Handling Legal Challenges Common to Family Businesses: Real-Life Scenarios and Remedies

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INTRODUCTION

According to the U.S. Small Business Administration, small businesses make up 99.7% of U.S. employer firms, 64% of net new private-sector jobs, and account for 98% of firms exporting goods.[1] Family owned businesses account for nearly two-thirds of all businesses around the world, and an estimated 70-90% of global GDP annually is created by family businesses.[2] Family businesses are built on blood, sweat and tears, and are the life-blood of our country.

With the emotions tied to a family business, the monies generated from these businesses, and the dynamics of working with family members, family owned businesses can create a plethora of issues. Some of these issues can be avoided through proper planning. Others, irrespective of the safe guards in place, will not be avoided.

This article delves into some of the common challenges with a family business and is from the perspective of someone working in a family business and having represented and litigated issues regarding numerous family owned businesses.

A. FAMILY DYNAMICS; GOALS AND VALUES BEHIND THE BUSINESS.

When working with a family business, it is paramount to know the goals and values driving that business. Obviously every business has its own industry specific goals and values. Those goals and values are important too, but when working with a family business, you need to know more than just the goals and values set forth on the company's website or advertisements presented to the customers. Some family business owners create and grow the business with a goal in mind of one day turning the reins of the business over to their child or children. Others run their business knowing full well that their children have no interest in the family business or they want to ensure that their children do not continue in the family business. Either way, you need to find out.

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[1] *Frequently Asked Questions, Advocacy: the voice of small business in government*, U.S. Small Business Administration, https://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.
[2] *Global Data Points*, Family Firm Institute, Inc., http://www.ffi.org/?page=globaldatapoints.

Most children grow up with an ideation of their parents as super heroes, or at a minmum, role models. The children see their parents working hard in the family business and providing for the family. More than likely, the children have also contributed some services themselves to the business in their youth and see themselves eventually working in the family business. The children have grown up with the products or services offered by the family business and have become familiar with the manner in which the business is run.

With this background, the family often has one of two ideas in place: the children will carry on the legacy of the family business, or the children will not. Certainly over time these ideas may change, but it is important to understand these goals as they will drive the manner in which the business is run.

It can be very satisfying for the children to learn the ropes of the family business, take on more responsibility over the years, and finally reach executive status. In many family businesses, however, the company founder is often both the CEO and the parent of many top managers. Those roles may become so intertwined that it can be difficult for him or her to retire gracefully and let the next generation take over.

That is a bad move, however. Younger family members can become frustrated with their failure to advance and leave the family business, notwithstanding their devotion to the business and years of experience. While family relationships last a lifetime, the chief executive's role does not need to. The business leader should commit to a plan on retirement or succession plan that helps in preparing for the orderly transition of the business and helps reassure the children that advancement and ownership is possible.

Alternatively, if either the parent or the child do not want the child to work in the family business, it is important to know that so that the parent can make plans on who to train to take over the business, when to sell the business, and for how much the business should sell. With the substantial investment in the business, the family business is usually the largest asset of the owner and will mostly or entirely fund the owner's retirement. While the continuity of operations of the business is often important to the owner upon exiting, being able to sell the business for the highest value is also paramount. Knowing that the child will not be involved in the continuation or purchase of the business will allow the owner to look at outside sources for purchasing and running the business.

In this context, the author is currently engaged in representing the father of a family owned business. The father and now deceased mother started a meat processing business. The parents' three sons also worked in the business. When it came time for the parents to sell the business and retire, the parties involved an appraiser and had the business valued. Based upon the appraisal, the parties executed a buy-sell agreement in which the sons would pay the parents a certain amount each month for the parents' shares in the business and the building in which the business operates, the parents would be available to consult on the operations, and the parents would continue to own the building as collateral until all the payments were made. The parties had done everything right as far as involving independent valuations, fully disclosing the business' financial statements, and engaging attorneys to draft the applicable agreements.

Notwithstanding, within a couple of years, the parents and the sons were embroiled in bitter litigation. The sons were unable to make the payments they had agreed to and alleged that the business was overvalued when they bought it. The parents, needing the agreed upon payments as their primary source of retirement income, and having been unable to resolve the issue otherwise, were forced to proceed to litigation with their three sons. The parents requested specific performance of the agreements. The sons alleged that the parents had engaged in fraud as part of the sale of the business. A continuous six year legal battle ensued with five separate lawsuits and a bankruptcy in which the father, after the mother having passed away and past the age he thought he would be fully retired, purchased the shares of the business back from the one remaining son still involved in the business via the bankruptcy trustee. The sons no longer speak with their father, did not speak with their mother, and are now out of the family business.

