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Distributions and Family Financial Dynamics

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When a potential leveraged buyout of a third-generation manufacturing business failed to close, a long-simmering conflict boiled over. Two family shareholders not involved in day-to-day operations wanted higher annual dividends and resented what they saw as elaborate compensation for the two family members running the company as chief executive and chief financial officer. The CEO and CFO and their non-family management team felt that, in the midst of an industry-wide downturn, the company's free cash flow should go to ramp up operations at its newly purchased plant in Mexico and not be paid out to shareholders in a dividend.

The crisis could not have come at a worse time -- but there's never a good time for a family business conflict. And few issues are more contentious than shareholder distributions.

Who gets how much, and when? Should excess free cash flow be reinvested in the business or distributed to shareholders? How can companies balance the desire to grow the business with the legitimate financial needs of family members not on the payroll? For family firms in the second generation and later, the question is not whether there will be conflict over distributions, but when.

Having an explicit, thoughtfully crafted distribution policy can help avoid expensive conflicts that can force a sale of the business to resolve the conflict. It helps to anticipate where stress points can occur over distributions, to educate shareholders outside the business about operations and finances, to understand the financial alternatives available and to know what legal challenges can arise.

Why does the conflict start?

Family businesses frequently struggle with competing visions for the company and its future. One generation wants to grow the business by implementing new technology and processes and developing new products and markets, while long-time owners think things are just fine "the way we've always done it." Disagreements over family businesses arise between shareholders who work in the company every day and those who do not want to work in the business but do want a current return on their capital. If mismanaged, these disagreements result in an "us vs. them" fracture among family shareholders that may find family dividing into two distinct camps: "insider" and "outsider." These are not exactly the sort of classifications that breed family harmony, mutual respect and trust -- or good business decisions.

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The fundamental conflict typically mirrors what happened in the manufacturing company we counseled: Family “insiders” push for capital reinvestment and long-term appreciation, while “outsiders” want distributions for a current yield.

Let’s start by acknowledging that both sides have merit. Family shareholders are justifiably proud of earlier generations’ accomplishments. For insiders, the top priority is to continue growing their business legacy for future generations, which means nurturing it, keeping it competitive and reinvesting in it.

Of course, that’s easy for insiders to say. After all, they get compensation from the company in the form of salaries and benefits. Many also get perks such as vehicles, travel and country club memberships. Sometimes, things are taken to an extreme: The child of a controlling shareholder in a family business we know of was hired -- just out of college -- as its human resources manager at a salary five times the market rate!

Outsiders see all this and recognize that their capital is being put at risk, and they have no way to exit the illiquid private investment if they do not like the decisions being made. Frankly, life is short, and if they are not receiving distributions from family business ownership, outsiders will often favor selling the company and cashing out. This decision can come at the wrong time in the business life cycle, and value can be sacrificed.

It is important to understand that outsiders usually are not being unreasonable in their demands and that efforts should be made to provide them some return on their investment. This should be a priority not only to maintain family harmony at family gatherings, and to facilitate good business decisions, but also because there are potential legal pitfalls to ignoring outsiders’ perspective.

How squabbles can escalate

Many family business owners may not realize it, but there is no legal obligation for a company to pay dividends on common or preferred stock. Unlike debt payments, dividend payments are completely discretionary. A company’s board of directors is charged with making disinterested decisions, in good faith and with due care, about whether long-term shareholder value will be maximized by reinvesting cash in the business or distributing it to shareholders. If the board’s decisions can be shown to be in the best interests of the corporation and its shareholders, they cannot be second-guessed by a court.

There are also some legal constraints that prevent shareholder distributions (for instance, capital requirements set by lenders and statutory requirements about business solvency). And the company’s cash flow requirements take priority, of course.

Let’s consider minority shareholders, a status that describes many family business outsiders. Historically in a court action, the burden of proof was on the complaining shareholder to show fraud, bad faith or unreasonableness. But in the past two decades, there have been enough instances of unfair exercise of majority control to trigger a shift. Now, there is a general

expectation that an equity participant has a right to a proportionate share of corporate earnings and a general notion that returns should exist.

