

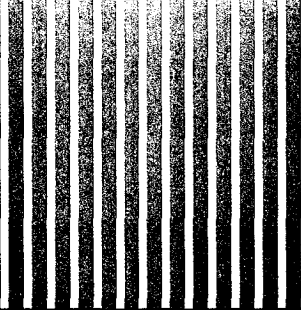


# YOUR LAWYER:

An Owner's Manual

A BUSINESS OWNER'S GUIDE  
TO MANAGING YOUR LAWYER

Henry C. Krasnow



**“Captures the essence of what business owners must know in order to guarantee that their lawyers help make their businesses more successful.**

**Written in clear, direct language, this is a one-of-a-kind book.”**

**JOHN L. WARD, PROFESSOR OF FAMILY BUSINESS, KELLOGG SCHOOL OF MANAGEMENT,  
NORTHWESTERN UNIVERSITY, AND FOUNDING PARTNER, THE FAMILY BUSINESS CONSULTING GROUP**



either sell their stock or, if they know they can sell their stock and are not being forced to hold an illiquid asset, will be less suspicious of how the company is being run.

- It reduces pressure from the uninvolved shareholders to have the company adopt other kinds of strategies that show immediate results.
- It reduces management's reluctance to adopt long-term strategies for fear that the noninvolved shareholders would be impatient.
- It requires that management reserve cash to fund prospective buyouts, thus preventing management from paying themselves excessive salaries or otherwise depleting the company's working capital.
- It can provide a remedy for the problems created by an estate plan that gives corporate control to uninvolved shareholders by treating the children equally. If a business owner's will divides her stock equally among her children, a liquidity agreement can protect the child running the business by giving the uninvolved siblings an opportunity to liquidate their holdings without punishing the child who runs the business. When everyone is communicating well *and* a liquidity plan is in place, equal ownership can be a virtue, by reducing the resentment caused by some family members having more long-term benefits than others.

### **Prenuptial Agreements—Shortcomings and Alternatives**

The prospect of a marriage should present a situation of great joy. However, for the members of a business-owning family, marriage sometimes has the potential to create considerable anxiety. What if the marriage doesn't work? Will our new son or daughter-in-law want to get stock in the business? How much of the family business finances (which we have kept secret from the industry) will their divorce proceedings make public? Disclosure of our margins

would give our competitors a great advantage. The common wisdom is that a prenuptial agreement can address many of these concerns.

However, these agreements often do not provide the expected benefits, and what benefits they do provide might be better achieved by other means that have far less emotional cost.

### *Costs versus Benefits*

Lawyers and consultants who have negotiated prenuptial agreements between young people marrying for the first time will verify that they are in fact sometimes hard negotiations, and not collaborative efforts between two people who easily come to an understanding. Rather, they often involve painful discussions requiring those two young people to condition their love and commitment to marriage on an arrangement concerning money.

People who have been married before and have adult children or grandchildren to whom they have financial commitments may find this negotiation easy and helpful. But it is rarely something that people under the age of thirty wish to contemplate, let alone negotiate.

If parents are pressuring their child to negotiate a prenuptial agreement, it can put incalculable strain on the young couple's relationship. While most children want their parents' approval and encouragement about their decision to marry, healthy children come to that decision independently of their parents. Having parents insist that the children negotiate a contract that, from the children's point of view, seems to serve only the parents' agenda, can be infantilizing.

In addition, in the minds of spouses coming into family businesses, there must be the concern that although their prospective in-laws appear to be welcoming them into the family as full-fledged members, there seems to be some mistrust, and the in-laws seem more concerned with money than whether the newlyweds are beginning their marriage on a healthy footing.

The expected benefits most often used to justify prenuptial

agreements are that they will (a) prevent protracted court battles that expose the family's finances; (b) keep the family from being taken to the cleaners with high legal bills or an unfair alimony or support award; (c) ensure that the business stays in the family; and (d) avoid use of business capital to redeem stock. Yet many matrimonial lawyers would observe that in bitter divorces, these goals are rarely achieved. Prenuptial agreements are very hard to enforce. Under the law of almost every state, a prenuptial agreement is enforceable only if it is entered into without undue duress and provides full disclosure of the value of each party's assets. In fact, in some states prenuptial agreements are not enforced unless they are considered fair both when signed *and* enforced.

The "full disclosure" issue is almost always a big problem. After all, at the time that most prenuptial agreements are negotiated, no one has the incentive to make full disclosure of the value of the family business. The parents who own the business certainly do not want their in-law to know how prosperous the business is, as it may encourage gold digging or be perceived as bragging. The estate planning consultant also does not want something in writing that could be used by the IRS as evidence that the estate planning documents (which are usually premised on the lowest valuation thought to be defensible) are incorrect. Competent divorce attorneys, aware of these tendencies to undervalue the business, can wreak havoc by litigating the agreement's enforceability on the grounds of undervaluation.

