Enterprising Rural Families™

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TIP OF THE MONTH:

Family bonds, whether cousin, great uncle, or child, can help make a strong, successful business if…

1. The family has a customized family plan.
2. The family has a clear understanding of roles.
3. Family members are involved in planning and decision making.
4. Household budgets are separate from business budgets.
5. Children are allowed to make a conscious decision about leaving the family business.
6. Children are given authority along with responsibility.
7. The family has a business plan.
8. The family has a compensation plan.

SHAREHOLDER AGREEMENTS

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Consider a family in business together. One of the five siblings is killed in an equipment accident, then, within a few months, another announces that he is divorcing his unfaithful wife. As shareholders in the family business, each of these siblings inherited equal shares of the company. As children, they always got along well and their hard-working parents assumed they always would, so established no guidelines for what might eventually happen to the shares they gave each child.

A couple years later the wife of the dead brother marries a man that none of the other siblings trust and who has no interest in actually participating in the operation of the business, but considers himself an owner and is only interested in spending his wife's share to have "fun." The brother splitting up with his wife ends up going through a bitter and costly divorce proceeding, and to finally satisfy her demands, he signs over half of his company shares to his ex-wife and they now come under the primary control of her new husband. This new shareholder continues to find fault with the organization and contends most of the decisions and even files litigation from time-to-time to get what he wants. Now the siblings agree that Mom and Dad should have executed an agreement that kept all ownership shares with blood relatives.

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. Many business owners think of this as a great blessing and benefit to heirs, when 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.

A partial solution to thwart this problem 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. 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. Even so, a large percentage of family owned businesses do not have Buy/Sells. According to a recent 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 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, 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 which are being passed to heirs – an aggregate wealth transfer of $12 trillion. Buy/Sells should be considered 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 amounts to each offspring, including those not involved in the business. 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. The heirs often 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 – family members may have to sell out, borrow money, liquidate assets or, as a last straw, partner with "vulture" investors to raise the cash.

Think how you would feel owning an asset worth a lot of money that you can't liquidate -- you can only hold it. 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 and 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 are even available to competitors.

The best 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 neutral professionals from outside the family can help family members understand realistic expectations for their various positions. One family member may not be part of the business and be earning a salary which is comparable to others in their profession. Yet, when they find out that their sibling CEO of the family business is making considerably more than they, it may cause an eruption. It may take outside counsel (consider an advisory council, which is a group of trusted advisors from outside the family) to help the non-management family member realize that their sibling is only receiving a salary justified for their degree of responsibility in the business world, or to help develop a more equitable pay grid for family members.

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.

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.

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. With planning, founders can insure continued growth and safeguard the business even through unforeseen storms future descendants may encounter.

Reference: James Olan Hutcheson. *Shareholder Agreements – A must.* October 1, 1998, Regeneration Partners, www.regeneration-partners.com.

Buy-sell provisions are an important part of the documents that govern a company. These types of provisions should be drafted when you start up your company and updated regularly to ensure that they continue to reflect the desires of the owners for the disposition of their ownership interest in the event of an untimely death.