get so caught up in the war that they do not realize that they are setting fire to the bridge that they are standing on. However, most of the time the actions of the combatants are fairly predictable, because they are motivated by one of three factors, each of which are fairly simple to understand. These are: ego; a desire to be treated fairly; and money. The first two of these factors can usually be resolved by dealing with the third factor.

In a family owned business, determining the motives of the combatants usually requires a more complex inquiry. The battle may be framed as a battle for control of a corporation, but is that just an excuse to strike back at a perceived favourite child, or to demonstrate to a parent that a sibling is blameworthy? Perhaps the dispute is between a son or daughter and a parent who cannot see the "child" as a mature and independent adult, or who wants to maintain control for emotional reasons. In family owned business disputes, we have seen positions taken which cannot be explained in any rational manner, and will probably never be fully understood by anyone who did not grow up in the family home.

Only by determining why a dispute has arisen and what a combatant needs to achieve to settle the dispute, is it possible to negotiate a successful settlement.

Morality Might Be Different

When family members are involved in a business, it may be more difficult to determine right from wrong than when the shareholders are not related. We often see conduct which could never be justified in an arm's length situation be shrugged off as completely acceptable in a family business. We also see genuine attempts by parties to resolve matters by making financial concessions which in an arm's length situation would amount to saint-like conduct being regarded as paltry by another party in a family owned business situation.

In one dispute that we helped to resolve, a father and son were involved with one company which was a supplier to a second company owned by the father. The second company had run up a very significant trade account. The father was the sole director and the senior officer of the supplier company, which continued to supply to the customer company even though there was no hope that

the customer could survive on its own. Some professional advisors would see this as a clear breach of fiduciary duty by the father, in favouring the interests of his own company over the interests of the company in which his son was a partner, and might advise the son that the customer company should be cut off and sued, together with the father personally. However, in our discussions with the son, we understood that, from the son's perspective, his father had created both companies, taught the son the business, been good enough to allow the son to become a shareholder in one of the companies, and could do as he pleased, even if it was putting the son's financial security at risk.

In another situation that we dealt with, a father and son actively operated a business in which another son was not employed but owned a percentage of the shares. It seemed perfectly reasonable to the active participants in the business that they declare significant bonuses to themselves, even though the result was that the inactive son would not receive much in the way of dividends. Undoubtedly they were bolstered in this belief by the fact that the father had made other financial arrangements to protect the inactive son's financial security.

This appeared to accord with the inactive son's views of what was right and wrong during his father's life time, but not after his father passed away. Unfortunately, the shareholders had not followed a formal process of approving bonuses and dividends. The absence of standard resolutions approving the financial transactions opened the way for the inactive son to launch a costly legal battle that could otherwise have been avoided.

The Stakes Are Different

In a family owned business, a dispute among shareholders may mean that children become estranged from parents, or brothers and sisters from their siblings. It may mean that grandparents lose their relationships with their grandchildren, or cousins no longer get to play with each other. It may make family members choose sides in a war that does not concern them directly, and make an entire family dread holidays and get-togethers.

Finally, disputes that become public may bring with them a level of disclosure of sensitive information, and potential personal embarrassment that would not be present in an arm's length situation. This is yet another factor to consider in determining how to best resolve disputes.

The Willingness to Go Legal Is Different

Since the motivation and morality of the combatants may be different in a family business situation, and the stakes are different, it should come as no surprise that the willingness of a combatant to involve lawyers, give buy-sell notices and start legal actions might be different.

With the exception of circumstances where the particular family dynamics might make a combatant desirous of inflicting the maximum embarrassment on a family member and therefore somewhat trigger-happy, it would seem on anecdotal evidence that in family business disputes, the combatants are content to snipe at each other and make each other's lives miserable for extended periods of time rather than to bring the matter into a legal setting.

A Different Approach Is Required

Even where shareholders do consider legal proceedings, their professional advisors should be cautious. Given the importance of the relationships between the combatants and those around them, thought must be given as to how to maintain and do as little damage to those relationships as possible. For this reason, negotiation, mediation and other ADR mechanisms should be considered. The use of ADR can also provide a greater degree of confidentiality, minimizing the chances of public disclosure of personal financial information and potential personal embarrassment.

Lawyers are in the business of resolving disputes. We resolve disputes the easy way through consensus building, negotiation, mediation and arbitration. We also resolve disputes the hard way, through litigation. When we litigate, we either do it in an orderly and cooperative manner, or (to quote a lawyer one of the authors once worked with) "we declare global thermal-nuclear war". An effective lawyer will adapt his or her approach to the situation. For example, the global thermal-nuclear war approach tends not to work that well when dealing with the Canada Revenue Agency, as we understand that the lawyer in question learned the hard way.

When dealing with family business disputes, lawyers first have to understand the basic concept that things are different. Then, they have to understand that it is important to find out the manner in which things are different in the particular family in which the dispute is occurring.

As Leo Tolstoy said, every unhappy family is unhappy in its own way, and a lawyer must understand what is motivating the combatants in the dispute at hand, and how they will react throughout a process of consensus building, negotiation, making threats, mediation, arbitration or litigation, in order to develop a good strategy for resolving the dispute.