

# Divorce and death in the family firm: A business law perspective

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Almlöf, H., Haag, K., Sund, L., (2010), Divorce and death in the family firm: A business law perspective, *European Business Law Review*, 21(2), 101-118. <https://doi.org/10.54648/eulr2010008>

Original publication available at:

<https://doi.org/10.54648/eulr2010008>

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### *Subscriptions*

#### *European Business Law Review*

is published bi-monthly. Subscription prices for 2010 [Volume 21, Numbers 1 through 6] including postage and handling: EUR 740/USD 986/GBP 544 (print). This journal is also available online at [www.kluwerlawonline.com](http://www.kluwerlawonline.com). Sample copies and other information are available at [www.kluwerlaw.com](http://www.kluwerlaw.com). For further information please contact our sales department at +31 172 641562 or at [sales@kluwerlaw.com](mailto:sales@kluwerlaw.com).

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This journal may be cited as [2010] EBLR 101-265.

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**ISSN: 0959-6941**

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# Divorce and Death in the Family Firm – A Business Law Perspective

LARS-GÖRAN SUND\*, HANNA ALMLÖF\*\* AND KAJSA HAAG\*\*\*

## 1. Introduction

A significant number of articles and books in family business research focus on succession planning – or the lack of it – in family firms. Most studies focus on management succession while few deal with succession of ownership. Considering that family businesses are in majority in most economies, succession concerns all the levels of family, business and society (Sharma, 2004). Only a limited number of scholars focus on succession through unexpected events, like divorce and death, or preparations for such occasions. This gap will be further elaborated on where we discuss the current status of family business research.

The paper identifies potential problems because of the business law system, which can have a negative effect on the family firm, particularly how unwanted acquisitions of shares, in case of the divorce or unexpected death of a shareholder, can pose a threat to a successful business. Further, the aim is to present tools that can be used by shareholders and their advisors to counteract these drawbacks. Even though legal instruments can limit the negative consequences, due to legislation on divorce and inheritance, the sole effective alternative in order to abolish the drawbacks is to alter the legal framework. Therefore, we find it urgent also to address the EU Commission and national legislators on the issue of future regulations. It is especially important that the EU Commission, when amending the Recommendation on the transfer of small to medium-sized enterprises (OJ L 385 1994), also includes sudden events, such as a divorce, since these can also induce transfer of shares in SMEs as well as overthrow a well planned future succession.

The method used to assess the law is the traditional approach in legal science, ie, we use legal sources, including statutes as well as leading legal writing. We also shortly compare legal rules and solutions in a few Western countries. The paper entails aspects from business administration, which provides a multidisciplinary approach.

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The concept of *family-owned firm* has been defined in many ways. Within management literature, a family business is rather frequently defined as a firm in which family members dominate the ownership, are involved in management and perceive their firm as a family business (Sonfield & Lussier, 2004; Hall, Melin & Nordqvist, 2001). We focus on small to medium-sized businesses (SME) and define a *family owned SME*<sup>1</sup> as an unlisted company limited by shares and owned by not more than four families or individuals, who together hold more than 50 percent of the shares (voting power). At least one family-shareholder influences management, as CEO or member of the board. Alternatively, the family or families exercise an indirect influence through a family council, or similar. Another aspect of these firms is that a qualified majority of the shareholders wish the business to remain in the family. The shareholders can be manifold, as long as there are not more than four owner-families. Behind this definition lies the endeavour to capture businesses where there is some form of overlapping of roles between owners, leaders and family members, as depicted by the Three-Circle model (Tagiuri & Davis, 1996; Gersick, Davis, Hampton & Lansberg, 1997; Gersick, Lansberg, Desjardins & Dunn, 1999).

A *family* is constituted by husband and wife, or cohabatees, and their descendants, including adopted or step children and officially recognized foster children. Since we adopt a succession scenario, also nephews and nieces, as well as their offspring, are included in the family concept. Further, we regard the spouse of a child as a family member, since s/he will have an influence on the next generation.

Before we continue with the questions on divorce and unexpected death respectively, it is relevant to look further into how succession in family firms has been treated so far.