The second challenge to most prenuptial agreements is that the agreement may have been entered into under duress, a *very* complicated issue. As every parent and many judges know, duress can be put on young people in all sorts of ways. Waiting to finalize the prenuptial agreement until after the wedding plans are made and the invitations sent is a classic example. Duress can be claimed regarding the many prenuptial agreements proposed shortly before the wedding, when the future spouse did not have sufficient time to review the terms.

This means that because of the many opportunities that exist to litigate prenuptial agreements, it's difficult to keep family finances

a secret or save money on legal fees. If the prenuptial agreement is not generous enough for the spouse coming into the family with the business, there can almost always be issues that, if shrewdly presented to a judge, will result in there being considerable court disclosure. Thus, even if the judge does not give the incoming family member a better deal, the family will almost certainly be unable to keep its finances confidential.

Most family business owners put a high value on keeping their finances secret. They do not want to make public the salaries of the owners, the value of the business, the profit margins, or any of the hundreds of ways that many families take advantage of the tax laws. The mere threat of a trial is usually enough to negotiate a better deal than the one offered in the prenuptial agreement.

There are other ways in which prenuptial agreements can end up as costly disasters. In many states, prenuptial agreements have no effect on child support. Even if the prenuptial agreement were easily enforceable, there still can be protracted legal battles over child support that expose family finances. And it is logical to assume that merely insisting upon a prenuptial agreement can increase the likelihood of any subsequent divorce being more bitter. In many cases, the insistence upon a prenuptial agreement causes an emotional injury that may never adequately heal, especially in a marriage that does not succeed. After all, what better way to pay back the in-laws for the pain they caused when you were getting married than a court battle that promises numerous opportunities to embarrass the family?

Finally, most horror stories about the stock of the family business falling into "enemy" hands are largely apocryphal and overstated. Few people give an accurate, objective summary of what happened in a lawsuit in which they felt they were being taken advantage of or even blackmailed. On the other hand, since stock in a family business rarely pays dividends and has no real value unless the company is sold, it is doubtful that very many nonfamily members or ex-spouses genuinely want the stock for its value; rather, they seek the stock merely as a way of gaining leverage against their soon-to-be former in-laws.

Divorce lawyers will attest that judges award the stock of family business to nonfamily members or ex-spouses only under unique or the most bizarre circumstances. Certainly, few people want their cash tied up in a business that is managed by their soon-to-be-former-in-laws, who have none of the controls put upon owners of a publicly held business. People often use the threat of getting stock in the family business as a method to raise its value when the family appears to be cooking the books to create an artificially low value.

### *There Are Alternatives*

As a practical matter, a prenuptial agreement is simply not necessary to ensure that ownership of the business stays in the family without having to buy back stock at an unfair price. A family can accomplish these goals in ways that are emotionally neutral to the young couple and more comprehensively address the core issues involving ownership of the business.

- *A buy/sell agreement.* This is an agreement signed by all the shareholders that can prohibit the transferability of stock to nonfamily members without first giving all of the family members an option to buy the stock at the price offered by the outsider or at an even bigger bargain rate. In other words, stock could not be transferred to a spouse without the remaining shareholders being first given the chance to buy it at a fair price.
- *A liquidity agreement.* The company makes a standing offer to buy the stock of any disgruntled shareholder at a price determined by a formula specified well in advance by the stockholders (see above). Since few divorcing sons- or daughters-in-law really want to own the stock of the family business, a divorce judge would likely set the stock's value according to an outside formula (applicable to all shareholders) adopted long before the divorce, in order to avoid litigation on that issue.

- *Maintaining nonmarital property status.* In many states, not all of a married couple's property is subject to division by a court upon the dissolution of their marriage. Typically, property owned by a spouse prior to the marriage, or gifted to only one spouse and not intermingled with other assets, is legally considered nonmarital property and therefore not subject to division during a divorce. Under many circumstances, the stock of the family business can be maintained as nonmarital property, and will not be subject to the divorce.

Parents who continue to reject alternatives to prenuptial agreements might merely be expressing their desire to control their children's behavior. In other words, if the parents' true motivation is to reduce legal fees, keep family finances secret, avoid the use of business capital to redeem stock from a former daughter- or son-in-law, or keep ownership of the stock among family members, these alternatives may better accomplish these goals with little, if any, emotional impact on the marriage.

### **Twelve Great Reasons to Have an Advisory Board**

Many privately held companies are reluctant (with reason) to have a board of directors in which independent outsiders have real power. After all, it seems foolish to give independent outsiders the ability to shape the policies of a business in which they may have no stake whatsoever. On the other hand, having a board to which reports must periodically be made has a value of its own. It has become a popular best practice for privately held businesses to have an advisory board of this type. Some of these reasons may not apply to all businesses, but all of these apply to some businesses. Such a board can offer the following:

- I. Provides safety if CEO dies. If a company is dominated by one person, it's hard to find a comparable senior executive with the leadership ability to take over in an