Reinhart
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Family Business Ownership and Governance after the Founder's Death: A Case Study

The Founder started buying buildings as a hobby, eventually acquiring a large portfolio of quality industrial properties and a reputation for responsive owner management. When the Founder's three children (with vastly differing levels of involvement in the business and appetites for risk) inherited the business, Reinhart Boerner Van Deuren s.c. helped them adopt a new organizational structure that allowed them to make decisions together, protect their investment and honor the Founder's dedication to quality.

Started Small

Founder started buying and managing rental properties as sideline. He had an eye for well-constructed buildings in viable locations, but didn't pay attention to how he organized this sideline endeavor or how the properties were held. He made all of his business decisions without seeking advice and did most of his bookkeeping in his head.

Founder had three adult sons. After a while, Founder took Son #3 into the business and named him president. Eventually, the business started doing its own construction and its portfolio of industrial rental properties grew. The business continued to have great relations with tenants, and the buildings were almost always 100% occupied. Founder and president had a good relationship with their lenders and, by then, president was doing the bookkeeping in his head just like Founder.

Late in his life, Founder gave all three sons shares in the business. The sons, as new owners, signed buy-sell agreements and started taking a greater interest in the business, but Founder continued to make all the business decisions. The sons were required to give unlimited personal guaranties to the business's lenders.

Founder's Death

When Founder died, his remaining interest in the business passed to his sons in equal shares. Thanks to the hard work of the president, the business did not lose tenants, lender loyalty, employees, momentum or reputation.

However, Son #1 was getting nervous. President still had the bookkeeping mostly in his head, and the business was under-served by its accountants. The "business" was in the form of a haphazard group of multiproperty LLCs and limited partnerships, and commercial loans were secured by a web of cross-collateralizations. The brothers' unlimited personal guaranties were now more important and more of a risk than ever before.

Son #1, who lived out of state, wanted to sell the properties, pay off the mortgages and put his share of the net proceeds in a conservative marketable securities account. He wanted to hire an independent, professional property management firm, become a passive owner and slowly sell properties.

In contrast, the president and Son #2 wanted to continue to grow the business, build more buildings and manage the properties as hands-on owner-operators.

Chained Together

The sons were essentially chained together as the banks would not release an owner from his personal guaranty unless he sold his interest to the other two sons. However, the buy-out price in the buy-sell agreements would yield just pennies on the dollar if only one of the owners sold his interest. Therefore, to protect his respective personal guaranty, each son chose to stay active in management, which meant they each had a fiduciary duty to act in the best interest of the business and the

other owners. Further, all the properties were held in flow-through entities. But, with the governing documents not requiring tax distributions, each owner was incentivized to earn compensation from the business to ensure each was receiving cash flow. Finally, if remained active in the business, they were taxed at a lower rate than if they were passive owners.

Despite these incentives each owner had serious end game problems because, even at death, the buy-sell agreements required that ownership interests be sold only to the surviving owners (at the same pennies-on-the-dollar formula that would apply to lifetime buyouts).

Although it seemed like the owners were stuck in the business, the business was also dependent on the cooperation of all three owners.

Management believed the business would lose its competitive edge if it did not increase its inventory, however, the banks would not lend to the business unless all three owners continued to provide their personal guaranties. In order to entice Son #1 to give his personal guaranty for new projects, the other sons would cause the business to occasionally sell an underperforming property and then distribute the net proceeds as a "dividend," or use cash flow to reimburse all three owners for expenses that were not deductible. As a result, the business grew in fits and starts, with 2-1 votes for an acquisition, followed by some kind of concession to the recalcitrant Son #1.

The Solution

Finally, the owners retained Reinhart to represent the business to improve its governance, ownership rights, and owner exit planning. Reinhart did the following:

- Supported the owners' decision to use an accounting firm that was a better fit, and insisted that the owners allow the new accounting firm to improve bookkeeping and reporting systems.
- Supported the owners' decision to hire a qualified controller.
- Helped the business reorganize into one parent LLC with separate wholly owned subsidiaries, so as to optimize use of cash throughout the portfolio and begin diminishing the use of personal guaranties.
- Helped the owners compose a new governing board. Each owner sat on the board and had the right to appoint one qualified independent director; ownership shares were classified so that an owner could pass his board seat to his heirs.
- Helped the owners adopt descriptions for each owner's job.
- Supported the board in requiring president to submit budgets and adopting a dividend policy and guaranty fees for owners.
- Wrote an LLC agreement for the parent company that required unanimous consent for certain economic commitments, but also allowed the owners to independently pursue projects that the business rejected.
- Prepared a buy-sell agreement that allowed owners to pass their interests to their heirs and, in the alternative, offered a more equitable at-death buyout, funded with life insurance.

The Business Today

Today, the business continues to grow. The owners are making better decisions together, taking less personal risk and realizing greater financial reward. Son #1 decided to remain in the business based on the new business structure, which lowered his personal risk, provided a dependable cash flow and ensured that his heirs would receive the full value of his investment. Most importantly, the owners are happier as a family.