## 2. Succession in Family Businesses

Succession of *leadership* in family businesses is an important and complex matter. It has been identified as the No. 1 concern of top executives (Chua, Chrisman & Sharma, 2003) as well as the most critical issue facing family firms (Ibrahim, Soufani & Lam, 2001). It is commonly described as a process consisting of several steps. These steps often comprise some sort of initiation, integration, joint management and ends with retirement of the predecessor (Cardieux, Lorrain & Hugron, 2002; Murray, 2003). This model assumes that the predecessor will stay involved throughout the process. However, if succession is caused by unexpected death, this can never be the case. Planning is often pointed out as the key to effective successions (Santiago, 2000). This planning is largely depending on the incumbent owner manager (Sharma, Chrisman & Chua, 2003) but against their human nature according to Brockhous (2004) since it somehow means to plan for making themselves disposable. Without any succession planning the family firm

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<sup>1</sup> A *SME* is defined as a closely held limited company with a maximum of 250 employees, which partly coincides with the definition by the EU Commission (2003/361/EG).

may, in a worst-case scenario, face its demise (Goldberg 1997) or severe problems when the heirs have to find a new leader (Bowes, 1991; Santiago, 2000). Yet, approximately half of the companies in a study by PriceWaterhouseCoopers had no succession plan what so ever (PWC 2007/08). Further, in practice, the process is mostly not properly prepared (Gersick et al., 1997).

Planning for the succession of *ownership* of SMEs is also crucial, which is emphasized in the EU Recommendation (1994). However, planning for transfer of shares within the family partly demands a different approach compared with leadership succession, e.g. tax planning (Sund & Melin, 2008). Transfer of shares within the family is by some described in terms of four phases: Initiative, planning, execution and follow up (Bjuggren & Sund, 2005). In family firms, the separation of ownership and leadership is often vague which further increases succession complexity and must be taken into consideration.

Granted, planning for succession is utterly important. Still, there are areas which have so far not been met with adequate scholarly attention.<sup>2</sup> When succession is caused by unexpected events, it is too late to start planning. Sudden events cannot be truly *planned* for, but the family and other close stakeholders can *prepare* themselves on how to cope with the unexpected. In order to do this, the entrepreneurs and their advisers must have a genuine understanding of what could happen, eg what are the legal and economic effects in case of a sudden divorce or death. Therefore, it is relevant to look further into what happens in case of unplanned successions and if there are any precautions/preparations to be made in that regard.

The *literature on unexpected* events of this type is limited. In one article from 2001 Steier explores modes of transferring social capital from the older to the younger generation, ie unplanned, sudden succession, rushed succession, natural immersion, planned succession and deliberate transfer. He identifies these modes, but does not further explore their consequences. Brown (2003) emphasizes preparations for the unavoidable, namely change (in life). In one book, she deals with sudden death and provides a 'fire drill' of preparatory arrangements, such as writing down the address to eg relatives and accountants and the location of the last testament. Additionally, she emphasizes useful information on professional advisors as well as through an extensive estate planning. She also stresses the importance of establishing strategic goals, ie what is most important: The heirs' possibility to handle wealth, business continuity or family harmony? Once decided, the next question is of a tactical character. How is eg business continuity achieved? The contributions from Brown (2003) are highly valuable. However, while she tackles the problems from a mainly family perspective, we choose a business and business law angle.

According to PWC (2007/08), two-thirds of the respondent had made provisions in case a manager or shareholder becomes incapacitated. However, the extent of these

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<sup>2</sup> For a more thorough assessment of family business research in general, including succession in particular, we refer to the excellent review articles already available (see for example Handler, 1994; Sharma, Chrisman & Chua, 1997; Bird, Welsch, Astrachan & Pistrui, 2002; Brockhous, 2004; Sharma, 2004; De Massis, Chua & Chrisman, 2008).

provisions is questioned. Further, also other unexpected events, such as a divorce, should be considered. On the topic of a shareholders divorce and its potential effect in a family firm, Cole and Johnson (2007) has explored the opportunities for spouses, who are companions and go through a divorce, to continue as ‘copreneurs’. In such cases, the former spouses have a joint interest in avoiding the family turmoil hampering the business.

This part has briefly introduced succession as a research topic and pointed to the importance of better understanding of unplanned transfers of owner- and leadership. The paper will now continue to explore this area of succession by offering a mainly business law perspective on transfers caused by divorce and death.

