Selling a Family Business Without Selling Out the Family

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Working in a family business can be extremely rewarding and utterly frustrating, especially when the younger generation (often minority owners) view the future of the business differently than the older generation (usually majority owners). The younger generation, especially those who are active in the business, often assumes that the company will be "given" to them; however, the older generation may have different motivations.

For example, the older generation may want to sell the business in order to gain liquidity, financial security or to diversify assets. Additionally, a majority owner may lack faith in management or successors, concerned primarily with additional capital requirements, competitive pressures, technological changes, labor issues or lender pressure (real or perceived). What happens if the majority owner decides to sell? Often it results in a "take it or leave it" proposition for the minority owners. In a stock deal, the minority owners can either sell their interest and divest themselves from the business entirely, or they can attempt to stay on as minority owners or employees with a new, and often unknown leader.

In an asset deal, however, the minority owners may not have the ability to remain part of the business. If the minority owner wants to stay active in the business and does not wish to sell — what rights, if any, does the minority owner have with respect to the sale of a business?

Generally a majority owner cannot exercise majority power in a way that unfairly prejudices the interests of the minority owners (even when parents believe they are acting in the best interest of their children). Courts imply a fiduciary duty and evaluate the sale with "rigorous scrutiny," using a "comprehensive rule of good faith and inherent fairness" from the perspectives of both the company and the other owners. *Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 110.

If the majority owner obtains an advantage from a transaction, the burden of proof is squarely on the majority owner to show such "good faith and inherent fairness" to the minority owner. *Brown v. Halbert* (1969) 271 Cal. App.2d 252, 267. This fiduciary duty is not waivable by a minority owner. Moreover, any such waiver is void as against public policy. *Neubauer v. Goldfarb*, 108 Cal. App. 4th47, 56-57. How "comprehensive" is this duty, and what should a majority owner consider when selling a business?

A hypothetical: Dad (66) and Mom (63) are the majority owners of the family's rubber band business. Their son, Joe (42), is employed by the company, owns a minority interest, and dreams of taking over when his parents retire. Their other son, Bill (31), does not work in the business but has a minority interest.

Business is good but the parents have decided to sell, in part, because they think Joe's strengths and abilities lie elsewhere. They find a buyer who will pay a good price for the business, give dad a consulting agreement, as well as a new long term lease on the building the parents own.

This satisfies the parents. Bill and Joe will get a lump sum payout for their interest and Joe can hopefully find a new career. Joe, however, is unhappy. He depends on the business for his livelihood. Although he will get a fair price for his shares, he wants to continue the business but cannot afford to buy out his parents. What is the parents' fiduciary duty to Joe and Bill?

Although the fiduciary duty of a majority owner toward a minority owner is broad, such a duty appears to be designed to protect the minority as *shareholders* and not in their capacities as employees. Per *Ahmanson*, this prevents the parents from using their control to obtain an advantage not available to Joe and Bill, in the absence of a compelling business purpose. Thus, if the kids receive proper value for their shares or have the option of receiving such value but choose to keep their shares, the parents can likely meet the "good faith" standard.

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But what if the parents negotiate a lower sale price with a potential buyer to keep Joe employed with the company? Can Bill claim his parents violated their fiduciary duty to get the best possible price for Bill or the company? Not likely, if the price obtained was not unreasonably low, as a majority owner may consider the impact of the sale on an owner as an employee as one of a number of factors, without running afoul of his or her duties to the minority owner to secure the highest possible price for the shares. *Mills v. Acquisition Co. v. Macmillan Inc.* (Del. 1989) 559 A.2d 1261, 1282, fn. 29.

What if Dad receives a generous employment or consulting contract? This may be fine, but it too has to be fair and not in exchange for a significant decrease in the purchase price. Since Dad receives a direct financial benefit here, this transaction is likely to be closely scrutinized.

What if the parents get a higher price for their majority interest? The majority's fiduciary duty does *not* include a requirement that the per share price for their shares are the same as the price for Bill's or Joe's shares. Since the purchaser of the parents' shares will obtain control of the company, it may be proper for the parents to accept a premium price for the sale of their shares, unavailable to the minority, without running afoul of their fiduciary duty.

However, the *Brown* case notes that the parents have a duty to act affirmatively with *full disclosure* so that every opportunity is given to the minority owners to obtain substantially the same advantages as the parents. Only where the amount received by the parents is "so disproportionate" to the price available to the minority owners will the parents be required to show that no advantage was taken of the minority. Thus, if the majority owners are seeking a premium, they are well-advised to communicate with the minority early and openly regarding the possible sale, and the parents should not attempt to increase their premium by devaluing the minority shares.

Fiduciary duties can arise in unexpected places. For example, non-competition agreements need to be handled carefully with respect to their financial consideration and scope. Care should be given to the interest of the minority who may need to continue working in order to maintain his or her lifestyle.

Likewise, if the sale of the business provides that the buyer must continue the lease for another 10 years at an above-market rent so the parents can maintain their desired income stream, they must show there was a good faith or compelling business purpose that makes this fair to Bill and Joe too. For example, if the parents can show Bill and Joe received some tax benefit they would not have received without the leaseback, that may be sufficient. Without a compelling business purpose, however, the parents may be liable to their sons for damages.

So, here are some issues to think about in negotiating the terms of a sale of a business with majority and minority owners:

Inform the minority owners about the deal. They'll have an opportunity to negotiate the best price for their minority interests, or at least have a seat at the table.

Employment, consulting, management, non-competition, non-solicitation, and similar agreements, and property leases owned by the majority owner, have to be fair and not devalue other portions of the total consideration.

Decide who makes the representations and warranties and who is liable for misstatements. It's not fair to make owners who don't participate in management liable for misstatements. Make representations based on actual knowledge, not "best" or "constructive" knowledge.

Consider tax implications to *all* of the owners of asset versus stock transactions.

All of these pieces, and many more, are part of the "purchase price." Evaluate the business in its totality for inherent fairness to the minority owners. A failure to do so could result in more than selling out the family. It could cause heated litigation and the payment of extensive damages. Therefore, it is important to consider these and other issues in selling a family business.

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