Family Business Disputes

By Benjamin Means

As any experienced litigator could attest, family business disputes tend to be ugly, protracted, and destructive. For a case in point, consider the recent discord among members of the Demoulas family regarding control of the Market Basket supermarket chain. Demoulas family hostilities stretch back decades and include courtroom fistfights. The latest flare-up, which was reported extensively in the *Boston Globe* and other national newspapers this past summer, jeopardized the viability of the business and approximately 25,000 jobs. Ultimately, one of the two warring factions agreed to a buyout, but achieving that commonsense result apparently required the personal involvement of the governors of Massachusetts and New Hampshire.

Needless to say, most family businesses cannot expect gubernatorial assistance in resolving their private disputes. Yet, even if typical family business disputes involve lower economic stakes, family businesses in the aggregate are tremendously important for the U.S. economy. Family businesses represent the majority of all businesses, employ about half the nation’s workforce, and contribute a substantial amount to the nation’s gross domestic product. Also, apart from any wider economic implications, family business disputes can be devastating for those involved. Accordingly, the distinctive characteristics of family business merit careful study.

This article offers an overview of issues relevant for lawyers who represent family businesses. First, it identifies typical sources of conflict in family businesses that practitioners should recognize in order to understand the underlying dynamics of family business disputes. Second, it shows how family law can affect business outcomes and, accordingly, emphasizes the need for contractual planning that includes both business and family considerations. However, even if represented by counsel at formation, family business participants may be reluctant to negotiate at arm’s length and cannot, in any event, hope to anticipate every possible dispute that might arise. Therefore, as family businesses increasingly gravitate toward the LLC form, this article contends that there remains a need to apply standard judicial remedies for abuse of control, mostly developed in the corporate law context, which protect the parties’ reasonable expectations.

**Sources of Conflict**

In a “family business,” a single family controls business decisions and at least two family members are involved in the business. A more complete definition would require significant elaboration, but in most instances, the family status of a business will be perfectly clear to the owners, to the employees, and, of course, to legal counsel. Fundamentally, family businesses are extensions of family relationships – the business system and the family system are deeply interrelated.

Unfortunately, while business values and family values overlap, they do not necessarily align. In part, this can be understood as a problem of social roles. For most of us, our workplace identity is very different from the role that we play in family life. But in a family business, role separation becomes more difficult. If Mom is the boss, when she talks to one of her employees, she may also be addressing one of her children. The expectations that we have of members of our family – that we put the family’s interests first, that we take care of each other – may conflict with the goal of maximizing economic return in a business. To the extent social roles are incompatible, family business has a built-in conflict.

Also, the overlap of family and business enables conflict to spread from one domain to the other. In one case, an individual who...
worked for his family’s business married outside the religious faith and was then frozen out of the business by his father and his brother. In another case, a woman refused a buyout offer by her parents, not because the price was too low, but because her brother would be the beneficiary. Family problems become business problems and vice versa. Depending on how they are managed, family relationships can serve the interests of the business, or fatally undermine it.

Conflict can arise from any direction, but succession often poses a serious challenge for family businesses. If a family business is to survive as such, each generation must eventually cede control to the next – and yet many family businesses fail to plan for succession, dealing with the issue only after the death or incapacitation of a controlling family member. Such avoidance can be understandable. For instance, to the extent work and family are linked, stepping down from a position of responsibility within the business may seem like a surrender of status in the family. Also, parents may hesitate when faced with the choice whether to treat all children equally or transfer control to the most able member of the next generation. Yet, the tax and governance consequences of ignoring the inevitable can cripple a business that would otherwise have been well positioned for continued success.

**Family Law’s Influence**

Setting aside the myriad difficulties of combining family intimacy with the workplace, family relationships may also have straightforward legal implications for family businesses. While this statement may not seem revolutionary for some, for many, business law and family law fall in separate categories. In law school, we teach business law courses and family law courses. Family business law courses are almost non-existent. Legal academia adheres to the same artificial distinction – there are academics who write about family law issues, and academics who write about business law issues. Family business lawyers, however, are well aware that legal principles relevant to the parties’ family relationships can affect the outcome of their business disputes.

In this regard, the laws governing divorce and inheritance are particularly important.

If a family business is co-owned by a married couple, for instance, a divorce will have enormous implications. Not only must the parties exit the marital relationship, but their separation will also in most cases involve the exit of one or both parties from the co-owned business. Just as a practical matter, the simultaneous disruption of two different legal entities – the marriage and the family business – creates problems of coordination. Further, the parties’ rights are not identical in each context and equitable principles of divorce law often trump conflicting business law rules.

