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Learning From Others' Mistakes: Succession Planning To Avoid Family Business Blowups

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MIDDLESEX, SS. SUPERIOR COURT
C.A. NO. 90-2927

ARTHUR S. DEMOULAS
vs.
DEMOULAS SUPER MARKETS, INC. & others

FINDINGS OF FACT, RULINGS OF LAW, AND JUDGMENT

Introduction

This is my [brother], mine own Telemachus,
To whom I leave the sceptre and the isle,--
Well-loved of me, discerning to fulfil
This labor, by slow prudence to make mild
A rugged people, and thro' soft degrees
Subdue them to the useful and the good.
Most blameless is he, centred in the sphere
Of common duties, decent not to fail
In offices of tenderness, and pay
Meet adoration to my household gods,
When I am gone. He works his work, I mine.

Alfred Lord Tennyson, "Ulysses"

This case involves a supermarket and real estate empire created by two brothers, Telemachus and George Demoulas. George died in 1971 leaving his wife and children's welfare in the hands of Telemachus. This poem by Alfred Lord Tennyson would have been an appropriate farewell by George to Telemachus. As the facts demonstrate, our modern day Telemachus has not lived up to his literary namesake.

Three Case Histories

Case One.

This case involved a family oil business. The founder had two sons and two daughters. One son died accidentally before the founder's death. The other son had a mental illness which prevented him from participating full-time in the business although his father did make him an officer and a director. This son had two grown daughters before his father died. The two daughters of the founder were uninterested in participating in the business. One of these daughters had a daughter who married a local high school athletic coach. This gentleman joined the business and, by the time of the founder's death, had risen to a position of authority in the business but had been divorced from the founder's granddaughter.

At the founder's death, the company was a Subchapter S corporation, all of its stock was held by his children and his grandchildren with no one in a majority position and the Board of Directors consisted of the surviving son and his two daughters, the coach and his ex-wife and the two daughters of the founder. The coach, with the help of his ex-wife and her mother and aunt seized control of the business. He ran it for his own benefit and paid himself an enormous salary. He refused to make sufficient distributions from the company so that its shareholders could pay the taxes on their allocable share of the company's income. Finally, he began diverting corporate opportunities for his own benefit. The three women, the ex-wife, her mother and aunt, allowed this to occur for two reasons: some of the largesse the coach was accruing flowed through to the ex-wife and her children and, also, they were passive shareholders and directors who did not believe their brother and uncle was capable of taking over the reins of the company.

In other words, the founder had left his company with no plans for succession and his family with no protection from the villainy of an outsider. We brought suit on behalf of the surviving son and his two daughters. After a lengthy and costly court battle, these shareholders were bought out by the company and the coach was permitted by the other family members to continue his despoilment. This certainly could not have been what the founder would have wanted to happen.

Case Two.

This company produces a very specialized product of limited application. Its customer base was relatively narrow but very steady and it enjoyed a dependable profit each year of operation. The company was founded by five gentlemen who had worked together in the same industry at another company. The company was formed with Class A voting stock and Class B non-voting stock. Both classes had the same dividend rights. One of the founders was the original President and Chief Executive Officer of the company. He was succeeded by two of the other founders.

By the time the third founder had acceded to the Presidency, he had managed to acquire a majority of the Class A voting stock. This gentleman had four daughters and a son. He brought the son into the business but the son never evidenced the capabilities to succeed the father. Meanwhile, he began to rely heavily on another employee, a woman who quickly became his confidant and his right-hand person.

This President had an estate plan prepared upon the recommendation of his female aide-de-camp. The estate plan provided that a little less than half of his stock in the company would pass through his estate and he named one of his daughters as executrix. However, slightly more than half of his Class A stock was placed in a trust which provided for the executrix daughter and the aide-de-camp to be co-trustees who would always have to act unanimously.

Before the President's death, the executrix daughter was employed by the company but not in an executive position. During the time the President was suffering from his final illness, there was a deterioration in the relationship between his children and his aide-de-camp. Upon his death, the aide-de-camp, with the help of her ex-husband who was a significant shareholder and a director, installed herself as President and Chief Executive Officer of the company. Prior to his death, the Board of Directors had consisted of the President and his executrix daughter, the aide-de-camp and her ex-husband. Now, the executrix daughter was powerless as a director because she was consistently outvoted two to one.

The new President began buying shares of Class A stock from other shareholders until she finally had enough to outvote the estate shares of the dead President. The trust shares remained deadlocked because the executrix daughter and the new President could not vote unanimously. Thus, the new President completely cut out the old President's family from participation in the company of which they owned, at least beneficially, the majority of voting shares.

We brought suit on behalf of the executrix daughter and two of her sisters alleging breach of fiduciary duty against the new President and seeking to have her removed as trustee. Three weeks into trial, the case settled with the company buying out the stock of the old President's family and the new President resigning as trustee. Once again, things did not work out as the older President wished.

Case Three.

The Demoulas case. The facts of the Demoulas case have been well publicized. For anyone who remains unfamiliar with them or would like to review them again, the facts as set forth in the Fourth Amended Complaint in Rafaele Lorain Demoulas et al. v. Telemachus A. Demoulas et al., Middlesex Superior Court Civil Action No. 90-2344. These facts show how Telemachus Demoulas seized power over Demoulas Super Markets, Inc. ("DSM") and stripped the plaintiffs, the members of the family of his deceased brother, George, of substantially all of their assets. This case is the subject of a decision of the Supreme Judicial Court, Demoulas v. Demoulas, 428 Mass. 555 (1998).

