# CHARGE IT TO THE BUSINESS: FINANCING THE FAMILY-OWNED OR CLOSELY HELD BUSINESS

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Imagine that you are a lender who has just been handed two new large accounts by your employer. The first is a $50 million loan to a family business. You're about to meet the family and you've learned the following:

- The owner is 79 and still makes every major decision.
- His wife, all three adult children, the spouse of one child, and the significant other of another child all receive salaries and benefits from the business.
- The business owns the family's five cars, four houses, and three country club memberships
- Two of the children and the spouse of one of the children all work in the business. The owner believes the spouse is best suited to take over the business.
- The family is considering seeing a psychologist to address potential conflicts related to succession and passing on of ownership.

The second loan is a $30 million loan to a car dealership owned by two unrelated partners who have been in business together for 40 years.

- One partner's only child works in the business, but lacks the drive to run it long-term.
- The other partner has four kids, none of whom work in the business but all of whom "take an active interest" in the business. One of this partner's kids was recently arrested on embezzlement charges.
- One partner lives frugally while the other "lives large". This partner recently divorced his spouse and has married a "trophy spouse".

After clearing your head, you realize that there are complex relationships and family dynamics at play, which you must understand in order to properly evaluate and manage these loans. This article sets forth a number of issues that a prudent lender must consider in lending to a family-owned or closely held business.

Family Dynamics - "If you don't know the family, you don't know the business."

Understanding the family and, most importantly, the family dynamics, is critical in lending to a family business. Two simple questions should always be answered:

1. Who's in charge?
2. Who plays what role in the business and in the family?

The first question is typically answered most easily when the founder of the business is still running it. However, as the founder gets older or becomes less active, responsibilities for running the business may shift. Some founders have a hard time letting go, and in these cases it is important for the lender to discern who is really calling the shots. A prudent lender will want to assure itself that the business will continue to run properly even if the founder is no longer actually involved, so evaluating whether those who appear to have been given responsibility (i) actually have it, and (ii) are capable of exercising it are important parts of the lender's due diligence.

The second question presents a few more complications. In many cases, family members of the owners play different roles in the business, some more active and important than others. In other cases, "trusted advisors," which may include the family attorney or accountant, the owner's golfing buddies, the "guys at the Rotary Club," or even the lender, play critical roles in the operation of the business. In the case of family members, it is important for the lender to determine what role each family member is playing and whether he/she is properly suited for that role. Sometimes this results in the uncomfortable situation in which the lender must gently tell the business owner that his relative may not be well-suited for the job he's been assigned.

Similarly, the lender must assess the role of the "trusted advisor," especially when it is not clear as to how independent the advisor is. Lenders often want to consult with trusted advisors in order to get their impressions of the business and of its management. Often the lender works in tandem with trusted advisors to help the owner devise strategies for the growth or sale of the business. However, if the trusted advisor is really a "yes man" for the owners, whether out of loyalty or fear, the lender needs to understand that and evaluate the advisor's input accordingly.

Finally, the lender must always be aware of, and sensitive to, changing relationships within the family or among the owners of a closely-held business. It is a truism in these businesses that the lines between family relationships and business relationships are often blurred. It is quite normal for "family issues," which can be as simple as a dispute between father and daughter or as complex as the arrest of a child for embezzlement, to spill over into the business, whether simply by distracting the attention of the owners or by resulting in the loss of the person who is being groomed to run the business. Often the trusted advisors, including the lender, are put in the uncomfortable position of having to "take sides" in a family dispute. Lenders must be particularly sensitive to the existence of family disputes and their potential effect on the business, both short-term and long-term.

What happens when the family decides to seek professional help? Although lenders don't often think about psychologists, many business-owning families turn to psychologists to assist them in working through family issues, and many psychologists devote substantial portions of their practices to advising family businesses. Often these psychologists become de facto business advisors, so it is important for the lender to recognize their role and work with them constructively.

**Succession Issues - "You Mean That Kid is Going to Take Over"?**

Statistics indicate that large numbers of family-owned and closely held businesses are likely to be turned over to the "next generation" or sold within the next ten years. In our examples above, the business owner is 79 and the two partners have been in business for over 40 years. Who will take over? How will that succession be determined? Who will succeed to the actual ownership of the business, and how will that jive with who is running the business? Are the successors ready to take over? And, last but not least, will the founders really allow their chosen successors to take over or will they try to run the business from the background?

In looking at these issues in the context of a borrower, a lender must look into, among other things, the adequacy of the family's or founders' succession planning, the quality of the underlying books and records of the business, and the quality of the company's advisors.

