RELATIVELY SPEAKING

A Publication of ReGENERATION Partners
October 1998
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THE NEWSLETTER FOR FAMILIES IN BUSINESS

SHAREHOLDER AGREEMENTS – A MUST

The stock market wasn't the only thing that crashed on "Black Monday," October 19, 1987. The Phillips siblings (real case, fake name) remember the day all too well. On this particular day one of the five Phillips children was killed in a grotesque car wreck while another announced, hoping to end the abuse from years of an unfaithful and physical husband, that she had "moved out and filed for divorce." These events, it turned out, only served as the starting point for many more painful family realities.

The five Phillips siblings each inherited equal amounts of shares in a Southwest based multi-unit, retail clothier with revenues exceeding $150 million. As children, they were truly the best of friends and the outward affection for one another gave their immigrant parents the confidence to believe "the children would always do what is right and look after each other." The parents were correct. But they didn't consider how marriage, divorce, taxes, and litigation can challenge relationships and alter ownership.

If there is one area ripe for the explosion of interpersonal relationships in a family business, it is when shares are passed down to family members through inheritance. While many business founders perceive this as a great blessing and benefit to heirs, it often has the opposite, almost detrimental effect on the family business. What is viewed by the founder as a great legacy can be fruitful ground for future problems, even in the most close-knit, loving families.

The Phillips battle began on that fateful Monday when the wife of the dead brother inherited his shares in the business. Two years later she remarried, according to one sibling, "a scoundrel who has never worked and is interested only in her money. He views himself as an owner and, frankly, there is not much we can do about it." To settle a very costly and protracted divorce case, the divorced sister ended up splitting her ownership in the family business with her now ex-husband. "I am sure that my ex and his new wife appreciate the income from my family business." All four siblings comment that they feel trapped in a bad situation. "We try to just ignore them as minority shareholders, but they keep tying us up in paperwork and litigation. It is really unpleasant and a distraction to the business." They agree universally, "We wish Mom and Dad had put into place an agreement that kept ownership within the blood relatives."

> **. . . marriage, divorce, taxes and litigation can challenge relationships and alter ownership.**

A partial resolve to thwart this virus is to establish a Shareholder Agreement with a "Buy/Sell" provision. Whereas Shareholder Agreements usually address a broad range of business related issues, Buy/Sell Agreements define the rights and privileges of what shareholders, or their estates, can and cannot do with their stock. "Without question", says Dallas, Texas based attorney Tom Hurtekant, "Buy/Sell Agreements are advisable wherever ownership in a private company is held or will be held in the future by more than one individual." Surprisingly, however, not all family owned businesses have Buy/Sells. According to a recent Arthur Anderson/Mass Mutual study, an amazing 44% of family-owned businesses do not have a valid Buy/Sell in place.

When no Buy/Sell is in place, family members who inherit stock in the business may legally sell them to anyone. When divorces, lawsuits, employee terminations, or even deaths occur, stock shares may end up in the hands of strangers, competitors, out of favor ex-relatives, or even worse, out of favor ex-relative's new spouses. Unless majority shareholders have contractual controls over stock share purchasing procedures, a family business may face expenses and hassles

(See **BUY/SELL** on page 2.)

WORTH THE PRICE

The cost of establishing a Shareholder Agreement or a Buy/Sell agreement ranges from under $1,000 to tens of thousands of dollars. But the cost may be worth it to save a company, even when no children are involved.

Esprit de Corps is a successful clothing design company based in California. The founders, a husband-wife team, divorced but remained business partners. They battled constantly over company control. Neither had the resources to buy the other out. No prenuptial or separation contingency plans had been made, and no Buy/Sell agreements had been established. Though the owners' bickering didn't directly affect creative design or business decisions, it created uncertainty – the kiss of death. In the most successful decade for American clothing designers, Esprit de Corps lost ground by losing talented designers and failing to recruit top talent. In 1996, a non-family Chairman and CEO was brought in to refocus the company efforts and once again, Esprit de Corp. is delivering quality clothing to fashion conscious consumers with enthusiasm, devotion, and honor.

