



When Family Opens for Business

David R. Russell

Foster Swift Commercial Litigation E-News

July 1, 2010

Who better to go into business with than family? In some instances, the answer may be nobody. Family-owned companies make up eighty-nine percent of all business and employ sixty percent of all U.S. employees.¹ While family members may understand roles and familial bonds, there is a new set of legal rules and duties they must recognize when opening for business.

One of the fundamental rules in any business venture is creating a corporate entity to protect individuals from personal liability for the debts and liabilities of the business. To do so, the family may want to create a Limited Liability Company or a Corporation. There may also be some hybrid form of entity created depending on the circumstances, but normally the end goal remains the same - protect the individuals from personal liability. As part of that, the entity must keep up with "corporate formalities" such as holding annual meetings, memorializing votes, keeping accurate records, etc. These formalities must be followed to avoid a piercing of the corporate veil. When the corporate veil is pierced, the protection of the corporate entity is lost and individuals become personally liable.

UNDERSTANDING DUTIES

Once the entity is set up, the individuals become members or shareholders and are governed by either an operating agreement or a shareholder agreement. The requirements for the creation of a shareholder agreement are statutory.² This document sets forth such things as voting rights, meeting requirements, sale of interest, rights of members/shareholders, corporate succession and events for dissolution. In addition to the requirements under the governing document, the individuals may become fiduciaries, not just to one another, but to the entity itself. The law regards the entity as separate and distinct.³ This means the entity is seen separate from the individuals, and it may be owed contractual and fiduciary duties. Therefore, these contractual and statutory duties must be understood and followed.

AUTHORS/ CONTRIBUTORS

David R. Russell

PRACTICE AREAS

Business & Commercial Litigation

Commercial Litigation

Family Owned Businesses



LITIGATION TRIGGERING EVENTS

There are many causes of litigation in both family and non-family businesses. Many times the family business is a success, but family relations are not. This dynamic may lead to an event that triggers litigation.

Familiar triggering scenarios are a death in the family or a divorce. Family members may take sides when family drama unfolds. Sometimes one family member is at odds with everyone else. In this example, the members/shareholders may oppress that person's rights in the business; thereby potentially triggering a breach of the governing documents, fiduciary duties, or statutory duties. It is important for family members to remember that even during family turmoil, everyone is still bound by the governing document and statutory duties.

AVOIDING LITIGATION

To avoid a lawsuit, the shareholder/member must be cognizant of their duties under the governing document and any fiduciary duty they may hold to others and to the entity. It is said that good contracts make good relationships. A good contract, however, means nothing unless the parties understand the terms; thus each individual should take time to do the following:

- Contemplate scenarios that could unfold in the business relationship;
- Have every member/shareholder read and review, with their attorney, the governing document;
- Make certain that everyone understands their role in the company; and
- Ask an attorney to prepare a memo laying out the duties for each member/shareholder.

One can never fully insulate oneself from litigation, but one can minimize the risk. Oftentimes, individuals or family members never read the entity's governing document until a dispute arises. Becoming familiar with the governing document from the outset will minimize risk of later disputes when everyone already knows and understands what the document requires, they will be less likely to take actions that result in litigation. Having all members take part in the creation of the substance of the governing document is yet another way to protect against future disputes. Everyone should feel free to ask questions, and request changes that they think may be prudent.

As one can see, family members who go into business together must understand when they are acting in their familial roles and when they are acting as a Member, Manager, Shareholder, Officer, or Director of the entity. The initial up front costs in working with your attorney to set up the corporate entity may save you, your family, and the business a lot of unnecessary time and expense.

¹ *Once you Enter this Family There's No Getting Out*, 75 UMKC L Rev. 1085, 87 (Summer 2007),

² MCL 450.1488

³ *Elliot v Smith*, 47 Mich.APP 236, 240; 209 N.W.2d 429 (1973).