Financing the Family-Owned Business

If you don't know the family, you don't know the business

by James C. Schulwolf

A radio commercial for a car dealership illustrates one of the challenges of financing a family-owned business. The purpose of the commercial is to announce that two sons will be taking over the dealership from their father, who founded the dealership and established its reputation.

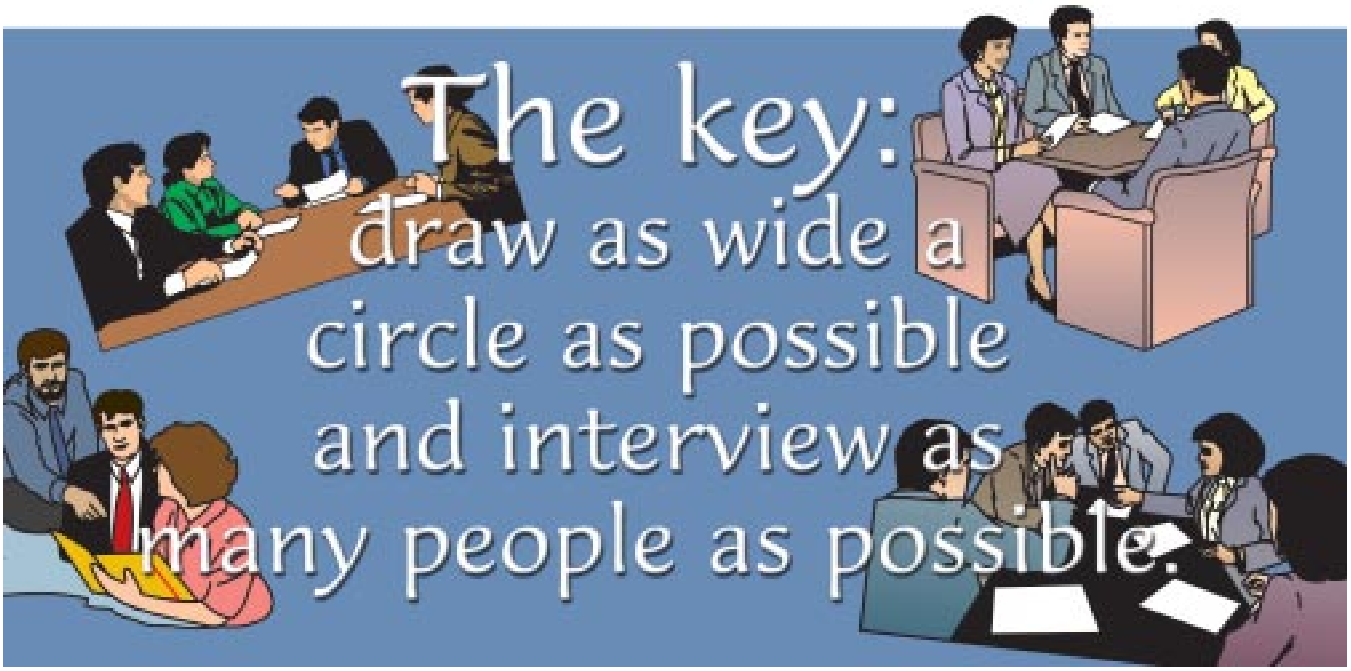
Son 1: "I'll be in charge of the sales department and continue our family tradition of personal attention."

Son 2: "I'll be in charge of the service department and continuing our family's reputation for top-notch service."

Both sons together: "Our customers can be assured of the same attention and dedication that our business has provided since our dad founded it."

Dad: "And just remember, if you have any problems, you call me and I'll take care of them."

(Continued on page 54)



If you are thinking about making a loan to this business, what are you to make of all this? Are the sons independent of the father? Does the father still run the show even though he's "retired"? Who's in charge here?

Determining who is actually in charge is just one of the factors lenders must take into account when financing a family-owned business. The key point to keep in mind is that family dynamics affect the operation of the business — and vice versa. Financing a family business comes down to a basic but all-important concept: If you don't know the family, you don't know the business.

Often, the simplest configuration for a family business involves a scenario in which the founder is still firmly in control. As the business evolves and passes through generations, however, layers of complexity often emerge. Siblings may vie for control, nonfamily company principals struggle for dominance, less-ambitious family members may be living the good life at the company's expense.