BUY/SELL (Continued from page 1.)

that could destroy it. These procedures should be set in place long before ownership changes occur.

"Buy/Sells have been around throughout the twentieth century", says Hurtekant, who has represented families for the last 20 years. "But recently, more people are looking to Shareholder Agreements and Buy/Sells as a vital part of estate planning." One reason for this is the vast number of businesses which were started after World War II are being passed to heirs – an aggregate wealth transfer of $12 trillion. Estate planners and family business consultants encourage use of Buy/Sells in trusts and when gifts of family stock are made to children. Buy/Sells simplify bequests and help to preserve and guard the family business from future hostilities.

The word "gift" may be misleading. Often the family business patriarch starts from scratch. He or she believes their children are fortunate to own stock in a business that has supported and nurtured them throughout their life. Typically, ownership is passed in equal amount to each offspring, including those not involved in the business. *(Our consulting experience tells us that on average, one-half of the family will join the business and the other half will have other professional or personal interests.)*

Shortly after receiving this "gift", the non-business heirs get the bill from Uncle Sam: they owe the IRS 55% of the value of the business – in cash. Desperate, the heirs may seek professional advice and learn that the only way to protect themselves from total financial ruin is to sell the entire business or force the business to buy back the stock.

This is the beginning of many problems in the family business – maybe even the beginning of the end if, for example, the business cannot fund a repurchase. Family members may have to sell out, borrow money, liquidate assets or, as a last straw, partner with "vulture" investors to raise the cash.

Family business consultants are chock full of such horror stories. As consultants, we have worked with many family-owned businesses that have experienced the wrath of unknown taxes and sudden changes in ownership as well as the "unanticipated inevitables" that come to pass. We have seen the frustration and hurt on both sides of the table.

"Think how you would feel owning an asset worth a lot of money, that you can't liquidate – you can only hold it," says Hurtekant. "You can see how this can be fertile ground for litigation and all kinds of trouble for the family business. This is when heirs challenge sibling's compensation and management decisions and do everything in their power to make their siblings wish they were not a shareholder. It can literally explode a business." Or family.

Numerous businesses without shareholder agreements and Buy/Sells have been sold, suffered litigation, or were forced to go public. However, it is not always feasible to go public in the same manner as for example, a Ford Motor Company. The costs and risks involved can be tremendous, even for significant companies.

Although there is much prestige attached to being a publicly held company, it is not simple and is not usually the best option for many family-owned businesses. The Pandora's Box of going public usually requires new management controls with "outsiders" at the helm. Family shareholders are accountable to public shareholders and quarterly financial results take priority over long-term developmental projects. Because of strict regulations, complete disclosure of company information is required. Public companies have greater formalities including more reporting forms and paperwork, and salaries are reported to outside stockholders and the IRS and is even available to competitors.

Preserving the Legacy

Are you setting your kids up for conflict? If going public is not a viable option, how can a family business owner preserve the legacy? What can be done to ensure harmony when ownership or financial complications arise?

Our advice is to educate and communicate. Sit down with family members and tell them about the business. Even if they don't appear to be interested today, they may be forced to make some critical decisions in the future. Help each family member understand the capital needs of the business, how the business works, what makes this particular business "tick", how decisions are made, and what the strengths, weaknesses, and needs of management are. Discuss every aspect of the business, including realistic salaries and what you expect from future ownership. And above all else, create or update a shareholders agreement with a particular emphasis on a Buy/Sell provision.

Sometimes ownership expectations are unrealistic. Trusted and neutral professionals from the outside can help family members adjust their "far-out" thinking and help paint a more realistic portrait, as in the case with a family in the picture frame business. One brother who did not work in the family business was a schoolteacher earning $30,000 a year. When the discussion of salary came up during a family council meeting, he was shocked to learn that his younger sister, the executive VP for 12 years, was earning a salary of $100,000 plus bonus. He literally came out of his chair. As independent consultants we were able to show him that his sister's salary, compared to both regional and national norms in similar companies, was actually less than her peer group.