Regardless of the parties’ allocation of control and ownership rights as to a particular business venture, a family court overseeing a divorce has broad, equitable discretion to divide marital assets, which can include business assets. In the context of divorce, the relevant economic partnership is the marriage, not the business, and equity is the overriding consideration. For example, in a recent case involving the L.A. Dodgers, Jamie McCourt owned none of the stock, but was able to claim half the value of the business in her divorce from Frank McCourt, the team’s sole owner. By contrast, the Texas oil tycoon Harold Hamm was recently ordered to pay his ex-wife Sue Ann Hamm $1 billion; a staggering sum, to be sure, but far less than 50 percent of the value of his stake in Continental Resources, a company that he led as CEO during the marriage. Had the award been higher, Harold Hamm might have been forced to sell his controlling stake in the business in order to satisfy the judgment.

Family considerations can also affect business outcomes when control of a family business passes to the next generation. For instance, the six siblings who now own Luray Caverns, a tourist-attraction cave near Washington, D.C., have been battling for years, aligned roughly in two camps – the older siblings and the younger siblings. As reported in the Washington Post, the dispute turns in large part on the parents’ will and related trust instruments. The older siblings have objected to the appointment of certain trustees for the trusts that manage the family’s stock interest in the business. Of particular note, the will contains a no-contest provision that purports to disinherit anyone who challenges the parents’ choices with regard to trustee appointments. Relying upon that provision, which would be unheard of (and likely unenforceable) in a corporate charter or LLC operating agreement, the younger siblings have sought to obtain full control of the business by disinheriting their older siblings according to the terms of the will.

Moreover, as the Luray Caverns litigation shows, inheritance issues often implicate trust law. If the business founders establish a trust to hold company stock for the benefit of family members, the applicable governance and fiduciary rules are thereafter a matter of trust law as well as business law. Technically, the trust owns the stock and the family members, who are beneficiaries of the trust, are not themselves owners. Thus, as part of a plan of succession, a more capable child or an outside manager could be selected to serve as trustee while the remaining offspring receive some measure of economic security through their beneficial trust interest. Alternatively, parents might give children a stake in a business, even a majority share, without relinquishing their own control. In trust-controlled businesses, the law of trusts can supersede otherwise applicable business law.

**Contractual Considerations**

In advising family businesses, a lawyer’s most important resource is usually contract. The choice of entity form matters, but no existing type of business association contains default rules that smoothly reconcile business values and family values. The available business forms – chiefly, partnerships, corporations, and LLCs – do not presume any preexisting relationships among the investors. Moreover, given the variety of objectives that any family might have in operating a business, it is not clear what rules would best suit the majority of family businesses. Therefore, private ordering through contract is crucial to ensure that all participants are treated fairly and their expectations are taken into consideration.
Consider the example of marital divorce. Since nearly half of all marriages fail, divorce litigation should be seen as a regular, recurring feature of family business ownership. Proper planning is essential. In some cases, shareholder agreements can help to ensure that business assets stay in family hands, for instance, by providing a right of repurchase should stock end up with an ex-spouse. But shareholder agreements aren’t enough to get the job done; as noted previously, the equitable division of marital assets in a divorce takes precedence. Marital agreements, however, can state whether business assets count as marital property and, if so, how those assets should be allocated. The point is that the shareholder agreement and the marital agreement are, in fact, two pieces of the same puzzle.

In a contested divorce, the enforceability of a marital agreement may determine the fate of the family business. To return again to the McCourts’ dispute over the Dodgers, Jaime’s claim to 50 percent was valid under the default rules governing divorce in California. The Dodgers were acquired during the marriage and there was no question that Jamie had contributed substantially to the effort. However, shortly after acquiring the Dodgers, the couple had entered into a marital property agreement. Apparently, in order to limit exposure to creditors, the agreement put their several houses and personal property in Jamie’s name, and the businesses in Frank’s name. Jamie claimed that she never read the agreement and failed to understand that it would affect her rights in a divorce. In the end, Jamie convinced the judge to throw out the agreement – otherwise, the divorce settlement would have looked very different, and Frank McCourt would probably still own the Dodgers.

Marital agreements are not the only device available to protect family business assets from intra-family dissension. As mentioned earlier, parents often use trust instruments to give children a stake in the business without relinquishing control. Because the trust owns the stock, trust agreements may protect family assets should a child (or grandchild) divorce. Also, the trust structure can be used in some cases as part of a plan to minimize taxes. Indeed, many family businesses are structured in substantial part to achieve estate planning and related tax objectives, so that trusts, wills, and other testamentary documents may be as much a part of the business as articles of incorporation, bylaws, and shareholder agreements.