This article provides the lender the necessary tools to understand — and successfully finance — the family business. It includes recommendations for due diligence, critical areas of inquiry, such as analyzing family loans, salaries and expenditures, and a look to the future, including succession planning and insurance policies.

As a starting point, to know the family and know the business, a lender must talk to as many family members as possible, even minor players. Chances are, most will have something to say about the inner workings of the business and the family. Another key information source are "trusted advisers" — attorneys, accountants and other professionals that serve the family. Some may be strict loyalists and divulge only the barest information, but others may provide a more comprehensive picture.

And, similar to any other business inquiry, lenders will also want to interview suppliers, vendors and others. The key: draw as wide a circle as possible and interview as many people as possible.

The interview process will ideally also yield another important, less-tangible benefit: The lender will be able to make a well-informed judgment about whether he or she has confidence in the company's principals and their management skills.

Fundamental due diligence: What you need to know as a lender

In addition to normal financial due diligence regarding the business itself, the initial investigation must include the following areas of due diligence:

- ➤ Determine who actually owns the company and whether ownership interests are voting or nonvoting. Also, determine the number of minority or nonfamily owners.
- ➤ Take a careful look at each involved family member. Make an assessment of the leaders, the key players, and those merely in the business and collecting a paycheck without making a professional contribution.
- ➤ Determine how much money family members are taking out of the business each year in salaries, bonuses, business expenses (legitimate or not) and other expenses charged to the business.
- ➤ Investigate whether a shareholders' agreement or a buy-sell agreement exists and the terms and funding for those agreements.
- ➤ Look at estate-planning techniques that have been employed.
- ➤ Investigate who owns the assets, both personalty and real estate.
- ➤ If multiple generations are involved, determine who really runs the show.

(Continued on page 56)

- ➤ If children or grandchildren (or nieces/nephews, etc.) are working in the business, determine whether they have had any outside experience or whether they have spent their entire working lives at the business.
- ➤ Determine if a succession plan and its details are in place, as well as any insurance policies in effect for key players.
- ➤ Investigate whether any skeletons exist in the closet relating to either the family or the business.

The lender must uncover potential pitfalls and deal with them up front. Some examples of certain consequences that may result if due diligence is not conducted include:

- ➤ Poorly planned funding of a buyout can put the business in a serious bind, either unable to live up to its buyout obligations or forced to fund and end up in default.
- ➤ If individuals own the business, require their guaranty and secure it with a pledge of their ownership interests. If the ownership is held in trust, however, consideration becomes a major issue and must be addressed.
- ➤ If there are minority owners, they may have rights that can frustrate the financing and ongoing operation of the business.

Key financing issues

Personal piggy bank or well-run business? The next step is to analyze key financing issues and determine if the current situation is acceptable.

In short, the lender must determine whether the business is a personal piggy bank or a professionally run and managed enterprise with legitimate expenditures.

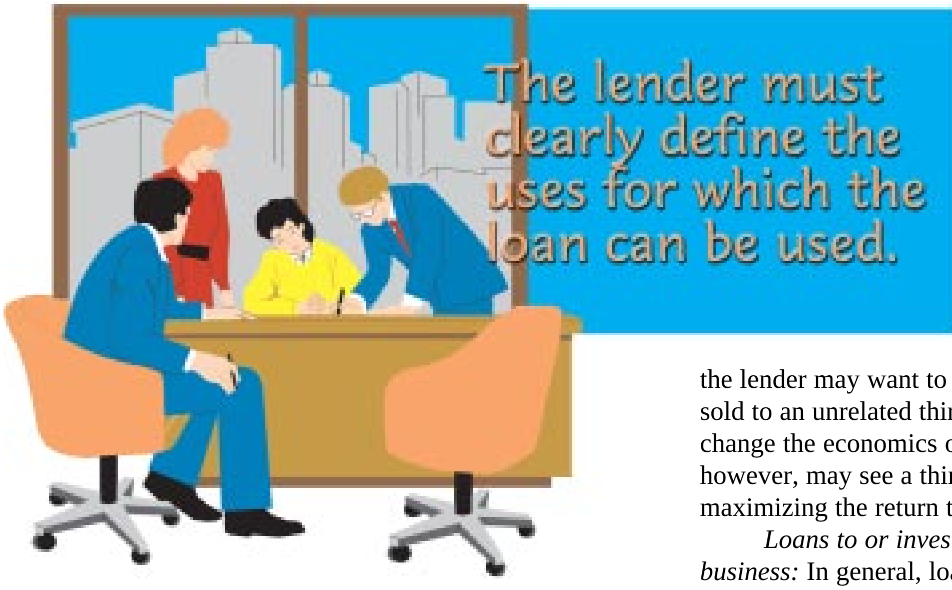
If too much money is being taken out of the business, — through inflated salaries, bogus expenditures, sweetheart leasing or other deals — the business may be unfinanceable. The lender must keep a close watch on expenditures, track the company's cash flow, and carefully review the company's reports and accounting controls.