### **3. Divorce**

#### *Introducing Divorce*

Divorce is common in the Western world. For example, in Sweden, the divorce rate in 2007 was 43 % but the average rate during the last decade (1998–2007) was 53 % (Statistics Sweden). According to one study, 21 percent of family-business owners experienced at least one divorce during a five-year period (MassMutual, 2002). However, we believe that few business owners prepare for a divorce or separation (between cohabitees). For example, only 9.7 percent of the participating families had a pre-nuptial agreement (MassMutual, 2002). Further, divorce is often forgotten as a triggering event in transfer restrictions (Morrow, 2001). In family businesses, where the owners often are also the managers of the business, a divorce of a shareholder may have an impact not merely on the spouses, but also on co-owners and managers. First, we broadly describe the legal situation in Western countries in case of a divorce. Next, we give a detailed example, illustrated by a case vignette based on Swedish matrimonial law, in order to describe the impact of divorce on the close stakeholders. Further, some tools for shareholders and their legal advisors are presented. Last, we briefly compare with the legal situation in a few other countries and present one important legislative alternative.

#### *The Law on Divorce in General and a Detailed Example*

Broadly, only omitting a few details, division of matrimonial property follows the same pattern in the Western world: All the property owned by each spouse is included. The only exception is separate property according to eg a matrimonial settlement. Thus, the shares in the family business will be included except if they have been transformed into separate property. The debt of each spouse is deducted and the total net value is divided equally. The deducted debts are added and the sum constitutes the so-called value share of each of the spouses. Thus, due to legal rules the division protects the financial interests of the spouse who owns relatively less property.



Even though the main features of family law on divorce is common in Western countries, the details still differ. Below, a case vignette is used to illustrate the effects of a divorce for the shareholder, her spouse, the co-owners and the firm. In order to provide a realistic picture, also details of a legal system must be taken into account. Therefore, we use the Swedish system as a starting point.

A owns one third of the shares in Alfa Ltd. The other shareholders, X and Y, hold equal parts of the stock. A’s husband B files for a divorce, which is granted. The market value of A’s shares have been estimated to one million Euro and her other property has a value of € 100,000. The debts of A amount to € 200,000. B’s property has a value of 200,000 and his debts are € 100,000. The division of matrimonial property is pictured as follows:

	A	B
shares	1,000,000	-
other property	+ 100,000	+ 200,000
debts	- 200,000	- 100,000
	<hr/>	<hr/>
	900,000	100,000
	↘	↙
	↙	↘
	500,000	500,000
deducted debts	+ 200,000	+ 100,000
	<hr/>	<hr/>
value share	700,000	600,000

When the value share is filled out with assets, each of the parties has a right to keep his or her belongings. In this case, A decides to keep her shares, as well as other property. Thus, the value of her total property (1.1 million) exceeds the value share (700,000) with € 400,000. Then, the ex-husband can claim compensation, which can become costly for the business. This will be further elaborated on in the next subsection.

*The Effects for the Shareholder*

In the case above, A’s shares have a higher value than her value share, after division of the matrimonial property. If she decides to keep them, the ex-spouse (B) must be compensated, if claimed. In most cases, this is financed through a personal loan. (For other alternatives, see Drake & Lawrence, 2001.) Mortgages and interest are mostly paid with money withdrawn from the firm. Withdrawals, in the form of an additional salary or dividend, are taxed which results in additional drainage of capital from the company and the total cost for the firm may become manifold higher than according to the terms of the loan (depending on eg national tax

law). It will put a financial burden on the business, which sequentially may hamper risk willingness and the capacity to make investments (Astrachan & Tutterow, 1996; Galbraith, 2003; Rutherford, Muse & Oswald, 2006).

The alternative for the shareholder, to abstain from shares in the business in favour of the ex-husband, may have an even more devastating impact, not least for the co-owners.

### *The Impact on Co-owners*

In the case above, the ex-husband (B) can become a new shareholder, which may turn out to be disturbing for the delicate balance between co-owners. Further, a divorced spouse becoming a new shareholder can also affect the composition of the company board, which in turn has potential to change the strategic direction of the firm. An even more aggravated situation occurs in the likely event of the ex-husband selling his new shares to either an external person or a previous shareholder, again resulting in a disarrangement of ownership positions. Such prospects can spur the co-owners to use eg buy-sell agreements in order to buy out the new shareholder, which we further deal with in the next sub-section. However, a buy-out may require a personal loan, which will, as mentioned, become costly for the business.

