Helping your family and business through challenging economic times

BY HENRY C. KRASNOW AND MICHAEL A. BRANDESS

Financial challenges make it harder for the leaders of a family business to choose between rational business goals and compromises designed to resolve a family's emotional conflicts and financial needs. If these challenges occur after generations of success, the leaders' dilemma is complicated by the guilt, blame, disappointment and fear often uniquely present in a family business (e.g., "How could you fail after Grandpa built this great business?" or "My son spent his life preparing to run this division; how could you outsource it?" or "I can't pay the mortgage on my house if you insist on reducing our annual dividend").

And, of course, making the wrong decisions can cripple the wealth and well-being of the family for generations.

In these situations, making the right choices is far easier said than done.

There is no one-size-fits-all formula for finding the right path. In fact, often there are no solutions, only the opportunity to avoid making a bad situation worse. Many businesses must decide among several bad alternatives — e.g., investing more family finances into the money-losing business or making payments that benefit the family in the short run but result in years of lawsuits from former creditors.

The only comfort to those involved in such precarious situations is that several valuable principles can serve as guides.

Key perspectives

Timing is everything! Most opportunities are like windows in that they all open or close temporarily. Once an opportunity closes, there is no way to know if it will ever reappear. Indecision often leads to the need to make harder choices among less promising alternatives with a greater risk of destroying business value or family bonds.

Timing is important not only from an economic point of view but also from a legal perspective. If a family business is on the painful path toward insolvency, the actions (or inactions) of the company's officers and directors come under greater scrutiny. If failure occurs, everyone has the benefit of 20/20 hindsight. Many will later second-guess decisions without realizing the role of emotion and that fact that tough calls had to be made in the heat of the moment.

No matter what, those who make decisions in these circumstances should understand and consider their emotional agenda to avoid regrettable choices.

Don't hide bad news. Keeping your family advised of bad news is often difficult, but it is usually a good idea even if it causes distress, anxiety or blame. Those involved in the business will be dramatically affected by what is happening, and they deserve to know. Failing to inform them can profoundly affect long-term relationships.

This doesn't mean leaders should tell their family everything. Many business decisions must remain private to avoid making a problem much worse. Fortunately, conversations between a business and its attorneys are protected by law against any disclosure. But beware — if that conversation is shared with anyone other than an attorney, it is no longer confidential, and other people (not just other family members, but also creditors, for instance) can find out what was discussed.

Be aware of available estate planning techniques. When a business runs into hard times, an often-overlooked strategy to protect yourself and your family is estate planning — using trusts, gifts and other techniques to place assets out of creditors' reach no matter what happens to the business.

Henry C. Krasnow, Esq. (left) and **Michael A. Brandess, Esq.** are partners at the law firm of Sugar Felsenthal Grais & Helsinger LLP (www.sfgh.com).

The strategies that will work best for you depend on your unique personal factors such as timing, your role in the business and family, your wealth, your marital status, your age and that of your children or grandchildren, and their financial circumstances and maturity.

These techniques can be perfectly legal and appropriate when implemented correctly and should always be thoughtfully explored — the sooner, the better.

Landmines to be avoided

Preferences and fraudulent conveyances. "Preferences" and "fraudulent conveyances" are the formal legal names of transactions that can lead to money being "clawed back." When these situations are uncovered, a bankruptcy trustee or other legally empowered person can seek to persuade a court to order the return of money or other property that was determined to have been improperly given, sold or distributed to family members, other owners or creditors.

For example, think of a business that fully repays a supplier owned by an in-law a few days before the business closes its doors. Then, after an orderly sale of the business's few remaining assets, the other creditors are repaid only 10% of their debts. In such a situation, the in-law who got paid in full received a "preference" of his debt over the other creditors, and thus may be subject to a court-ordered clawback.

A fraudulent conveyance, in its simplest terms, is a sale or transfer of an asset, during certain critical times, for less than full value.

The motivation for such a transaction is easy to understand. For instance, imagine a business that had a string of losses and seems headed toward closing. At that point, the owners may want a way to have family members receive value that would otherwise go to outsiders. For instance, a father/CEO "sells" a machine worth $200,000 to his son for $5,000. The CEO's motivation may never be known, but the transaction could still be attacked as a fraudulent conveyance.

Creditors and their lawyers know exactly where to look to uncover preferences or fraudulent conveyances.

This is not to say you must always steer clear of anything that could be claimed to be a preference or fraudulent conveyance. By being aware of the laws relating to transactions like this, you can accurately evaluate the risks and rewards involved in deciding to move forward with the transaction based on sophisticated and informed analysis.

Breach of fiduciary duties. In unharmonious families facing business distress, the controlling owners might be tempted to make arrangements that benefit some family owners over others.

Like those hurt by preferences or fraudulent conveyances, those who feel they have been wronged are often prone to pointing fingers at those in control. The legal name for such claims is breach of fiduciary duty — that is, the duty of people in positions of power to be totally honest and loyal to the owners, sometimes to the other company officers and, in some limited instances, the company's creditors.