Salaries, expenses, leases and distributions: When the spouse of a family business owner who had recently sold his business was asked how he was enjoying retirement, she replied, "He loves it, but he just can't get used to the idea of having to pay for his own gas."

Many owners view the family's cash flow and the business's cash flow as interchangeable and operate as if they are one and the same. As a result, many expenses which are really personal and not business-related are charged to the business, and creative arguments are used to justify them as business expenses. The following chart illustrates the point.

(Continued on page 58)

Expense	Okay (Legitimate Business Expense)	Gray Area	Not Okay (Clearly Personal)
Business buys or leases 3 cars	Owner's (used 90% for business)	Owner's Spouse's Car (used sometimes for business purposes)	New car for owner's 16 year old (used once a year for business purposes.)
Country Club Memberships	Owner's Membership (entertaining customers suppliers, etc.)	Retired Founder's Membership in local club	Membership for family member not active in business.
Remote Location Board Meeting (e.g., Disney World, Hawaii, Palm Springs)		Owner's expenses (if the meeting happens to coincide with a family vacation)	Other family members' expenses



The lender must be comfortable with the amount of money being taken out of the business. Analyze salary and business expenses incurred by each person. Determine if the expenses are legitimate business expenses or personal expenditures. In many cases, the lender should limit aggregate compensation, including salaries, bonuses and distributions.

Distributions to pay owners' share of income tax liability in a partnership or LLC are traditionally permitted. However, the lender must determine whether to allow these distributions if an event of default exists at the time. This is often a very contentious issue. In any event, if distributions exceed actual tax liability, the excess should be reinvested in the business as a subordinated debt.

Use of proceeds: The lender must clearly define the uses for which the loan can be used. It is not unheard of for a lender to find out after the fact that a business loan has been used to finance a vacation, second home or other personal luxury.

The loan may be used for working capital or other direct expenses. Family members should be expressly prohibited from using the loan for personal reasons, such as financing a house or car, even if the intention is to repay the loan. Similarly, the loan should not be used for investing in areas outside the business, such as real estate, without the lender's express written consent.

Real estate and leasing issues: Lenders must investigate leases that have been drawn up between company principals and the business. The lender must ensure that the leases represent fair market rental for the property and are not a disguised salary or bonus to the principal. Leases unduly favorable to the principals can create or preserve extra tax advantages and can also make it more difficult to sell the business as a going concern in a workout.

The lender should always obtain a lessor's consent (also known as a landlord's waiver) from an affiliated landlord. The lessor's consent should give the lender broad occupancy rights, rent free. The lessor should not be paying money to the owner of a defaulted business, even if the owner is a guarantor. The business owner should not have the right to hold up the lender or interfere with liquidation by virtue of being a landlord.

Finally, who has the right to sell the property? In many cases, the lender may want to prevent the property from being sold to an unrelated third party, as it could substantially change the economics of a transaction. An estate planner, however, may see a third-party sale as a vehicle for maximizing the return to the family.

Loans to or investments by family members in the business: In general, loans to or investments by family members in the business must be subordinated, typically on deep subordination terms. Such transactions are often structured as "debt" to provide certain tax advantages or accounting treatments. The lender will typically treat the loans or investments as equity for purposes of calculating financial covenants, such as leverage or net worth. The notes evidencing the loans must be endorsed and delivered to the lender.

Ensuring a stable future for the company

Succession planning: Next focus on the future and the continued stability and growth of the company. Lenders will want to be assured of, or put in place, important safeguards to protect their investment. A clear succession plan is particularly important if key family members are older or nearing retirement age. The rationale is clear: lenders certainly want an orderly transition and a business that will continue to run without interruption.