### *Tools for Shareholders and Consultants*

The shareholders and their advisors can tackle the described problems from two different angles: firstly from a family law perspective and secondly from a contract and company law angle. The two alternatives can, and often should be, combined and used supplementary in order to uphold maximum effect.

Seen from the first angle, spouses can through a matrimonial settlement state that the shares are separate property, which is not included in a division of property. In most cases such an agreement has to be made before the marriage, otherwise the spouse, B in the example above, may not be willing to enter the deal. If the ownership of shares was transferred from an older generation to the current owner, eg through a gift or a will, it must be taken into account if a donor had stated that the gift was to be separate property of the beneficiary. In such a case, the shares will not be included in the division of matrimonial property; thus, the donor has avoided future acquirements of the shares by a spouse through divorce. In some countries all property given or tested to one of the spouses will, also without such a statement, be alienated from a division.

For example, if the shares in the previous case vignette are separate property, they will not be included in the division and, thus, the family business will not have to face the risks linked to either having a new co-owner or financing a buyout of the shares from the same person. When the shares are not included, it is depicted the following way:

	A	B
other property (than shares)	+ 100,000	+ 200,000
debts	- 200,000	- 100,000
shares (as separate property)	-1.000,000	-
	<hr/>	<hr/>
	0	100,000
	↘	↙
	100,000	↘
	↙	50,000
	50,000	
deducted debts	+ 100,000	+ 100,000
shares	1,000,000	0
	<hr/>	<hr/>
value share	1,150,000	150,000

When A’s shares are not a part of the division of matrimonial property, her value share will include the shares and if she decides to keep them, as well as other belongings, the value of the property (100,000 + 1,000,000=) € 1,100,000 is lower than her value share (1,150,000) according to the division above. Further, if B decides to keep his belongings, the value (200,000) will exceed his value share (150,000) and, thus, he has to compensate A with € 50,000. Compared with the first scenario (when the shares were included in the division), the staggering difference in value shares (for A 700.000 versus 1,150.000) means that A instead of compensating B with € 400.000 now can claim € 50.000 and thus continue as a business owner and leader without alienation of shares and disturbances caused by having a new shareholder or costs for buying him out.

Seen from the second angle, the shareholders can make agreements which hamper the possibilities for a spouse to acquire shares via a divorce. Co-owners cannot only rely on a matrimonial settlement since the spouses can easily amend or withdraw such an instrument. For example, rights of first refusal, post-sale purchase clauses or buy-sell agreements can, depending on the national company and contract law, be included in the articles of association or in shareholders’ agreement. In such a case, the companions may have the right to buy the shares before or after ownership has passed to a spouse through division of matrimonial property. Divorce is, however, often neglected as a triggering event in these instruments (Morrow, 2001). Further, a buy-out can become a very costly way of keeping a stable circle of shareholders (Sund & Bjuggren, 2007). For example, if A’s shares in the case above are not separate property and acquired by B and if they are, in accordance with a buy-sell agreement, bought by the companions, these can have to pay a considerable amount. Later the shareholders can demand compensation in the form of eg an additional dividend.

*A Few Details in other Legal Systems and One Important Alternative*

A division of matrimonial property, as part of a divorce process, seems to follow the same patterns in other Western countries, eg in England and Wales (Drake & Lawrence, 2001; Hamilton, 2002; Cretney & Masson & Bailey-Harris 2003) and the USA (Katz, 2003; Oldham, 2007). One main difference is that a judge, in a divorce case, has wider discretionary authority in England/Wales and the US. For example, the separate property, according to a marriage settlement, may in these countries be included in a division of matrimonial property.

According to the main rule in German Law, as an example of another main difference, only the accumulation of the value of the property of each spouse, from the date of marriage to divorce, is divided equally – ‘Zugewinnausgleich’ (Börger & Engelsing, 2005; Schwab, 2006). In detail the differences are manifold.

Typically, marriage settlements and transfer restrictions can be found in all legislations. The impact of these instruments on the potential negative effects, in case of a divorce, on a family business varies. Further, the creation of the tools can be time-consuming and build up expensive consultancy fees. This can deter owners from creating the necessary instruments to avoid unwanted acquisitions of shares. Additionally, the instruments are not always sufficient since a marriage settlement can be withdrawn and transfer restrictions are sometimes bypassed (See further by eg Pennington, 2006, pp. 925–927.) In addition, buying out a new shareholder can become costly not least for the family firm. Thus, it is important to find other opportunities to counteract the drawbacks of the instability of family unions.