The moral of the story – even with the best intentions, the dynamics and emotions involved in a family business can, at times, overcome the most careful of planning and best drafted legal documents and result in expensive and painful litigation.

B. VALUING AND DIVIDING FAMILY BUSINESS ASSETS AND INTERESTS.

How to value and divide the business assets and interests are often delineated in the limited liability company's[3] Operating Agreement, or the Bylaws or Shareholders Agreement for a corporation. If applicable, the owner should refer to those Agreements. This section will deal with exiting the family business if the owners have not laid out an exit plan in the applicable agreements.

[3] Limited liability company is referred to as LLC or company herein.

In the LLC context, if the members have not adopted an Operating Agreement, the default provisions of the Minnesota Revised Uniform Limited Liability Company Act[4] ("LLC Act") control.[5] Section 500 of the LLC Act sets forth the nature and manner of transferring the member's interest. Pursuant to Section 502, a member is permitted to transfer their interest[6], however, absent consent of the other members, the transferee is not entitled to participate in the management or conduct of the LLC's activities and is not allowed access to records or other information concerning the LLC's activities.[7] The transferee is only entitled to the economic benefits of ownership of the interest.[8] If the member transfers less than all of the interest, the transferor retains the rights of a member other than the interest in distributions transferred to the transferee (i.e. voting rights and access to information).[9] Essentially, unless otherwise agreed by the members, the transferee is simply entitled to the economic benefits of ownership without any say in the management of the LLC. Thus, the purchase price for the membership interest will often take this into consideration via a lack of control discount.

Additionally, Section 600 of the LLC Act provides guidance as to how and under what circumstances a member can dissociate from the LLC. A member is permitted to dissociate from the LLC "at any time, rightfully or wrongfully, by withdrawing as a member"[10] and giving notice to the LLC.[11] Be mindful, however, that dissociation is separate and distinct from a buy-out or transferring interest in the LLC. A member that wrongfully dissociates subjects the dissociating member to liability to the LLC and other members.[12] Moreover, dissociation does not automatically discharge the member from the debt, obligation or other liability to the Company.[13]

Section 602 also delineates several specific events that cause mandatory dissociation of the member, such as death of the member[14], bankruptcy by a member in a member-managed

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[4] This article references the Minnesota Revised Uniform Limited Liability Company Act, Minnesota Chapter 322C, and not its predecessor set forth in Minnesota Chapter 322B.
[5] Minn. Stat. § 322C.0110, subd. 2.
[6] Minn. Stat. § 322C.0502, subd. 1(2).
[7] Minn. Stat. § 322C.0502, subd. 1(3)(i) and (ii).
[8] Minn. Stat. § 322C.0502, subd. 2.
[9] Minn. Stat. § 322C.0502, subd. 7.
[10] Minn. Stat. § 322C.0601, subd. 1.
[11] Minn. Stat. § 322C.0602(1).
[12] Minn. Stat. § 322C.0601, subd. 3.
[13] Minn. Stat. § 322C.0603, subd. 2.
[14] Minn. Stat. § 322C.0602(6)(i).

LLC[15], the LLC participated in a merger and is not the surviving entity[16], or the LLC terminates.[17]

In the corporate context, while transfer restrictions under certain situations are permitted in the Bylaws or Shareholders Agreement, the Minnesota Business Corporation Act ("Business Act") does not impose any default transfer restrictions.[18] The Business Act goes further to provide that a shareholder is entitled to appraisal rights and to obtain payment of the fair value of their shares in the event of, among others: consummation of a merger,[19] share exchange,[20] disposition of assets,[21] and certain amendments to the articles of incorporation.[22]

Because of the relative ease in exiting the business, it should come as no surprise that the well advised family business often has restrictions contained in the LLC's Operating Agreement or the corporation's Shareholders Agreement or Buy-Sell Agreement limiting how, for how much, and to who the ownership interest may be sold.