As noted above, family dynamics often play a big role in succession planning. Some family members, particularly children of founders, believe that they are rightfully entitled to take over the business, whether they have actually been groomed for the job or not. In the examples used in this article, each set of founders believes that the spouse of one of their children is the person best suited to take over the business. It would not be a surprise if that ultimately led to conflict, and the lender must be prepared

to deal with that conflict and its potential consequences.

In each case described above, a generational shift could result in ownership being spread among a number of parties. From a lender's perspective, this can create headaches, particularly if the person who is taking over the business or being groomed to take over will not have a controlling ownership interest. A lender should work with the business and its owners to ensure that succession issues will be dealt with in a way that maximizes the likelihood that the business will continue to run smoothly. If a lender is concerned about succession, it can try to protect itself by requiring key person life insurance, so that it will be paid out if the founder/owner dies.

**"Charge it to the Business" - Legitimate Business Expense or Personal Piggy Bank?**

One of the trickiest and most sensitive issues that lenders deal with in lending to family-owned or closely held businesses is the interplay between legitimate business expenses and those that are really personal expenses, but are run through the business. Often this is complicated by the view of many business owners that "the money will wind up with me anyway, so why does it matter if I take it out of the business or pay it to myself and then spend it?" In evaluating the financial health or creditworthiness of a business, the lender must evaluate the legitimacy of certain expenses and determine whether they are really business or personal.

As noted above, a prime example of the interplay is reflected in the fact that the spouses of the owners and all of the children of the owners and their spouses and significant others draw salaries and receive benefits from the business. For those that are actually working or contributing value to the business, these expenses are legitimate, but for those who aren't, they are really just disguised distributions.

Similarly, asset ownership is often commingled between business and family. In the family-owned business example above, the business owns 5 cars and 4 houses. It's possible that all of the cars are used for legitimate business purposes, but it's equally possible that some or all of them are the family members' personal cars. Similarly, it's likely that some or all of the houses are used for personal purposes and not for business purposes. In each case, the lender must determine what category these assets fall into and evaluate the company accordingly.

How does a lender attempt to control its borrower being used as a "personal piggy bank"? It can, among other things, impose limits on compensation and other distributions to family members, as well as requiring that certain expenses not be run through the business.

Another way in which a business owner can take money from the business is by owning property in a separate entity which leases the property to the business. In this case, the lender must evaluate the lease to be sure that the rent is market rate, and not excessively above-market. The lender should also provide that no rent can be paid if the business is in default, since allowing rent in that circumstance would effectively provide that company cash is going to the owner before the lender has been paid in full.

**Death, Disability and Default**

In lending to family-owned and closely held businesses, a hot button issue often revolves around the death or disability of the owner/founder. If the lender is not comfortable with the succession plan, it will typically try to make the death or disability an event of default. The lender may also be concerned about who will wind up owning the deceased owner's share of the business. In the example above, one of the partners in the closely held business has a "trophy spouse." It is likely that neither the lender nor the surviving partner would want that "trophy spouse" to be involved in the running of the business. Unfortunately, no matter how rational the lender's (or partner's) concern may be, the business owner typically considers this default request to be highly offensive and so an accommodation needs to be made. That accommodation typically involves either a buy-sell agreement with a key person or other insurance policy to fund the proceeds or a voting trust where the surviving owner/partner can run the business going forward.

**Due Diligence and Fraud Concerns - "They Did What With the Cash?"**

In evaluating a family-owned or closely held business, effective due diligence is mandatory. Often, formality is low, "that's the way we do things" is the norm, and the potential for fraud is high. Among the things commonly seen by lenders are: (i) a lack of corporate formalities, (ii) a disparity between the documented ownership structure and the actual arrangements being followed in the business (often because "we just never got around to updating that"), (iii) excessive cash transactions, (iv) intertwining of financial arrangements between affiliated companies, and (v) blurry distinctions between affiliated companies. When multiple entities owned or controlled by the same family are involved, lenders must be particularly vigilant to make sure that the financial statements are not being "cooked" and that transactions among the affiliated entities are legitimate. As an example, if an account receivable is from an undisclosed affiliated entity, it may not really be eligible even though it might appear to meet the relevant criteria on its face.

**Conclusion**

Lending to family-owned or closely held businesses can be very rewarding and successful for the lender that does his homework and understands the special dynamics at play in these businesses. Remember: "if you don't know the family, you don't know the business." TSL

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