THE FAMILY BUSINESS CONSULTING GROUP

Minority Shareholders & Limits to Liquidity: Another Important Case for Shareholder Education

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It shouldn't be too hard for any of our readers to envision the following imaginary example. Each of the subsequent points is fairly benign individually. Put them together, though, and a highly combustible compound capable of bringing disparate family shareholder factions to the brink of litigation or worse presents itself.

- At least three or more shareholders (there is no maximum on the number that can be thrown into the mix); for purposes of this example, assume there are eight—a mixture of relatives from the second and third generation.
- Family shareholders who work in the business and other family shareholders who do not.
- There is confidence in the family that those leading the business are doing a good job. In part due to this trust, and in part due to a tradition of frugality in the family, the family has not invested in educating the shareholders. In addition, the only time the business has been formally "valued" has been when it was necessary for estate planning reasons — the last time being six years ago.
- Some shareholders (call them Bob and Mary) want to sell their stock to diversify their personal asset allocation. For the sake of argument, assume:
  - » The company has a track record of healthy growth and a strong brand;
  - » Neither Bob or Mary work in the business, though both have rudimentary understanding of how to read the company's distributed financial statements;
  - » Both saw the article in last week's trade journal that a competitor's business was bought for a multiple of 10-times earnings.
- Bob and Mary each own 10 percent of the family business grandpa founded.

Even in the "best" of circumstances, when some family members want to sell their ownership interest in the family business — it will stir a range of hard emotions. Family members who work in the business may perceive this (fairly or not) as a "vote of no confidence" on their leadership. Some family members may see this choice as a rejection of the family somehow and could respond by emotionally cutting off the family members who are looking to sell. This family baggage serves as the backdrop to the hard financial issues such as: what is an appropriate price for the shares? To whom can the sellers sell their shares? And, if the sale of shares is to the business itself, can the business afford this transaction and on what terms?

If the family has never engaged in conversations around "what would we do in this situation" (likely in the case of Bob and Mary's family, which has not invested in shareholder education), then there may be a whole lot of surprises that make this even harder!

First, there is no recent evaluation of the business as an objective measure of "total value" and there is a tradition of not incurring expenses like business valuations unless absolutely necessary. Who is going to pay for this valuation?

Second, if the family has not invested in shareholder education — Bob and Mary may have no understanding at all of minority discounts. They may be operating on the assumption that if the business is valued at $10 million, they can realistically expect to sell their 10 percent ownership for $1 million each. In truth, minority ownership in a business is always valued at a steep reduction. If the leaders of the family business try to explain this, Bob and Mary may perceive that their family is trying to "pull a fast one" on them somehow — eroding trust and leading to an escalation in tension.

Third, if there are shareholder agreements that detail when, to whom and how shares may be sold — it is likely that Bob and Mary are not very familiar with this document (as they never meet as a family to discuss issues of family and business overlap), may not have looked at it in six years, and may find that it substantially limits what they can and cannot do in terms of selling shares. A regular review of these documents among shareholders will help to manage expectations. When families only pull out these documents when there is a major "reason" to — like a shareholder wants to sell — it will create the impression that this document's sole purpose is to thwart the aspirations of the seller, when in fact, the document was likely drafted years before with a much broader purpose: to protect the interests of the business AND the shareholders.

Fourth, this document may or may not detail what the company can afford to structure in terms of buying out owners. Many clients we work with have language that stipulates a long time horizon for share purchases (you will only get paid out over 10 or 20 years) and only if the company has enough free cash flow to afford this payment. Again, if this comes as a surprise, the frustration of the aspiring seller will increase, as will their desire to possibly call a lawyer!

However, it is important to underscore that the company and the other shareholders will be in a MUCH worse situation if there are not these constraints drafted into the shareholder agreements somehow. If minority shareholders can force the company to buy them outright this could (even with the minority discount) seriously affect the cash flow of the company — possibly jeopardizing the entire family enterprise.

Both limits to shareholder liquidity and the concept of minority discounts —that reduction in value often applied to anything less than a company's majority ownership — are often the source harmful fights and long standing resentments between shareholders in family business. Normal and predictable though they may be, these challenges to family shareholder harmony and company cash needs are almost always avoidable. Regularly revisiting the relevant data points and fully educating shareholders will dramatically lessen the opportunity for battles and concurrently raise management's ability to predict cash availability.

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