A prime example of the issues that arise in the sale of and management of the family business is the *Northern Air Serves. v. Link*[23], a Wisconsin case involving a multi-year, multi-million dollar litigation over the Jack Link's meat business. Jack Link's is the beef jerky company that has the "Messing with Sasquatch" commercials, is sold in over 40 countries and is headquartered in Minong, Wisconsin.

The *Link* case centers on a bitter interfamilial dispute among John Link ("Jack") and his two sons, Jay Link ("Jay") and Troy Link ("Troy"), and their various companies that produce and distribute meat and cheese snacks. In the mid-1980s, Jack began selling meat snacks in Minong, Wisconsin. The business steadily expanded, and in 1995, the business became entirely family-owned when Jack's sons, Jay and Troy, acquired shares of the company.

As a condition precedent to their ownership of the company shares, the three Links agreed to enter into a Buy-Sell Agreement in which, among other things, the Buy-Sell Agreement granted the company "the option to redeem all or a portion" of Jack's, Troy's, or

[15] Minn. Stat. § 322C.0602(7)(i).
[16] Minn. Stat. § 322C.0602(11)(i).
[17] Minn. Stat. § 322C.0602(14).
[18] Minn. Stat. § 302A.429.
[19] Minn. Stat. § 302A.471, subd. 1(c).
[20] Minn. Stat. § 302A.471, subd. 1(d).
[21] Minn. Stat. § 302A.471, subd. 1(b).
[22] Minn. Stat. § 302A.471, subd. 1(f).
[23] *Northern Air Servs. v. Link*, 804 N.W.2d 458 (Wis. 2011).

Jay's shares if their employment with the company was terminated, with or without cause. The Buy-Sell Agreement provided that the purchase price would be the "fair market value" as determined by an appraiser mutually agreed upon by the parties.

The Links managed to co-exist in a state of grudging comity until around 2002. At this point, the somewhat amicable relations between Jack and Jay began to fray, and conflicts between the two arose with increasing frequency. Jack and Jay had serious disagreements about how to run the company which eventually culminated in a 2005 Departure Memorandum executed by the company and Jay. In the Departure Memorandum, the parties agreed that Jay would be terminated as an employee and officer of the company and the company's affiliates, and the parties would attempt to negotiate an amicable buy-out of all of Jay's interests.

After executing the Departure Memorandum, there was a period of unsuccessful negotiation regarding the documents necessary to close the purchase of Jay's shares. What followed was a more than six-year litigation in which the parties asserted a litany of claims against each other for specific performance of the Buy-Sell Agreement, breaches of fiduciary duty, shareholder oppression, and other tortious conduct. Jack and Troy sought to buy-out Jay. Jay sought to have the company dissolved or to receive his "fair value" of his shares as opposed to "fair market value" of his shares.

The parties then engaged in two years of discovery before trial in May of 2008. Due to the complexity of the issues, the trial court ordered the trial to proceed in three separate phases. Phase I involved the equitable claims that were not the subject of any appeals.

The second phase involved a six week jury trial to resolve the legal claims and damage claims against each other. The jury concluded that Jack breached his fiduciary duties to Jay, awarded Jay $736,000 in compensatory damages and $5,000,000 in punitive damages to be paid to Jay by Jack. The jury also concluded that Jay breached his fiduciary duties to the company before he departed, awarded the companies $1 in compensatory damages to each company and ordered that Jay pay $3,500,000 and $1,500,000 to the respective companies.

After this phase, the trial court advised the parties that any post-verdict motions would be due on July 29, 2008. On July 29, 2008, Jay filed his motion at 4:32 p.m., two minutes after the close of usual business hours, but accepted by the clerk of court. On July 29, 2008, Jack mailed his motion from Chicago. The clerk filed Jack's motion on July 30, 2008, one day after the deadline. The trial court granted both of their motions and reduced the damage awards. As a result, Jay was ordered to pay $1 in compensatory damages and $1 in punitive damages to the company and Jack was ordered to pay Jay compensatory damages in the amount of $736,000 and punitive damages in the amount of $736,000.

The third phase was tried to the Court and involved the claims for specific performance and judicial dissolution. The Court concluded that Jay was not oppressed, denied Jay's claims for judicial dissolution and granted the company's motion to compel specific performance of the Buy-Sell Agreement. The Court ordered Jay to surrender his shares in the company for $19,400,000 and implicitly authorized the buy-out, even though not expressly authorized by statute, rather than dissolving the clearly viable company (the statutory authorized procedure).