Claims like this from family members or others who feel strongly that they were mistreated are difficult to rationally resolve, often because of complicated emotions that can make rational compromises more difficult to reach.

Family loans and personal guaranties. Generally speaking, hope springs eternal — and sometimes for good reasons, since financial problems are often temporary.

The danger of this typically loving and healthy viewpoint is that it can lead to wealthier family members giving "life support" to the "critically ill" business in the form of making loans to the business of providing personal guaranties for third-party loans.

Offers such as these must not be rejected out of hand. But if they are to be accepted, these financing arrangements should be undertaken only after careful examination of the circumstances and an understanding of who, if anyone in the family, will suffer the loss if the optimism turns out to have been unjustified.

And, unlike many other family transactions, they should be documented in carefully drafted written contracts. If the business fails, handshake agreements often will not be remembered in the same way by all involved and cannot be counted on to be lived up to or enforced. Family members who had casually promised to share in the loss from a personal loan to the business or a personal guaranty often "forget" making that offer or do not agree on some of the details.

Promises made in a situation of financial distress should always be put in writing. If everyone agrees to share in a loss based on their percentage of ownership, make sure that agreement is written by a good lawyer and signed. Even if there is no malicious intent, agreements are often honestly forgotten or misunderstood. Asking for a pledge of collateral and a demonstration of the ability to pay is simply wise, not unloving. Often merely asking that these agreements be put in writing will be traumatic. However, that trauma is far less harmful than the trauma that will ensue absent such protections.

Which advisers should you consult?

The road traveled when insolvency occurs is perilous, and it is imperative to have advisers traveling with you

to help you avoid the many pitfalls. Three categories of advisers are essential in these times:

- **Business advisers:** Professionals who can clarify and prioritize the decisions that must be made will help you make wise decisions, such as how much cash needs to be available, which creditors should be paid (and when) and what can be done to save or preserve cash.
- **Accountants:** These professionals ensure you are basing your financial decisions on accurate numbers and not mere fantasies or guesses.
- **Legal advisers:** You need attorneys familiar with the nature of your business, the complications of family ownership and the local, state and federal laws concerning what can be done by a business in distress. A good legal adviser will minimize the risk that the business leader's decisions will be criticized and second-guessed by people using 20/20 hindsight.

Truly good advisers offer alternative solutions and honest risk-benefit analysis to evaluate each strategy. Every alternative comes with risks. Wisdom involves deciding which risks to take depending on the potential for rewards.

In times of financial distress, always remember: Act with a clear head. In dealing with creditors and with family members, act deliberately and with a sense of urgency. The more information at your disposal, the greater the likelihood that you will be able to save your business and your family relationships. FB

A 'double transition' crisis can result when CEOs hold the reins too long

(Continued from page 27)

continuity planning while there's time to do it properly. To avoid the crisis:

1. The controlling owner must ask: Do I really want this to be a family business? It's OK if the answer is no — not every great business needs to be handed down to the next generation. But if the answer is yes, the business leader must prepare a plan to give the next generation the authority to make meaningful decisions by themselves (without Dad or Mom as the mediator) and must commit to a timeline to hand over control. Identify who will take over which roles and clarify the authority behind those roles. Communicate clearly about when you will step down, first from the small roles and later from major leadership tasks.

2. The current leaders must build the governance needed for the future. Because there will no longer be one decision maker going forward, second- and third-generation family businesses need a board of directors (to represent the interests of the shareholders and oversee management) and an owner forum (a venue where owners can align on their purpose for owning the company and the high-level guardrails for how the business should perform). With these governance structures in place, future generations will be better equipped to operate in separate management, board and owner roles.

3. The second generation shouldn't wait to prepare the third generation for future ownership. This generation is likely to be more diverse and less connected than their parents. They will need education about the business and about the role of business owners. They will need an opportunity to decide if they want to be part of the business or if they would prefer to opt out of ownership. Start conversations with the third generation early; get their questions and their perspective on the table. Find ways to involve them in smaller decisions about the business and hold them accountable, as a way of building their decision-making muscles and fostering their ability to make decisions together.

Managing through the double transition

As difficult as the double transition can be, we have seen families navigate this situation successfully. Inevitably, the burden falls on the second generation. They must acknowledge the challenge, then move quickly to find ways to work together. As hard as it is, they need to exercise the discipline to put emotions and egos to the side so they can make essential decisions, clarify roles, support each other in those roles and invite the third generation into genuine engagement with the business.

The Pickens family was able to navigate the transition because they were committed to seeing the business go forward and because they found "common cause" as family members to get the hard work done. By refocusing their energy from debating "what would Dad have wanted" to "what do we want this business to be," they were able to forgive small slights, communicate their expectations, remember basic shared values and mobilize deep family connections.

The sense of accomplishment when families succeed in the double transition is immense. However, anyone who has completed this work will say the business and the family would have been better off with more time to plan and prepare. FB