Nothing and nobody in the world can guarantee instant resolution to family business ownership problems, but the following five safeguards can promote it:

1 Create the Shareholder Agreement while participants are healthy. Do not put this off until the founder or one of the owners is ill or near death. This agreement should be central to every family's estate planning.

2 Create a liquidity plan for all family owners with a special emphasis on providing financially for those family members who are not active in the business. These family members are usually happier with assets that produce income rather than holding a minority interest in the family business which does not provide income or tangible benefits.

3 To create liquidity in the event of a death of an owner, have the business purchase life insurance to repurchase the stock.

4 If a Buy/Sell is not funded with life insurance, provide contractually for a payout. Repurchasing stock on a moment's notice may place an undue strain on the day to day business operations. A contractual agreement to repurchase over time will enable the business to avoid potentially excessive and immediate debt.

5 All in the family. Control future stock ownership through a Buy/Sell with a Right of First Refusal for the business, then the family owners. To make a Right of First Refusal agreement work best, owners need to agree on a methodology at which a price for stock will be sold internally.

As the Phillips learned the hard way, planning for the unexpected is not an option. Buy/Sells insure that the company will have the first shot at any stock that may, through inheritance or divorce, termination or transfer, end up in the hands of someone other than a family member or friendly stockholder. This will help safeguard the business against competitor takeovers should a hostile or cash-desperate family shareholder want to sell to a competitor.

... complications that result from multiple owners can be resolved – or greatly reduced – by preplanning.

The conflicting objectives of family business ownership and the complications that result from multiple owners can be resolved – or greatly reduced – by preplanning. Often it is the hopes of family business founders to leave a legacy for future generations and to ReGENERATE the spirit and unique talent that originally launched the business. With planning, founders can insure continued growth and safeguard the business even through unforeseen storms future descendants may encounter. Just ask the Phillips.

IS IT TIME TO BORROW?

Incurring debt is among the foremost of issues to owners of family businesses. Most business owners either already have debt or will acquire some in the near future. Ben Franklin may have prophesied "neither a borrower nor lender be," but growing a business exclusively from internally generated cash flow is not always the best use of company funds.

During the fast and furious '80s, many businessmen believed that leveraging the balance sheet was good for the income statement, and that you could grow your way out of debt. The 1990s have been more conservative and, thankfully, logical in matching debt to need and opportunity.

Common Uses and Sources

Business opportunity is the most common use of debt. This may range from working capital to more complex situations such as the buyout of a family owner. Working capital may support the introduction of a new product, increase inventory for "just in time," allow the sales and credit managers to offer extended terms, purchase key equipment or real estate, or for sales growth. Commonly in today's market, debt is also used to fund strategic acquisitions.

Depending on the financial condition of the underlying business, there exist several options for funding. Commercial banks, private equity, leasing companies, and asset based lenders (i.e. commercial finance companies, insurance companies, factors, or key suppliers) are the more common sources. Underwriting from these traditional sources will consider the quality and consistency of cash flow, the appraised value or liquidity of real property, equipment, inventory, or accounts receivable, future earnings projections, and management. Commercial bankers can help steer the business owner to the appropriate financing source – the source that is best suited to handle your individual needs.

Lender's Considerations

In underwriting a working capital or term loan, commercial banks will emphasize historical cash flow levels, projected cash flow, the condition of the balance sheet, collateral, industry factors, recourse, and management's abilities, depth, and character.

Alternative financing sources will rely more heavily on collateral and the asset being financed. Asset-based lenders, or factors, typically spend more time evaluating the borrower's accounts receivable. Often, the borrower's customers' financial condition is paramount in determining the probability of repayment for a proposed transaction. In this case, credit worthy customers are a big help. An insurance company or leasing company may focus its underwriting on the borrower's cash flow in tandem with the current and long-term marketability of the real property or equipment being financed.