Judicial Monitoring

Although the parties to a prospective business venture, family owned or not, should clarify key points before investing – for instance, when capital contributions may be required, how business decisions will be made, how earnings (or losses) will be distributed, and what types of opportunities belong to the business – the resources of contract are limited. The parties cannot anticipate every contingency that might arise in a long-term business relationship. Also, because bargaining is expensive, the costs of negotiating a more complete contract will eventually outweigh the benefits. Moreover, the participants in a closely held business may rely upon trust, even as to matters that could have been specified in advance.

Family businesses present distinctive challenges for private ordering because they combine the values and expectations of the workplace with more intimate family bonds. Even if it were realistic to suppose that the parties would engage in arm’s-length contracting to define their mutual expectations, those expectations are complex and difficult to specify within the four corners of an operating agreement. Moreover, to the extent that arm’s-length negotiation reflects the values of the workplace and may be an affront to the informal norms that characterize family life, it cannot provide a neutral method for finding an appropriate reconciliation between the two sets of values.

In the corporate context, most jurisdictions recognize a need for judicial monitoring of the parties’ relationship to prevent the opportunistic exploitation of gaps in the contractual bargain. This is true for family businesses and non-family businesses alike. For instance, even when they have not negotiated specific protections, minority shareholders can seek relief for oppression, often premised on the notion that controlling shareholders owe fiduciary duties and must honor the minority’s reasonable expectations. While courts will not rescue investors from the consequences of entering a one-sided bargain, neither will courts stand by and allow controlling shareholders to deprive minority shareholders of any return on their investment.

In recent years, the LLC has overtaken the corporation as the entity form of choice for most small business owners. Notably, the LLC combines the flexibility of a traditional partnership and flow-through taxation with the stability and limited liability benefits of incorporation. Also, for tax reasons, families may use LLCs to hold real property for personal use. Thus, the continued vigor of judicial monitoring may depend upon whether well-established shareholder protections apply in disputes involving LLC members.

In some respects, the difference in organizational form between a corporation and an LLC does not matter because the fundamental problem – an overreliance on trust and a failure to document basic understandings among co-owners – is identical. Regardless of formalities, the family members may view themselves as partners in a common enterprise. However, in corporations and LLCs alike, controlling family members can abuse their power when informal consensus evaporates; the majority has the formal right to control business decisions, and there is no default exit right for a minority owner frozen out of any return on her investment. Therefore, to the extent the law has already developed an approach for protecting minority shareholders in corporations, it would seem counterproductive to insist upon new, possibly less effective tools for dealing with a shared problem.

However, while the contours of the problem may be familiar, one cannot assume that the available legal recourse is the same. Corporate law and LLC statutes in a jurisdiction may provide different standards for relief and offer different remedies. Also, to the extent LLC law places greater emphasis on private ordering, courts may be reluctant to imply equitable obligations not set forth
in an operating agreement, and they may defer to waivers of fiduciary protections that would otherwise have applied. As a policy matter, one could argue that it would undermine the LLC’s value as a distinctive legal form if courts simply imported corporate law principles and failed to respect the difference between LLCs and corporations. The salience of this objection, in turn, might depend upon whether one can distinguish intelligent borrowing from blind copying. (It does not instill confidence when courts persist in using corporate-law terminology when addressing LLC disputes).

Yet, even if LLCs follow a more explicitly contractual approach, perceiving a family business in contractual terms should not entail a narrow approach to the interpretation and enforcement of relevant bargains. That is, a contractual approach does not require courts to abandon minority investors, family members, or otherwise, to the explicit terms of their bargain, regardless of whether those terms are consistent with the parties’ reasonable expectations. If the business is a contract, it is a relational contract intended to endure over time and not a discrete, bargained-for exchange. Judicial protection of vulnerable minority investors conflicts with private ordering only if we assume the artificially rational world of neoclassical economics. But LLC members and corporate shareholders live in the real world, not in the pages of a game theory treatise, and the ties of family and friendship, the social norms of business, and the constraints imposed by transaction costs all affect the likelihood that the parties will negotiate adequate protections against possible future discord.

**Conclusion**

For better or worse, so long as family ownership remains a prominent feature of the business landscape, courts will be called upon to adjudicate business disputes among family members. Although unfortunate, the family grievances that tore apart the Demoulas family and caused the Market Basket fiasco are not uncommon. In this regard, perhaps we can supply a lawyerly caveat to Tolstoy’s famous dictum that “each unhappy family is unhappy in its own way.” Where the novelist might observe an infinite variety of miseries, the experienced lawyer will perceive repetitions of a relatively small number of themes: sibling rivalries motivated by competition for parental affection; aging patriarchs who cannot let go; parents who invite disaster by distributing business assets to children without regard for their ability or interest; active participants who resent uninvolved family members for expecting to profit from a business that they do not contribute to building; and, in what some might characterize as the central problem of business law, the ever-present temptation for those who control a resource to use it, disproportionately, for their own benefit.

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