To Have and To Hold

Only careful legal planning can help families keep ex-spouses and outsiders from usurping control of the family business.

By Kris Frieswick

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CINDY WITTE'S FAMILY saw her divorce coming, but they never imagined that her husband would actually try to get part of their company, Dallas-based SEI MetalTek, as part of the settlement.

During their weeklong divorce trial in March, Witte's husband laid claim to income she was receiving from stock she owned in the family business. "He claimed in court that my parents had intended for him to have shares," says Witte's brother, Kevin Grace, CEO and principal of SEI MetalTek. Because John Grace, the family patriarch who founded the company in 1966, is alive and could testify otherwise, the claim seemed easily disproved. However, as many who have lost family holdings to outsiders have painfully learned, stated intentions are not always enough to prevail in a case such as this.

Fortunately, the Grace family had also taken legal steps to ensure that MetalTek stock stayed exclusively in family hands. In 1998, when John and his late wife, Diane, transferred ownership of the company to their three children, they created a shareholder agreement that stipulated who could own stock, how it could be transferred and what would happen to that stock in the event of a shareholder's death. All family members and their spouses signed the document. The spouses further attested that the family

stock was separate property, not joint marital property, in case of divorce.

Owners of a family business can, like the Graces, keep stock shares strictly within the immediate family by creating legal stock ownership succession plans. These plans include not only shareholder agreements, but also buy-sell agreements, voting trusts and prenuptial agreements, all of which govern who can and cannot own stock in family companies. While erecting these legal barricades around marriages and other interpersonal relationships can sometimes strain family ties, creating and implementing them, however emotionally difficult, are essential to effective estate planning.

DIVISIVE DILUTION

Divorce represents a formidable threat to ownership continuity, but it is hardly the only one. Sometimes, particularly within large companies, family members who experience cash flow challenges or wish to support a charity may sell or give away stock to other people or entities. The greater the number of family owners, the harder it is to prevent these transaction. Such was the case with Benjamin Moore & Co., a paint manufacturer founded more than 100 years ago in New York. At the time of its sale to Warren Buffet's Berkshire Hathaway in 2000, the founding family owned less than 60 percent of company stock, largely because there were no restrictions on who could own it. According to Jack Moore, a fourth-generation owner, the company had used stock as executive compensation, and some family members had begun to contribute it to favorite charities. Control of stock became so loose that three years before the sale, some family members actually began selling their shares over the counter.

"We didn't have any stock sale policy that I know of," says Moore, who is retired from EDS and founded the family business initiative for the National Association of Corporate Directors, a corporate governance organization in Washington, D.C. "We were discouraged from dispersion of stock outside the family, but it was up to the individuals as to how they disposed of shares." He believes that there were more than 1,800 shareholders at the time of the sale.

While those who study family businesses concede that ex-spouses or other outsiders rarely hold a substantial portion of equity against the family's will, they point out that it is not uncommon for an outsider to acquire just enough voting stock to complicate family business decisions. Furthermore, a nonfamily shareholder who is forced to sell his stake could cause expensive problems by fighting the method the company uses to value his stake in the company as part of a settlement offer.

Problems like these can be expensive, says John Collins, a partner in the law firm of Haynes and Boone in Dallas who specializes in working with family business owners (he was the Graces' attorney). He recalls one client, a family owned business whose founder's son died at an early age. The son had changed his will to exclude his ex-wife after they divorced, but he had failed to amend the trust documents for his children's trust, and the ex-wife remained its trustee. She now demands cash payments from the company any time they need her to vote with her shares, Collins says. "It's expensive for them," he notes, "but it's easier than fighting her for control of the trust."

With proper planning, family business owners can avoid issues like these altogether. The first step is creating buy-sell agreements and shareholder agreements that stipulate who can own stock, how and when it will be transferred, and how the company or other family shareholders will buy it back. These contracts typically include an explanation of the stock valuation method that will be used. By putting these parameters into writing early in the ownership cycle, they become more resistant to challenges from angry family members or ex-spouses claiming the formulas were slanted to undervalue their holdings. Contracts should also include a provision known as a call agreement, which gives the company or other stockholders the right to buy back stock from an individual if certain conditions are met.

Voting trusts are another legal means for keeping stock from falling into the wrong hands. They operate in a simple way: Owners place their stock in a trust, and assign voting rights to trustees who can vote and distribute dividends. These trusts provide certain tax benefits along with protection from creditors and unauthorized stock transfers. Additionally, because the owners do not control the stock directly, voting trusts also reduce friction between family members over matters of governance.