In most cases lenders will structure a loan based on today's performance and balance it with future projections. Financial covenants of a loan agreement will be established with consideration of expansion plans, industry and economic cycles, seasonality, and changes in ownership, as well as other business issues. For many commercial banks covenants may measure operating results, balance sheet condition, industry specific measures, and will be established with consideration given to the future of the business. Asset based lenders may incorporate covenants that are similar to a commercial bank but may structure its covenants to preserve the quality of the particular asset being financed. Repayment periods are usually aligned with the life of the asset securing the loan.

Borrower's Considerations

Debt is almost always a means to a worthy end. It can, however, be a hindrance. Some business owners may opt for building-up a cash reserve to capture future opportunities. Others may choose to tap personal resources, borrow from a trusted friend or relative, or sell an ownership stake to raise funds.

The current pace of economic growth has fueled the use of debt. For debt to work to your advantage it must be managed carefully, which means adhering to financial discipline. Properly used, debt can substantially improve business profitability with no dilution of ownership. Before incurring debt talk with your professional resources – your commercial banker, CPA, attorney, and consultant. Before borrowing, consider the following and remember as a caution, don't ignore your own business instincts:

- The quality of the opportunity at hand, its long-term viability, where are we in the economic cycle?
- Is the opportunity funding a debt risk or an equity risk? Is it project financing or can current cash flow levels repay the indebtedness if the opportunity doesn't pan out?
- What is my back up plan if the opportunity fails or is slow to develop? Is down sizing an option to manage cash flow and debt?
- Type of debt needed; ie. short-term, long-term, senior, subordinated, repayment schedule versus the life of the asset/opportunity or the current economic cycle, the appropriate lender.
- In raising equity you gain a partner, share decision making, and dilute ownership; using debt you have sole decision making yet existing loan agreement covenants must be considered.
- How will the new debt affect the borrower's cash flow and balance sheet condition; now and going forward? How does that compare to your industry peer group's condition?
- How and where else can you hedge your risk to ensure opportunity success/debt repayment? Employment contracts, supplier contracts, repurchase agreements, business interruption insurance, interest rate risk contracts, maintenance contracts, etc.

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CHARITABLE WITH CHILDREN

By Michael Martin, CPA with Belew, Averitt LLP

With Federal estate taxes as high as 55%, many taxable estates end up paying more to Uncle Sam than to the designated heirs. Individuals with charitable giving as a high priority may offset this potential tax burden by establishing a Charitable Lead Trust.

A Charitable Lead Trust allows the taxpayer to transfer cash or assets into a trust which pays either a specific dollar amount or a percentage of the value to qualified charities for a designated period. The remainder interest is transferred to non-charitable beneficiaries, such as your children. When the trust is established, only the present value of the deferred gift to the children is subject to gift tax.

For example, assume that a taxpayer intends to give $70,000 annually to one or more charities for the next 10 years. The taxpayer forms a Charitable Lead Trust with $1 million dollars with a 7% guaranteed annuity payout for 10 years. At the end of 10 years, the remaining assets are distributed to the taxpayer's children. A $70,000 annuity to charities for 10 years is worth approximately $492,000 (present value). The remainder, $508,000, becomes the tax basis for the $1 million dollar gift to the children.

If however, the taxpayer chose to give $70,000 to charities each year for 10 years and then give the children $1 million dollars without the benefit of a Charitable Lead Trust, taxes would be owed on $1 million dollars, not $508,000.

If it sounds to good to believe, remember most tax saving opportunities come with tradeoffs. The Charitable Lead Trust is best suited for those who plan to give to charities, are willing to part with some assets, and do not nor will not require income from the money/assets used to form the Charitable Lead Trust. Maximizing strategies to save taxes requires full knowledge of your individual circumstances. Before embarking on any tax savings strategy, talk with both your accountant and attorney.