It should be remembered that there is also another case, a shareholder derivative case brought by one of the plaintiffs against the members of the Telemachus Demoulas family. In that case, Arthur S. Demoulas v. Demoulas Super Markets, Inc. et al., Middlesex Superior Court

Civil Action No. 90-2927, it was alleged and proved that Telemachus, his wife and his children usurped corporate opportunities of DSM and diverted its assets for their own benefit. The Supreme Judicial Court's decision with respect to that case is Demoulas v. Demoulas Super Markets, Inc., 424 Mass. 501 (1997).

The Lessons To Be Learned

1. Choose a Successor

It is not entirely clear from the facts of Case One or Case Two that the principals clearly thought through whom they wanted their successors to be. It is certain that they had doubts about the appropriateness of any of their family members. In both families, the available male heirs were unacceptable and no one, including themselves, appeared to consider any of the women heirs as successful candidates. Certainly, none of the women were groomed for such a position. In these circumstances, it may be necessary to look outside the family for a person to run the family business. If this is so, the safeguards for the family which will be discussed later should be an integral part of any such plan. As Case One and Case Two demonstrate, the choice of an outsider should not be simply the one nearest at hand. Rather, the principal should identify the criteria he or she believes is necessary with respect to the education and experience of candidates for a successor. This is true whether or not the candidate is a family member or an outsider. In addition, a plan should be in place to counterbalance the outsider for his efforts on the family's behalf which will compensate such a person for the lack of equity so that her or she remains challenged and fulfilled. Hopefully, this will deter the kind of stock grab which occurred in Case Two.

In the Demoulas case, George's choice of a successor was obvious. Because all of his children were teenagers and his wife was unsophisticated in business affairs, George had to rely on his brother, Telemachus, to shoulder the burden until the next generation became ready to participate. However, George went too far. He gave his brother not only complete control over his business but also over the lives of his family. He put his brother in the path of great temptation by leaving him as the sole decision-maker over his family's assets. George should have seen to it that there was someone else (besides his wife who he had to know would permit Telemachus free rein) whom Telemachus would have had to consult before taking action with respect to George's family's assets or the company's future. And that person would have had to be completely independent of Telemachus.

If there are family members who are interested in participating in the business, care should be taken to select from among the truly qualified. The members of the next generation should be assessed with respect to both their talent and their training. Some professionals who give advice or succession planning for family businesses advise that a prospective candidate be exposed to some training at another company so that he or she can learn the business in a more objective way. In any event the principal must be totally confident that his chosen successor not only can replace the principal but also can successfully address the concerns of other family members who have not been chosen but remain financially and emotionally connected to the company.

2. Protect Against Power Plays

No matter how confident the principal is that he or she has selected and groomed the right successor, there must be safeguards in place to prevent the successor from wielding excessive control over the family shareholders. All three of the case histories presented here demonstrate the wisdom of this approach. Based upon the events in the three cases, there are three recommendations:

A. Provide for independent control over the family stock. In both Case Two and the Demoulas Case, the principal gave his successor control over the stock he left to his family. The lesson of these cases is that the dual roles of trustee or executor and chief executive officer simply vests to much power in the successor. If George Demoulas had chosen a corporate fiduciary or a professional trustee or executor completely independent of the family or the business, many of the transactions at issue in the Demoulas case would not have occurred. Similarly, if the President in Case Two had appointed a professional and independent trustee of the Trust holding the Class A voting stock, the family would not have been deprived of their decision-making power.

B. Do not make the successor the sole voting trustee. If there is a Voting Trust Agreement in place, make sure that there is a trustee to counter the power of the Successor. When George Demoulas died, Telemachus became the sole trustee of the Voting Trust. As such, he completely controlled the Board of Directors which he populated with people beholden to him. Thus, there were no independent board members and the board rubber-stamped all of his decisions. It was in this way that the court found that he accomplished his plundering of the company for his own family's benefit. If it is determined for whatever reason that a Voting Trust makes sense, it should be made certain that there is a balance of power.

C. Have advisors not related to the successor. These advisors may be independent board members or they may be simply professionals hired by family members to assess management control issues. In essence, they would be anticipating and dealing with potential problems before they occur. Hopefully, through mediation or some other process, they would aid the family in avoiding family business blowups which would prevent the need to litigate such blowups.

3. Have An Exit Strategy For Family Members

In Case One and Case Two, where there were shareholders who did not have the ability or the desire to participate in management but felt that their family businesses were being run for the benefit of someone other than themselves, it would have been preferable to have had an exit strategy short of litigation. It certainly would have been more cost effective. Shareholder Agreements, which have already been discussed in this program, are ideal vehicles to provide disgruntled shareholders with the means to extricate themselves from the family business.

4. Inform The Family Members Of The Succession Plan

In all three of the case histories discussed herein, there was no formal succession plan in place. Each of the principals simply appeared to hope that the family business would continue after he was no longer involved and that his family members would be able to work together for their financial betterment. It has been demonstrated that hope is not enough. A succession plan must be put in place. Then each and every family stockholder must be fully advised of the plan. The concerns of any stockholder should be addressed and resolved. Only with full disclosure and the airing of all issues can a successful transition be accomplished. Otherwise family members become estranged and hostile. Then family business blowups become conflagrations with results as acrimonious and bitter as what has happened to the Demoulas family. It is a given that George Demoulas never wanted what happened to occur. Careful succession planning could have prevented it.