

MIKE HENNING'S

“ALL IN THE FAMILY” COLUMN



The Reality of Minority Ownership

I recently overheard this comment from a well-known business owner: “The value of a minority interest in my company is worth whatever I determine it will be.” Like it or not, this business owner is absolutely correct in his assumption.

One situation I am familiar with involved a son-in-law with a 20 percent interest in the family business, and his father-in-law owned the remaining 80 percent. After working for ten years in this successful business, the son-in-law decided to change his career direction in life. It was time to dust off the ole “exit strategy” official company procedure (which did not exist in terms of a buy/sell agreement, but was generally spelled out in the company board minutes), and begin to apply it.

Dad did not want to disappoint his daughter, who actually had her name on the shares of stock instead of the son-in-law, and the shares were in the company vault for safe keeping, so he arranged for the company CPA to perform an adjusted book value with the company financial statements, and arrive at a value that would eventually include a discount for minority shares. (Company net worth = \$2 million; 20% equals \$400,000 less 40% discount; net \$240,000) Apparently Dad had forgotten that son-in-law had sat in on the CPA meetings from time to time, and knew enough about the overall company value that \$240,000, albeit a handsome amount, was considerably below what he and his wife expected.

Time for Talking

In this real example, Mom and Dad sat down with their daughter and son-in-law to discuss what could be done to close the gap between what was offered for the minority shares and what was expected. Dad reminded everyone that the price paid for this stock would set a precedent for future stock sales. If the company is eventually passed within the family, to save transfer taxes it is important to take advantage of the minority discount. All agreed and set about finding a solution to plug the \$160,000 gap. Thus, it was agreed that the company would purchase the minority shareholder a new vehicle as a parting bonus, pay the departing shareholder \$25,000 per year to sit on the company's board of directors, and \$60,000 over three years to be available as a successor to his father-in-law in the event of a premature death or disability. These arrangements plus two all expense paid vacations were agreeable to all parties involved.

The Reality of Power & Powerless

Since the organization of a corporation is a business matter and governed by the law of the state in which the corporation is registered, majority owners have unilateral power to do most anything they wish so long as it meets the law. For example, majority owners decide what perks can be doled out to any employee. They decide if bonuses will be distributed, how much they will be and who will get them. They decide who will be hired and what their compensation package will be. They decide if distributions/dividends and their amounts will be declared. Consequently, the majority owner can hire who he pleases, pay them what he wants, give them perks as he sees fit, and he/she can take all the cash out of the company for their own

compensation, purchase a new SUV each year, travel to elaborate places and do it first class. The minority shareholder has no rights to receive any percentage of the benefits or earnings unless the majority owner approves it.

Do Powerless People Have Any Power?

In the situation described above, the parents were juggling the two issues of setting precedent for the price of their company stock and treating their daughter fairly. As you could see, a favorable result was rather easy to achieve. What happens if the owning parties are siblings or cousins or a mixture of both? Under these conditions achieving the same favorable result may not be so easy. Normally we see discussions turn to personal issues of what happened years ago as if it occurred two weeks prior, or what is right and fair and unfair. Often an agreement on stock price is not reached and unpleasant memories are stirred up with resulting resentment, jealousy and anger.

Minority owners typically become completely frustrated as they realize they are trapped between receiving a low price and staying the course as an owner that realizes no benefits. What can be done if anything? The answer is not a pretty one, but it is the only answer we know about – take steps to destroy the business. Who would be in their right mind to do such a thing? To destroy the family legacy and the company that provides a living for family members? On the other hand, was it truly the wish of the parents that one or two of their children get the vast majority of the cash and benefits from the family enterprise while the other children get little or nothing?

Entering the Legal System

Minority owners (the powerless people) do have the right to bring lawsuits against majority owners in certain cases and situations. For example, if the majority shareholder is found to be involved with fraud, abuses his/her power or authority, or mismanages the business or its property, they might sue. In other situations, if the majority shareholder is found to be dishonest or self-dealing, this can be reason for the court to appoint a custodian to manage the business. And lastly, if the shareholders become so deadlocked and set upon their values for the stock that it is harming the company, a judge has the power to dissolve the corporation.

Needless to say the legal costs for such action would be high in terms of most lawsuits. The value of the company is likely to decrease due to time and expense of owners defending themselves, their legal bills and losing focus upon the business's goals. When you examine the result the minority shareholder desires, it is not likely he/she will achieve their expectations or even come close due to all the expense and time that would be expended during the lawsuit, not to mention the extremely negative result between family members for generations to come.

Remember, it is not just a business deal it is about family as well. Before going to the courts for your answer, be willing to sit down and communicate, collaborate and compromise the final settlement. This will assuredly bring each party and the "golden goose" much closer to their original goals than fighting it out with attorneys.

This article appeared in Mike Henning's Family Firm Advisor newsletter, for more information about receiving one free copy of our newsletter, visit us at our web site: www.mikehenning.com, e-mail: hfbc@mikehenning.com, or call -- 217-342-3728. Mike Henning is a nationally and internationally respected consultant and speaker on family business issues.