For more information on the Charitable Lead Trust, complete the boomerang card and return it to ReGENERATION Partners or contact Michael Martin, 214.969.7007.

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EDITORIAL

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Three stories seem near impossible to avoid these days: the McGwire –Sosa battle, the Clinton affair, and the trials of family business. The first has been settled, the second will play out during his term in office, and the third, unfortunately, will likely go on and on. Why? Because reporters and publishers know that pain sells. (IE. All polls indicate "fed-up" with Bill and Monica yet the "Starr Report" first printing of 650,000 sold out within the first week.)

To many, "family business" means conflict. These are the stories that make the headlines. Reality, however, is that about 75% (some studies indicate 90%) of all business enterprises in the US today are family-owned and managed. They can't all be failing. Conflict is normal and at times, routine. It is only when conflict is not managed in a positive way that it becomes a destructive force.

Families that sustain successful businesses approach family and business with a "continuing education" attitude. In our experience, these families in business tend to **(1)** Have leaders that lead a balanced life – it is not all work or all play. **(2)** Communicate regularly – they have in place a system that fosters both playful and serious talk. **(3)** Agree on the business purpose. **(4)** Plan, plan, plan - strategic, marketing, estate, disaster, financial, etc. **(5)** Share power – everyone that can add value is allowed input and not all decisions are *de facto* from the majority stockholder. **(6)** Have entrenched traditions – we all have family traditions whether we plan them or not. Traditions help to keep a family connected. **(7)** Have similar values – big differences in some values make it tough to ever share a common outlook. **(8)** Compete in more stable markets and industries – they are not into fads, fashions, or the trendy. **(9)** Grow slower – rapid growth is difficult to manage. **(10)** Remain small to medium in size – when a family business tops the $1 to $2 billion mark the pressures mount. **(11)** Have strong and capable competition – in free markets monopolies do not succeed. Ali is considered the greatest because he had a Frazier, Norton and a Foreman to topple. **(12)** Exude passion for the business – these families tend to think beyond "getting rich" and emphasize the family legacy. And **(13)** Know their customers – it is common in these businesses to see long standing personal relationships with customers, vendors, and business partners.

We take great pride in our quality of work, as both consultants and publishers. However, even with safeguards, we occasionally err. Our most recent was in the last issue of *ReLATIVELY Speaking*. Scott Oliver contributed an article on offshore investing in which we missed a typo. His correct web address is www.offshoreoliver.com. For more information, please look him up through his site.

When it comes to the bottom line, marketing is typically what produces revenues. For the second time, we have gone to Dick Morgan, our marketing specialist, to give us his thoughts on balancing business efforts for maximum gain. One of the most frequently asked questions in our consulting work relates to debt. Owners and managers complain they either don't have enough or they have too much. Carlos Munguia has provided a primer on debt. He has volunteered to answer your questions via email. "Charitable With Children" is the latest from Michael Martin. As always, we are delighted to have Michael's contribution and expertise on tax and accounting matters.

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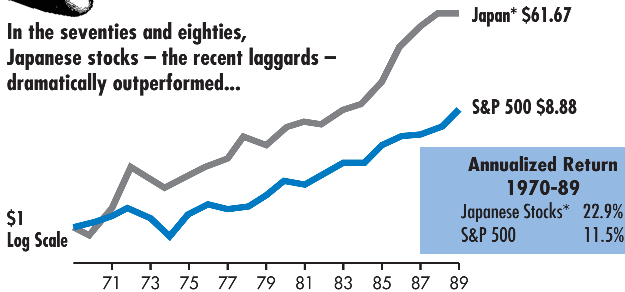
BALANCING ACT

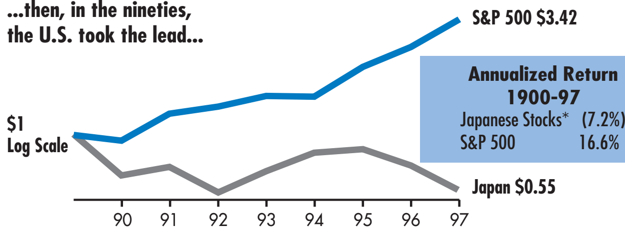
Picture your business as a three-leg stool with operations, marketing, and finance as the supporting legs.