An alternative is found in the Austrian Family Law system, 82 § Ehegesetz 1938 – EheG, according to which certain property is not included in a division of matrimonial property in case of a divorce, eg shares in a family business. The legislators wish to avoid jeopardizing the survival of the business due to acquirement of shares via a division of matrimonial property (Kriegler, 2002; Hinteregger, 2004; Schwimann, 2007).

We devote the rest of this subsection to the Austrian legal system. We find their solution important for the future of family firms, since it limits the illustrated drawbacks when shares in a family firm are included in a division of matrimonial property.

The rule in 82 § EheG has been criticized by Austrian authors. (See, among others, Wilhelm, 1983; Gimpel-Hinteregger, 1986; Nowotny, 1988). Without being experts on Austrian Law, we believe that the rule can be criticized from five angles, which we will elaborate on in the following. We assume that spouse A started the business and is the sole owner of the shares in the family firm. Spouse B has contributed, in one way or another, to the accumulation of wealth in the business. According to our opinion, the possible angles of criticism include the following:

1. B has invested money, or other property, which can be part of a division of matrimonial property, in the business. In Austria such an investment will be part of the division but only if it does not jeopardize the survival of the firm (91 § EheG).

2. Investments in money, or other property, by B in the joint dwelling and other family matters, have made it possible for A to invest in the business.
3. The system opens up for manipulations, eg if A transfers property, which otherwise would be included in the division of matrimonial property, to the business (Deixler-Hubner, 2004).
4. B has contributed to the wealth of the business by a substantial amount of work, be it operational or managerial tasks, in the business. In Austria there are, in such a case, legal possibilities to remunerate B (98 § ABGB).
5. B has put all his efforts into home and family. Thereby B has made it possible for A to focus on the development of the business.

It appears as if the rules are a result of legislators weighing two opposite interests. First, the business interest of not splitting the ownership of a majority shareholder or, at least, not causing a financial burden for the company when a remuneration or dividend is raised in order for a majority shareholder to compensate a spouse who has acquired shares via a division of matrimonial property. Secondly, the interest of the previous spouse (B) to be awarded a part of the accumulation of wealth in a successful business. It seems as if the critics are arguing only for the latter interest.

In our opinion, the criticism presented under p 1 and p 4 is relevant and should be accounted for. However, the criticism under p 2 and p 5 can be met with the argument that B has no responsibility for the debts of A, if the business goes bankrupt. In limited companies, the shareholder(s) has no responsibility for the debts of the firm. However, money invested in the business has often been acquired through a personal loan and a shareholder can stand in surety for the credit of the business. Further, also the interest of employees should be considered. If costs, or other similar effects, due to a division of matrimonial property, hamper the possibilities to make investments, or risk willingness, it has a potential to jeopardize the future of the business and sequentially employments. This group has no opportunity to support their interests in a divorce case. Additionally, critics emphasize the risk for manipulations (p 3). However, any solution will give room for fraudulent behavior. Further, if A's valuable shares are alienated from the division of the matrimonial property in case of a divorce, it would be unfair towards B, who is assumed to have invested his money in the joint dwelling, if A has a legal claim on half of the value of the house, furniture, etc. Adjustment rules have to be introduced. On the other hand such rules may not deprive A of a legal right to all items in the joint dwelling. Personal chattels have to be reserved for the owner. The crucial question is whether legal systems where a person can gain ownership of shares in a family business just by marrying and divorcing a shareholder can be argued to be fairer. We believe not.

### *Short Conclusions for the Case on Divorce*

To us, the Austrian legislators have created an example to follow. This approach enhances the possibilities for family businesses when shareholders are facing a

divorce. As previously mentioned, the shareholders often have to use expensive and sometimes insufficient instruments (eg marriage settlement and transfer restrictions) in order to avoid the drawbacks of the rules on divorce. In our opinion, legislative efforts are necessary.

We have reasons to learn from the Austrian experiences. However, we should not merely copy their legal approach, but use it as the starting point. Considering the critique in the Austrian legal writing, we believe the system can be further developed. If B has worked in the business, or invested money, he should be compensated. Manipulations by A, eg investing money in the business which otherwise would be a part of a division, must be taken into account. A manipulative intent may be difficult to prove, though. If B has invested all his money and work into the house and family and thus made it possible for A to focus on the business, each has taken a risk. No one should, as a main rule, be liable for the risks – eg loans – which have been entered into by the other, nor be able to grant from an accumulation of wealth through divorce should the investments (risks) turn out in a favourable way. However, the rule must be optional, thus allowing the spouses to enter agreements with another outcome.