All of these issues then proceed to an appeal to the Wisconsin Court of Appeals before finally reaching the Wisconsin Supreme Court. On appeal, the Wisconsin Supreme Court reversed the trial court and reinstated the $5,000,000 punitive damages award against Jack because his postverdict motion was untimely. And even though Jay's postverdict motion was also untimely by two minutes, the Supreme Court held that accepting the motion two minutes late was within the clerk of court's discretion. As such, while Jay's motion was two minutes late and resulted in the $5,000,000 punitive damage award against him being reduced to $2, Jack's motion which was mailed on the day it was due, but received one day late, was untimely and resulted in the $5,000,000 punitive damage award being reinstated – a $10,000,000 change.

The Wisconsin Supreme Court also affirmed the trial court's decision that Jay was not oppressed by holding that he did not have status to challenge the decision after selling his shares. The Wisconsin Supreme Court also reversed and remanded the matter to make an evidentiary decision on the evidence that Jay could present regarding his theory of damages on this breach of fiduciary duty claim against Jack and Troy.

Ultimately, the litigation spanned more than six years, resulted in multi-million dollar damage awards, a $19,000,000 plus buy-out, and certainly a severed family relationship. And this litigation resulted after the parties had put in place what they thought to be a Buy-Sell Agreement to limit the type of litigation that ensued. Even with the best of intentions, substantial litigation and several hundreds of thousands of dollars of attorneys' fees followed.

C. EMPLOYMENT ISSUES AND MANAGEMEN OF THE FAMILY BUSINESS.

In most businesses, it is clear who has the authority to make decisions in various departments and for the entire business. In a family business, the lines can be blurred with parents overruling a child's decision or siblings second guessing each other. This lack of structure can lead to hard feelings and disruptions to the business' operations.

The best way to avoid such problems is for a family business to set up formal lines of responsibility and stick to them. Parents can communicate to the family members in the business their wishes and expectations and this will help maintain family harmony. Family member employees should treat each other with the same respect that staff in any other business would expect from one another.

And while family members bring a unique dedication to their business, they often cannot provide all the experience and knowledge that the business needs. A business cannot survive unless it chooses the best person for each position, and sometimes that person may not be a family member. It is important to be open to hiring people outside the family as necessary and to accord these professionals the same respect, compensation and opportunities given to a relative in the same position.

Other considerations are non-compete and non-solicitation agreements for those involved in the family business. Because the family member has most often worked in several areas of the business, knows the family trade secrets, and would severely harm the profitability of the family business if they opened up a competing business, non-compete agreements and non-solicitation agreements are often a part of any family employment relationship and certainly any family business buy-out.

While Minnesota courts generally disapprove of non-compete clauses and will closely scrutinize such claims by employers, a reasonable and necessary non-compete may be enforceable and is generally enforceable when tied with the sale of a business. As established in a 1997 appellate court case, Minnesota employers may use non-compete clauses to protect customer goodwill, confidential information, trade secrets and customer contacts. Trade secret and confidentiality agreements (also called "non-disclosure agreements") may also be used to protect proprietary information and are not quite as suspect.

Minnesota law requires non-compete agreements to be reasonable with respect to geography and timing in order to be enforced. For example, a non-compete may not cover a longer period of time than is necessary for the employer to replace and train new employees; nor can it cover a geographical area beyond an employer's actual market area. A non-compete agreement lasting 20 years and covering the entire United States most likely would be unenforceable. Minnesota courts determine the reasonableness of non-compete clauses on a case-by-case basis, so there is no specific standard.

Minnesota courts are more likely to uphold non-solicitation agreements than non-compete clauses, but they also receive extra scrutiny as restrictive covenants. Unlike non-compete agreements, for instance, non-solicit agreements typically don't require geographical limits; however, they must have reasonable time limits. Also, Minnesota courts generally uphold non-solicitation agreements entered into once the employee advances within the company and takes on more responsibilities.

Non-compete and non-solicitation agreements can be a particularly sensitive subject with a family business, but given the knowledge gained by a family member in a family business, are often necessary to protect the ongoing viability of the family business if the family member leaves the business.