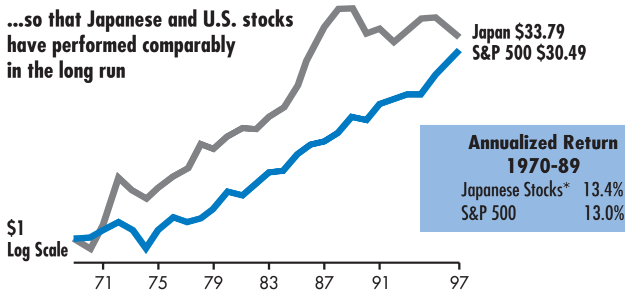
Now, picture yourself sitting atop that stool. If the legs are the same length, the stool is balanced, and you can easily shift your position. However, when one leg is too short, the stool becomes unstable and hard to manage.

Here are some examples of business unbalance. A business expands facilities and production capacity with borrowed money, but fails to add marketing effort. Sales remain static. A shortage of cash occurs as higher facility overhead costs chew up working capital. The company begins to miss purchase discounts and margin diminish.

FAST FACTS

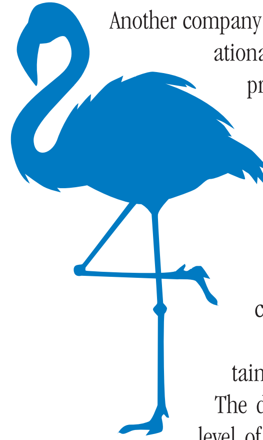






*MSCI Japan in U.S.$s
Source: MSCI, Standard & Poor's and Bernstein

Courtesy of John Mowrey, Sanford C. Bernstein & Co.



Another company with highly aggressive marketing outpaces operational capacity and available working capital. Hurried processing causes high rework and quality suffers. Good customers leave and are replaced by less desirable accounts at lower prices. Profits drop, down-sizing occurs, and related cost reductions only make the situation worse. At this point, no one wants to reduce sales to the prior level. Unplanned growth can be dangerous to a company's long-term health.

Focused, practical planning is a key to maintaining the balance and profitability of your business. The desire to increase sales needs to incorporate the level of financial and operations resources available to support the planned growth.

Lines of credit and affordable loans to cover seasonal working capital needs should not be taken for granted. A highly leveraged company may find the banker stone deaf to a plea for new financing, even when the need for cash is to support profitable growth. This is particularly true if the business is out of balance and financial ratios are lopsided.

Does this mean that growth is an impossible dream? Certainly not! Naturally, growth is easier for companies with available capacity. These companies are better able to generate the added capital needed for greater sales through retained earnings. And high capacity utilization usually equals greater profitability.

Companies that are short of cash, capacity, or sales should first regain their balance and control of cash flow before attempting expansion. Good business planning helps managers maintain the critical balance between marketing, operations, finance, and administration.

Remember, fundamentally there are only three areas to attack to increase operating profits and lower break-even points. 1) Increase profitable sales, 2) Improve margins, and 3) Reduce fixed costs

An almost infinite variety of combinations exist within these basic moves. However, accurate, up-to-date information, and careful planning really are essential for planned, profitable growth.

Each company has unique goals, challenges, and opportunities. There are no "pat answers" regarding strategies or tactics. My on-site business planning assignments with business owners emphasize the need to maintain balance and plan future actions. My assignments also highlight the value of an objective outside perspective to analyze the business situation and plan a company's future.

Dick Morgan is President of Morgan Marketing Solutions, Inc. and serves on the national board of directors of the Institute of Management Consultants. www.rpmorgan.mcni.com.

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