If the decision to forgo or sharply curtail distributions is perceived as a way to squeeze out certain family owners or enhance the employment positions of others, a lawsuit might be considered viable. The board's defense, of course, would be to show that curbing distributions is good business judgment and there was no oppressive conduct by the majority. Having all the proper legal documents in place before conflict occurs -- such as buy-sell agreements, voting trusts and agreements, articles of formation -- is essential.

We often see clients resort to buying out family shareholders who dig in their heels and will not be appeased. It hurts, but legal battles and estrangements are worse. We remind clients that their children are watching them and learning how to treat their siblings and cousins. Adult family members are wise to address powerful and often volatile subjects -- like whether to reinvest or harvest profits -- with neutral counsel and fair process.

Getting to amicable resolutions

There is a path to prevent conflict, or arrest it before squabbles turn into battles and wind up in court. We've found that outsiders concerned about distributions are almost always willing to be patient if they are given a transparent plan for long-term growth with evidence that the board is implementing that plan.

The keys are communication, transparency and education -- along with concrete milestones that show promises are becoming reality. Also, establishing and then meeting reasonable milestones will go a long way toward avoiding legal disputes.

Nowhere was the success of this approach demonstrated more vividly than in the case of the manufacturing firm we mentioned up front. Instead of ignoring or dismissing them, its board of directors responded vigorously to the outsiders' complaints. They ordered a business valuation and cash flow and balance sheet analyses. They had serious discussions about whether to take on more debt in order to provide liquidity for additional cash disbursements.

A review of upcoming capital projects was put on the table, along with a detailed plan showing the likely increase in corporate value and returns from these expenditures. The family engaged a highly experienced family business consulting firm, which all sides agreed was objective, to lead them all through a comprehensive review of the information and, as a family shareholder group, decide what priority would be given to continued business growth and profitability vs. liquidity.

The outsiders' worries about unfair compensation were also addressed, and an independent analysis was done to benchmark salaries. Eventually, that analysis determined that compensation for the CEO and CFO was within industry norms. Next, a valuation formula was designed so that family members could trade stock among themselves as an alternative to liquidity or, as is often the case, hold their ownership positions.

If the board wants to consider alternative, more complex and customized forms of distributions to address specific shareholder goals, such as leveraged recapitalizations, share repurchase or exchange plans, an investment banker can be enlisted to assist in the analysis and structuring of the plan and in the determination of what is "market" under the circumstances. When an independent outsider "runs the numbers" and takes the mystery out of the financial decision-making process, it generally works to everyone's benefit.

Those breakthroughs helped everyone agree on appropriate dividend levels and on the principle that they should be dependent not just on the needs of outsiders, but also on company earnings, capital requirements and balance sheet integrity.

Lessons to be learned

Shareholder goals must be positively and continually aligned around the basic sentiments of the enterprise and the family. What purposes do the business and the family serve? What do insiders and outsiders want from the business today, and what should it provide for them and their children over the long term?

It helps enormously to hold regular meetings that include an overview of company history and values, as well as education about the industry and how its profitability fluctuates over time. It's especially important to make sure that outsiders, who may be only tangentially familiar with the business, attend. Ask everyone to participate in discussions about how family ownership benefits the company and how the company benefits from family ownership.

Making sure that all your family shareholders achieve a high level of financial acumen and financial self-management can have a huge impact on their determinations about what level of distribution is sufficient. So can discussions that demonstrate how family members' dependence on shareholder distributions to maintain elaborate lifestyles is dangerous; it can increase pressure to sell the company -- or parts of it -- at reduced value.

We caution clients not to forget that parents can set good examples with understated lifestyles. They also can clarify that compensation for employment in the company is not the same thing as dollars paid for the use of one's capital or for putting one's capital at risk.

When a board of directors acknowledges that family shareholders should get a return on their capital and it sets defensible expectations for the company's need for capital -- through strategic planning and budgeting -- it should be clear to both insiders and outsiders what excess capital will be available for owner distributions this year and in years to come. FB

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