In our opinion, the legislators should promote the interests of the firm, not only family members, on these sudden events. Also a carefully planned succession of a family owned business can today in most countries be overthrown by a sudden divorce.

#### **4. Unexpected Death**

##### *Introducing Unexpected Death*

As has been shown in the PWC study (2007/08) businesses can rarely be expected to have fully prepared for all aspects of a sudden death among the shareholders. In our opinion, the legal framework prepares entrepreneurs in family businesses better for transfer of leadership than ownership succession. The reason is that, according to requirements in national company law, the board of directors are either consisting of several persons and/or deputies are required. In addition, management can consist of, besides a CEO, one or more deputies. Even if the firm loses one of its key persons, the mandatory legal rules enhances the possibility for the business to work continuously. Concerning ownership succession the situation is different. Family and inheritance law regulates such a transfer in cases of divorce and death among shareholders. The object of such rules is primarily to protect the individuals of a family, especially a surviving spouse, without taking into account what best serves the interest of the business. Thus, it is not as crucial to prepare for the impact of sudden events on leadership questions as it is to prepare for the effect on ownership positions, for example a sudden death among shareholders

First, we broadly describe the legal situation in Western countries in case of a death. Next, we give a detailed example, on the bases of Swedish inheritance law, in order to describe the impact on close stakeholders. Further, some legal instruments

for shareholders and their legal advisers are presented. Last, we briefly compare with the detailed legal situation in a few other countries and present shortly one important legislative alternative.

### *The Inheritance Law in General and a Detailed Example*

In case of the death of a shareholder, a new owner will acquire the shares, be it through a testate or intestate inheritance or a sale from the estate of the deceased. In case of an intestate inheritance, from an unmarried shareholder, the descendants will inherit all the estate of the deceased. A more complex situation occurs if the deceased was married. In most cases, half of the joint matrimonial property will be granted to the spouse, following the division of this property. It will, similar to a divorce, include the shares, or the value of them, as long as the shares are not separate property of the deceased. In most Western countries, the spouse will inherit the rest, or a certain quota, also shares that are separate property, which serves the financial interests of a surviving spouse. The most important exceptions can be found in cases where the deceased has a descendant who is not an offspring of the surviving spouse or has written a will, which leaves the property to someone else.

Example: If A, in the previous case vignette dealing with divorce, is deceased, the surviving spouse B will, according to the main Swedish rule for intestate succession, inherit all the estate of the deceased (after division of matrimonial property). This includes the shares in the family business (Alpha Ltd) even if they are separate property. If the deceased spouse has not written a will with one or several of the joint children as beneficiaries, the descendants will have to wait for an inheritance of the shares until the death of the surviving spouse, unless he waives the right to inherit. The outcome can cause, for example, inconveniences for the companions (X and Y), such as if B becomes a passive shareholder, or severe problems, if B eg sells the shares to an outsider, perhaps even a competitor. On the impacts on co-owners, see further in the next subsection.

### *The Impact on Co-owners*

In the following we assume that a surviving spouse, who has no or limited experience from the business, has inherited the shares in the family firm from the deceased. Further, the surviving spouse, despite having no interest for the firm, declines waiving his/her inheritance. There are two joint children, who have both taken part in operational tasks of the business. The deceased held the position as CEO.

If the deceased owned a majority of the shares, the surviving spouse will be in the same position. This will upset a usually delicate balance between shareholders. For example, if one or both of the children have positions in the company board, they may, with support from the surviving spouse, push for one of them becoming the next CEO. With support from the majority owner, they control the annual meeting of

shareholders, which has a direct influence on who will hold positions as members of the company board, which in turn controls who will become the new CEO.

Should the surviving spouse inherit a minority ownership of shares, the disturbance of the balance is less potentially detrimental. Another shareholder, in a majority position or with the assistance of other owners, can control events.

