Minority shareholders: Handle with care

Don’t think of inactive owners as a nuisance. Their patient capital means opportunities for the business.

By François de Visscher

Over the past few years, shareholder activists and their advisers have become increasingly vocal and demanding. Think of Liesel Pritzker, who sued her father, Robert Pritzker of the Hyatt Hotel family empire. And consider the family-owned Dow Jones & Co., where minority shareholder hostility created a corporate commotion.

The creation of a minority shareholder class is a fairly predictable event in the life cycle of a family company. Succession through multiple generations results in more inactive shareholders and dilution of ownership. The illiquid nature of stock in family-owned companies and the difficulty of keeping minority owners properly informed have heightened the demands, and in some cases the hostility, of minority shareholders.

Why should family business managers and board members listen to dissenting minority shareholders? In the past, it might have been expedient just to dismiss their demands. But in today’s environment, new corporate governance codes and bands of lawyers are fanning the fires. The nuisance factor alone can eat up tremendous amounts of management and board time and be very costly to the corporation.

Dealing with disturbance

What can you do when disgruntled minority shareholders threaten to disrupt your family company and destroy value for all owners?

• **Buy them out.** Buying out minority shareholders may seem to be the simplest way to deal with shareholder disruption. In theory, the business sets a valuation of the shares and uses its financial resources to provide liquidity to the minority owners. In reality, though, shareholder buyouts are very thorny to implement, for two reasons. First, it’s very difficult to get both sides to agree on value, particularly given discounting attached to

minority-stock valuation. Second, the financing needed to buy out minority shareholders may significantly hinder the company's future growth. A financial adviser can help you to bridge valuation gaps and develop a financing plan.

- **Install voting trusts.** If shareholder relations become impossible to manage, it may be time to set up a voting trust to enable the company to carry out its strategic plans.

In one Midwestern U.S. manufacturing company, six third-generation inactive shareholders who owned about one-third of the company were unhappy about the strategy pursued by the four family managers/owners. After buyout negotiations broke down and the inactive shareholders threatened to litigate, the active members of the family, joined by nine other inactive minority shareholders, decided to set up a voting trust and put all their shares into it. They elected the chairman and president—both active shareholders—as trustees to solidify control of that bloc.

Not surprisingly, the six marginalized minority shareholders tried to challenge in court the creation of the voting trust, but they were defeated. Also not surprisingly, while the company survived and continues to thrive, the family rift is unlikely to heal.

Voting trusts are a harsh way of dealing with minority shareholders, but they may be the only way when shareholders become so disruptive that management and the board cannot focus on company strategy. However, before looking into voting trusts and other voting structures, consult with an attorney to ascertain the legalities of such maneuvers in the company's jurisdiction.

- **Recapitalize the company.** This is an option when minority shareholders' demands have not totally destroyed relations with management shareholders. A recapitalization typically involves a private equity investor or partner. The most successful recapitalizations we've seen have occurred when all shareholders tender their shares at the same price. Those who want to remain in roll over some of the proceeds from the buyout into the new company. Those who want out receive the proceeds in cash or notes. There should be no disputes over valuation because all parties are getting out at the same price and reinvesting, if they wish, at the same price.

For instance, if a company with ten equal shareholders and no debt were

valued at $10 million, each shareholder would own $1 million worth of stock. Each of the ten shareholders would be given the choice of being bought out or staying with the new company. If three of the ten shareholders elect to stay on with the company, the recapitalization might be financed by $5 million in debt, $2 million in outside private equity and $3 million from the shareholders who remain with the company. Because of the debt, the total value of the company is no longer $10 million, but $5 million. Therefore, by reinvesting their $3 million worth of stock, the three remaining shareholders would see their equity position in the company increase from 30% to 60%.

• **Split up the assets.** Shareholder disagreements don't always occur because of liquidity needs. In many cases, shareholders have different views on the strategic opportunities for the company and its individual assets. In such cases, it would be opportune to explore splitting up the assets of the company, with shareholders owning different parts of the business. Whether they involve a spin-off or split-up of assets, the mechanics of such transactions are complicated and require detailed financial analysis.

In one split-up I'm familiar with, a transportation company happened to own significant real estate assets, both related and unrelated to the business. One of the three branches of the family had lost confidence in the managing branch's ability to run the transportation company, but these relatives were extremely bullish on the real estate. The family decided to split up the real estate into a real estate investment trust (REIT) for the benefit of those relatives, who redeemed their shares in the company in exchange for units in the REIT. Both sides of the family now manage their affairs independently, and the company pays rent to the REIT.

Managing patient captial

Minority shareholders can sometimes be a headache, but for forward-thinking family businesses, they also represent long-term, stable capital for the company. The best way to avoid minority shareholder issues is through regular communication and effective liquidity programs.

Watching for trouble and building relationships with your shareholders may safeguard the longevity of your patient capital. These suggestions might prove helpful:

• **Keep in touch with minority owners.** Family business managers have

a duty to understand minority shareholders' issues, which may affect future liquidity and investment needs. You could contact them informally or conduct formal meetings, surveys or interviews. Many families have used a family council or family office to keep management informed about shareholders' concerns.

• **Conduct shareholder information programs.** One of the most common complaints of minority shareholders in family companies is lack of information. Just as managers of a public company inform their institutional investors, managers of a family company must institute professional, transparent and regular shareholder information programs. This involves educating family shareholders about management challenges, strategic options and opportunities to create shareholder value. It's equally important to prepare shareholders to handle the information passed on by management. In many successful family companies, the family council and family office have taken on the task as part of their mission to educate family shareholders about general and industry-specific business concepts.

• **Provide effective, ongoing liquidity programs.** Patient capital does not mean trapped capital. The biggest deterrent to shareholder disturbance is the existence of effective, well-funded liquidity programs for shareholders. These programs should address the three critical liquidity needs of family shareholders: immediate liquidity, flexible liquidity and current income. There are many tools to address these liquidity needs, such as regular redemption programs, multiple classes of stock and clearly written dividend policies. The best time to propose and implement liquidity programs is when no apparent liquidity needs have arisen. Interestingly, companies that provide liquidity flexibility to shareholders and keep them informed about the business often find that few of their shareholders want to exercise their rights to liquidity.

It's important to remember that minority shareholders represent a significant portion of your capital structure, and the base of your patient capital. It's less painful to keep your minority shareholders informed and happy than to face more drastic measures.

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