D. BUSINESS SUCCESSION AND OTHER ESTATE PLANNING CONSIDERATIONS.

For most small to mid-size family business owners, their business constitutes all or a large part of their assets and retirement savings. These owners have been pouring blood, sweat, tears and their savings into keeping the business running. As such, ensuring that the business they worked hard to develop is either maintained in the manner the owner deems appropriate or sold to leverage the highest value, is of the utmost importance. Business succession planning should not be overlooked in this regard and should not be pushed off until it is too late. Too often business owners pass away without a succession plan in place; leaving the business and the heirs in unchartered territory without a clear path forward.

A business succession plan should address the systematic transfer of the management and ownership of the business. With regards to management of the business, the succession plan should include, at a minimum, the following:

- development, training, and support of management successors;

- delegation of responsibility and authority to management successors;
- whether outside directors or advisors are necessary to bring objectivity to management successors; and
- maximizing retention of key employees through equitable compensation planning for management, family and non-family employees, and other active members or shareholders.

A business succession plan must also consider ownership of the entity. If the business is owned by co-members or co-shareholders, buying out the owner's shares or interest upon death is often contemplated. The Shareholders Agreement, Buy-Sell Agreement or Operating Agreement will typically have a provision requiring that the living owners or the entity purchase the shares or interest from the estate. Life insurance or an irrevocable life insurance trust can be established to cover the costs associated with the buy-out and ensure the necessary liquidity if new key people need to be brought in.

The Shareholders Agreement, Buy-Sell Agreement or Operating Agreement will also establish the manner for selling stock or membership interest upon retirement. Typically, the selling owner must first offer the ownership interest to the non-selling owner(s) using a pre-established formula or providing a bona-fide third-party offer to the non-selling owner(s). This ensures that the remaining owner can keep control of the entity if they so desire. If the non-selling owner refuses to exercise this right of first refusal, the selling owner may then sell their ownership interest to the third-party.

If, on the other hand, the entity is owned by a single owner, the business succession plan needs to coordinate between who will run the business and who will manage the business, if different, as well as the timing of the ownership transfer. If the selling owner sells the business during their lifetime, a non-compete is usually included in the purchase of the business to ensure that the selling owner does not get back into business and compete with the entity that he or she just sold. If the business is being sold after the passing of the owner, the succession plan will detail who the ownership is passed to and how much of the ownership is passed to each individual/entity.

When the owner is selling during his or her lifetime, the retirement portion of the succession plan is paramount. To help achieve financial security, the selling owner should consider nonqualified retirement arrangements such as an executive deferred compensation retirement plan, or qualified arrangements such as a pension or profit sharing plan as part of the sale of the business. The owner should also consider whether leasing real and personal property necessary to the operation of the business could serve as additional sources of retirement income; this is often why an owner will establish a holding entity and an operating entity. The holding entity owns the land and building while the operating entity runs the business and owns the goodwill of the business. Separating the two entities is not only financially prudent when considering retirement and options for selling (*i.e.*, the ability to sell one or both entities), but also with regards to liability considerations.

Liquidity issues also often arise when the torch is passed between business owners. Liquidity is necessary for the business to meet future contingencies and to create reserves for ongoing capital needs. It may be necessary for the business or the business owners to meet obligations under the Shareholders, Buy-Sell, or Operating Agreement. It may also be necessary for the owner's family to meet estate tax obligations. An irrevocable life insurance trust is an effective vehicle in ensuring liquidity upon one of the owner's death thereby triggering a buy-out or estate taxes. A payment schedule for buying-out an owner upon retirement also helps ensure that the business is not saddled with a significant up-front payment while also helping the owner avoid the tax consequences of a large lump-sum payment.

Finally, appropriate estate planning should be completed to compliment the objectives of the business plan. The estate plan should contain the standard family and marital shares to take into account the remaining available exclusion from estate and gift tax at death. The plan may also include trusts or gifts utilizing the federal generation-skipping transfer tax. The estate plan should carry through with the business objectives of transferring ownership during life or at death in a manner that causes minimal disruption in the operation of the business and minimizes the tax obligations associated with the transfer of ownership.

Owning and operating a family business can be one of the most rewarding experiences. Family members often look out for each other in a unique way and there is a special bond between family members when working together towards a common goal. Hopefully this article helped highlight some areas in which family disputes arise and can (hopefully) be avoided. Because while you 'can't pick your family,' you can pick whether to be in business with them.

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