### *Tools for Shareholders and Consultants*

The legal instruments to use with the aim of avoiding these problems are as follows:

1. A testament by the owner. However, if one child is the sole beneficiary of the shares in the family business, the siblings may, depending on the national inheritance law system, claim a lawful portion of the estate. Thus, in a worst-case scenario, the shares can be scattered between siblings who show problems to cooperate as well as a limited interest for a successful business.
2. Co-owners can control the ownership of the shares by using clauses in the articles of association or shareholders agreement, eg a post-sale purchase clause or a buy-sell agreement, to buy out the new shareholder. This can turn out to become costly, though.

On the other hand, if the surviving spouse has taken active part in the business, especially in management, the inheritance may turn out to be beneficial for the firm, at least if the spouse is willing to succeed as CEO or otherwise assist other shareholders.

### *Other Legal Systems*

An intestate succession seems to follow the same pattern in other Western countries, eg in England and Wales (Kerridge, 2002; Lowe & Douglas, 2007), Germany (Börger & Engelsing, 2005; Schwab, 2006) and the USA (Leslie & Sterk, 2006; Herskowitz, 2007). Of course, in detail there are many variations. An important difference is that a surviving spouse inherits a quota of the estate of the deceased (after division of matrimonial property), eg one third or half of the estate or a lump sum, not all of it as in Sweden.

Even if it is, depending on the national legal system, possible for the shareholders to limit the potential negative impact of a death among shareholders on the family business by using various legal instruments, it – again – seems important to find other opportunities. One example can be found in Finland. According to their inheritance system a surviving spouse will, after division of the matrimonial property, only inherit the deceased spouse's share of the joint dwelling, furniture, etc., not eg shares in the family firm (Luomaranta, 2002).



*Short Conclusions for the Case of an Unexpected Death*

Preparing for an inheritance, using eg a marriage settlement, a testament and transfer restrictions, takes time and can build up consultancy fees. Further, the legal instruments are not always adequate in order to prevent unwanted acquisitions of shares and to buy out a new owner can become expensive and put a strain on the finances of the business. The Finnish solution seems more in line with what can be assumed to be the ambitions of most shareholders in family firms, namely to hand over the business to a younger generation (eg European Observatory for SMEs 1996, p. 187; Burley 2002; MassMutual 2002), if nothing else is planned. Thus, they do not have to spend time, energy and money on a coming inheritance, if the rules for intestate succession anyway coincide with their ambition. Further and as previously mentioned, also a well planned succession of ownership between generations can be overthrown by the sudden death of a shareholder.

**5. Concluding Remarks**

Unexpected events among shareholders that may have an impact on business performance are many and diversified. Here we deal with two, divorce and death. (For other examples, see eg Harvey & Evans 1994; Steir 2001.) Both are, as such, complex phenomena, as are their impacts. We are mindful that we have limited this paper to mainly legal aspects and omitted eg social and emotional constraints.

We would like to emphasize that the potential impact of divorce and death on business performance makes family firms unique. Shareholders in other types of businesses do not face the same threats, since ownership and management in limited companies are separated. In listed companies, most shareholders do not aspire to leading the business. Their interest is limited to dividends and capital gains when selling the shares. It is likely that the same applies to unlisted companies which are not family firms. In most cases, the owners are not planning for a succession of the ownership within each shareholders family. Instead, they may want to cash in when the shares have reached a certain value or when they consider it time to retire from the firm. In these businesses, divorce and inheritance are relatively less important issues for those who own and head a company. Instead, it becomes more of a private matter. A separation of leader- and ownership is in most cases only fiction in a family firm. Sudden death and divorce among shareholders are typically of major importance, affecting both leader- and ownership, especially for those who intend to run a business during several executive generations.

From this paper, conclusions can be drawn through different angles of the subject. First, we present our contributions relevant to the shareholders and their advisors, secondly we address how the problems can be minimized or avoided by actions from the policymakers (legislators), and finally we indicate contributions for family business research as well as legal research.

*Contributions to Shareholders and Advisors*

This paper contributes to entrepreneurs and their advisors by emphasizing the importance of specified preparations for the event of an unexpected divorce or death. Such occasions are not planned, as is the transfer of leader- and ownership from one generation to the next. However, to a certain degree preparations for sudden events can be made.

In a country where, according to the family law system, the main rule is that all property is, in case of *divorce*, included in a division of matrimonial property, also ownership of shares in a family business will be affected. If, in addition, the divorce rate of a country is high, the system compels the spouses, or donors or testators, as well as business leaders and co-owners, to act in order to avoid potential negative impacts on business performance. To avoid the drawbacks different legal tools can be used: (1) A matrimonial agreement between the spouses, (2) a statement by a donor or testator that the shares are separate property and (3) implementation of transfer restrictions by co-owners in the articles of association and shareholders agreement.

