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Scandal-proof your family firm

Three rules for avoiding Adelphia's mistakes with off-balance-sheet transactions.
By François de Visscher

What do family businesses share in common with Adelphia, Enron and other troubled corporations in the news? More than you may think.

In fact, family businesses all but invented off-balance-sheet transactions as a way for founders to allocate business assets or cash flow to the next generation. Often family stockholders pledge their illiquid shares as collateral for loans in order to provide liquidity to shareholders or to fund a venture outside the family business. Because the bank is lending the money directly to the shareholders, such loans are off the company's books, just as the agreement between the bank and the company is not part of any formal financial records.

So what was the fatal faux pas for Enron and Adelphia Communications? Both companies' leaders failed to disclose the loans and outside partnerships behind their transactions. Adelphia had guaranteed $2.3 billion in outstanding off-balance-sheet loans for Rigas family members. Enron's executives were guilty of more than mere silence: They touted their company's health while they quietly sold their shares at a profit—right before the company collapsed.

Off-balance-sheet transactions per se are perfectly valid and sometimes even essential. For instance, companies that don't provide liquidity for inactive shareholders through a company-sponsored loan program may cause restless or resentful shareholders to destroy the family business by selling their shares. Or a separate family real estate partnership, designed to purchase the property and lease it back to the company, can provide income to inactive family shareholders while spinning off appreciating real estate from the business to the family's next generation. But such transactions carry significant potential risks.

When credit is tight, banks require corporate guarantees on loans to shareholders. If the borrower defaults, the company's unwitting shareholders could wind up holding the bag. Yet these guarantees rarely appear on a company's financial statements.

Even without a corporate guarantee, pledging corporate shares as collateral may significantly endanger the family business. Consider a family company that invested $1 million in a relative's new chain of apparel stores. To help the

venture expand, the company structured some off-balance-sheet loan guarantees. When the venture hit tough times, the family business guaranteed still more debt. What began as an effort to “shelter” assets ended up putting an enormous amount of corporate assets at risk.

At Adelphia, the Rigas family used company loan guarantees to purchase potentially profitable but risky cable companies—not for Adelphia (where they owned only 40% of the stock) but for themselves. The Rigases also used personal loans backed by their Adelphia shares to buy back Adelphia’s shares—most likely to consolidate their control of the company.

The strategy backfired badly. When the value of Adelphia’s shares dropped, the Rigases didn’t have to pledge shares or provide other safeguards because Adelphia had done that for them. Adelphia’s non-family shareholders were outraged, and rightly so. And loss of shareholder confidence can be the first step toward sale of a company.

How to avoid Adelphia’s quandary? The following guidelines for off-balance-sheet transactions should help.

• Maintain a detailed inventory/disclosure of all off-balance-sheet transactions. Review it regularly with your board.

• Keep the amount of off-balance-sheet transactions to a conservative level relative to the company’s total debt. The definition of “excessive” is different for each family business. The board or audit committee should set up guidelines your company can live with.

For instance, if a company has guaranteed $20 million in loans to family members, I’d re-construct the company’s financial statements to reflect those off-balance-sheet liabilities as part of the company’s debt. If the financial analysts covering Adelphia had conducted this simple exercise, major red flags would have popped up.

• Strengthen the role of your board of directors. The presence of or plans for off-balance-sheet transactions should outweigh any reservations you may harbor about having an outside board. The board should delegate to an audit committee the task of crafting policies for transactions such as loans to family members or financing family ventures.

The clarity of your own financial books, ensuring their independent oversight, and keeping your company’s true financial ratios at or above the median of investment-grade companies will significantly protect your company from risky off-balance-sheet exposure and go a very long way to inspire confidence in your stakeholders.

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