For many family-owned businesses, succession planning can be a volatile issue and there may be some tendency to put it off. Sensitive family issues are often played out in the course of determining who will run the business when the next generation takes over. In some cases, previously inactive family members come out of the woodwork to assert their "rightful role" in the running of the business. The succession plan and its full terms must be disclosed to the lender. If not, the estate planner may attempt to put together a plan in direct conflict with the provision of the loan documents; or the lender may find its loan caught in the maelstrom of family dynamics which have nothing (and everything) to do with the day-to-day operation of the business.

Succession planning can encompass ownership transfers to key family members or buyouts by key employees, among other options. If known at the time the loan is

(Continued on page 60)

made, aspects of the plan should be disclosed to the lender and factored into the underwriting.

Death of a "key" family member: The death of a family member with a major role in the business triggers a wave of consequences, from financial considerations to emotional issues involving other family members. These consequences should be anticipated and dealt with at the loan's inception.

Following the death, the lender may be called upon to make a judgment about whether another family member can step in and ably lead the company or whether a leadership void will lead to dire results. A major question is whether default should ensue immediately or whether the company should be given an opportunity to prove it can maintain its past performance. Not surprisingly, this is frequently a hotly contested issue in the loan transaction.

Considerations include whether key employees will continue to function well under a new leader, particularly if it's the owner's offspring who developed a reputation for partying or an absent or previously inactive family member. It's also important to determine whether family members, when faced with a change in ownership or leadership, will work with or resist the new leadership.

"Key person" life insurance policy: Many lenders require a "key person" life insurance policy for family members integral to the business. The lender must be specified as the beneficiary and the company required to maintain the policy in force. An important issue: what happens to the proceeds if the "key person" dies, assuming that there are no defaults. A typical assignment form provides that the lender receives the benefits with full discretion on how those proceeds are to be used. For example, the lender may choose to pay down the loan or reinvest the proceeds in the business.

If there is no default, the business often wants the right to direct the use of the proceeds. Therefore, it is critical that the use of proceeds of the life insurance policy be clearly spelled out.

Another caveat for life insurance policies: Buyout provisions in shareholder agreements are often funded through insurance policies. Ideally, these policies should be separate from the "key person" life policy to avoid a battle over the proceeds. If that's impractical or impossible to accomplish because of cost or other reasons, it is imperative to clearly distinguish (by contract and in the assignment form) between the proceeds that will go to the lender and those that will go to the company.

Acquisition and Payouts: Lenders should also examine and plan for payouts to retiring family members and earn-outs if the business is acquired. Lenders will typically require that these payments be subordinated since, if financial challenges arise, this source of cash should stay in the company. Understandably, this is often a highly negotiated point.

Gifts and redemptions: Finally, if gifts or redemptions of stock and/or minority interests are contemplated as part of the succession planning, they should be disclosed up front. This is critical because most loan documents will forbid them. However, they can be carved out of the documents and contemplated as part of the ordinary running of the business.

Guarantees: Lenders will look to as many family members as possible for guarantees. However, not all participants in the business are acceptable. Regulation B and the Equal Credit Opportunity Act may forbid the guarantee of a spouse who is not an owner of or active in the business. In addition, the extent to which children, less-active or retired family members may guarantee a loan is frequently a negotiated issue. In addition, consideration and fraudulent conveyance issues must be analyzed.

If multiple entities are involved, issues become more complex. For example, cross-stream or brother-sister guarantees require more careful analysis and consideration. If there is a minority or unrelated owner, the lender must analyze the impact on consideration (i.e., what benefit is derived by that owner to justify the guarantee.) Also, cross-collateralization becomes more problematic, particularly if the businesses are separate or separately run. To the extent the lender ties up the assets of a brother or sister corporation, it becomes much harder to finance that corporation.

Conclusion

Successfully financing a family-owned business requires extensive due diligence, a probing analysis of the financing issues described above and a clear outlook on how the family functions within the context of the business. The guiding principle, "If you don't know the family, you don't know the business," will help the savvy lender make financing decisions that will maximize the likelihood that the lender's loan will be successfully repaid. ▲

The author wishes to thank Susan Etkind of Jacobs & Prosek Public Relations for her assistance in the preparation of this article.

James C. Schulwolf is a partner in the Commercial Finance Practice Group at Shipman & Goodwin LLP, Hartford and Stamford, Connecticut, and a Fellow of the American College of Commercial Finance Lawyers.