In case of the *death* of a shareholder, it seems odd with a system where, according to the main rule on intestate succession, a surviving spouse inherits all the shares. An *inheritance* by a surviving spouse seems especially odd, if the shares are separate property of the deceased according to a statement of a donor or testator. Both have shown that they wish to avoid a situation where the beneficiary is deprived of the shares in case of a divorce. Still, a surviving spouse can inherit the shares. To avoid unwanted acquisitions the following tools can be used: (1) A shareholder can make a will and (2) co-owners can insert transfer restrictions in the articles of association or shareholders' agreement.

*Conclusions for Policy Makers*

This paper holds that it is up to the legislators to act with the purpose of making the legal environment beneficial for family owned businesses. In both the case of a divorce and an unexpected death, as concluded above, the shareholders can limit the drawbacks of the legal system by using relevant and well known legal instruments. However, due to the complexity of the legislation, the shareholders must invest time for the process as well as money in consultancy fees in order to limit the negative effects of the legal system. Further, not all impacts can be avoided. Therefore and as a major finding of this paper, it lies in the hands of the policy makers to make relevant changes in the legal system.

The EU-Commission has in a Recommendation on the transfer of small to medium-sized enterprises (OJ L 385 1994) urged the member states to enhance handovers of ownership in all SMEs, eg by abolishing or lowering estate taxes. However, the special situation for family-owned businesses is not recognized in the Recommendation. (See further by Sund & Melin 2008.) Further, transfers of ownership through sudden events, such as divorce or death among shareholders, are ignored (with the exception of inheritance taxes) in the same document.

In our conclusion, shares in family owned SMEs should not be included in a division of matrimonial property in case of a divorce (compare the Austrian legal system under Divorce/Other Legal Systems). Another possibility is if the legislator implements rules according to which shares in unlisted firms are not included in a divorce settlement if they are subject to transfer restrictions according to the articles of association or shareholders agreement. In this way the alienation of shares, from a divorce, is not due to direct stipulations in the legal system, but depends on the initiative of the shareholders.

Further, legislators should establish a main rule, where the descendants of a shareholder are *presumed* to be the best new shareholders for a family business, and thus inherit the shares. (Compare Finland in Unexpected death/Other legal systems above.) Of course, the children may be too young or have other interests. However, if we consider it important that the offspring of owners of family firms continue to run a family owned business, the closest solution is to make it as easy as possible for them to become new owners (and managers) of the family firm. Thereby the inheritance system can make an important contribution to make use of idiosyncratic knowledge, established business networks and a relatively high degree of loyalty to family, firm and local community (Bjuggren & Sund, 2001; 2002; 2005). Spouses can always make a will altering such a system, especially in favour of a surviving spouse when both have taken active part in the business.

We further emphasize the importance of the EU Commission – when altering the Recommendation from 1994 – also include sudden events which have an impact on ownership positions. If we picture the scenario as a ‘fire drill’ (Brown, 2003), it certainly is as important to prepare for unexpected events in life as it is to plan for the unavoidable succession.

### *Contributions to Research*

From a business law perspective, we show how the legal system prioritizes family members instead of business aspects. The legal rules on distribution of shares, in case of divorce or death among shareholders, are not concerned with the survival and success of the family firm. However, a paper partly dealing with detailed legal problems has one immediate limitation: it is not possible to deal with all legal systems. This national obstacle can, in our opinion, be reasonably well-handled if there are a sufficient number of scientific articles, books, etc. that cover the same problems from different national angles. Hopefully, this article will inspire others to write about similar legal problems in their countries. There is obviously a need for further research, not least of a more detailed and comparative nature. For example, in which countries and under which circumstances can or cannot shares be acquired through a divorce? Further, which legislations present an unlimited preference for a surviving spouse in case of an intestate inheritance?

The field of family business research benefits from multidisciplinary attention. This paper contributes with a mainly legal perspective on family business transfers. Planning for the unavoidable succession process is obviously paramount for the

transfer of owner- and leadership between the generations. However, this should not blur necessary preparations for what could unexpectedly occur (eg a divorce or a death among the shareholders) on the journey to a successful execution of a well-planned succession.

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