Business owners must also be vigilant about upgrading their shareholder and buy-sell agreements frequently as the needs of owners, families and the business change and

TOP VIEW | Families that wish to keep their businesses in the hands of immediate family members must undertake careful and thorough stock succession planning. Legal mechanisms can protect family shareholders from losing their positions to divorce or lawsuits; others can prevent estranged family members from gifting and selling stock, thereby diluting the family's control. While building these legal bulwarks can strain family ties, they are often the only way to maintain a hard-won legacy.

diverge. "The lifecycles of all three components are constantly changing," says Tom Ogburn Jr., director of the Family Business Center at Wake Forest University's Babcock Graduate School of Management. "When someone tells me that they have succession planning all mapped out, I guarantee you there are things that they haven't considered in those plans."

YOURS, MINE, OURS

Creating an effective stock ownership succession plan can be time consuming and emotionally draining, which is exactly why so many families fail to do it properly, if at all. A 2003 American Family Business Survey, conducted by MassMutual Financial Group and the Raymond Institute, reports that 88 percent of family businesses surveyed stated a desire to keep the business under family ownership. Twenty-one percent had experienced at least one owner divorce in the past five years. Yet nearly 40 percent of respondents had no buy-sell agreements in place stipulating who could own stock, and 25 percent did not have ownership plans in place for the next generation.

"Family owners will argue about cash and control," says Greg McCann, an attorney, certified public accountant and director of the Family Business Center at Stetson University near Daytona, Fla., "but there is always an emotional issue underlying it. I had one client who gave one grandchild one share more of stock than the others got. Twenty years later, the family still had bitterness about that."

The legal documents that often present the greatest emotional minefield are the prenuptial or postnuptial agreements, which can force a new or current spouse to relinquish rights to any company stock. Conversations on this subject are difficult, sometimes even bitter. "How do you not leave that person feeling dismissed?" McCann points out. "It's like saying, 'Welcome to the family, but you'll never get your hands on the stock.'"

Families should not expect a spouse to give up those rights for nothing, especially with postnuptial agreements, wherein a spouse may already have had an expectation of some cut of the stock. "Usually, when a spouse signs those things," says Bernard Clair, a divorce attorney with Clair, Greifer in New York, "you talk about giving them some sort of financial consideration for that waiver." Experts also warn that a nuptial agreement can be found invalid in court if it is found to be abusive or coercive—for instance, if it stipulates a less-advantageous valuation method for the stock in the case of divorce than in the case of death.

Because of the integral role prenups play in stock ownership succession planning, families should begin educating children about them early on. Leslie Dashew, president of Human Side of Enterprise in Scottsdale, Ariz., and a partner in Aspen Family Business Group in Aspen, Colo., a consulting firm serving affluent business owners, counsels younger family members about prenups. She recalls that during one such conversation with three children from a wealthy family, the youngest of the three, then 16, came up with an idea to address the awkwardness of asking a potential spouse to sign a prenuptial agreement.

"She said, 'What if we all sign an agreement right now promising to get prenups, and if we get married without one, we forfeit a quarter of our assets back to the family,'" Dashew remembers. The other siblings agreed to what Dashew calls one of the greatest prenup ideas she has ever heard. "It takes pressure off the kids. They can say to their spouse one day, 'This agreement isn't about you. It was in place long before you came along.'"

While no one wants to start a marriage on a contentious, even hurtful, note, frank discussions about family assets and expectations, along with proper legal planning, can actually prevent greater emotional upheaval over the long term, a point to which the Grace family can now attest. The judge overseeing Cindy Witte's divorce trial agreed with the Graces, and her ex-husband walked away empty-handed. "Without those documents," Kevin Grace says, "he probably would have gotten something. Having the right legal representation and doing proper planning were absolutely crucial." W

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ESTATES BY STATE

Depending upon where you live, inherited nonpublic shares of a family business are either relatively safe or unsafe from inclusion in a divorce settlement. In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), anything inherited, gifted or brought into the marriage is considered separate, not marital, property that is excluded from the division of assets. The remaining states are common-law states; some of them consider everything that both partners own or hold as fair game for division, regardless of how or when they received it. These are the states that represent the greatest threat to unprotected family company stock. —*KF*