Closed Case Files Perpetuation Chronicles™

EXCLUSIVE. THIS BUSINESS DOCUMENT HAS BEEN PREPARED FOR ENTREPRENEURS, BUSINESS OWNERS AND MANAGERS.

The Chronicles come from the exclusive files of Private Capital Corporation (PCC).

The case stories are true. Only the names and places have been changed to protect the privacy and confidentiality of PCC clients.

CLOSED CASE 33

CASE BACKGROUND In the late 70's the Midwest was feeling the pain of the economic misery index. But high unemployment, double digit inflation and skyrocketing interest would not dampen the entrepreneurial spirit of Isaac McKown and Rudy Wrublewski. With 10 years of combined experience in food distribution, the pair believed their city was ripe for a new food superstore—one that would emphasize super service. Easier said than done, they knew. They would have to find a way to motivate employees beyond a paycheck. And simultaneously they wanted to find a way to accelerate growth. They didn't have long to wait to realize their ambition. The first store flourished. In less than a year, the pair installed an ESOP to shelter earnings that would quickly support a second store and give employees a piece of the action. The company very quickly built a healthy equity. One store became five, five became ten and the beat went on until 30 superstores dotted a regional landscape. In 20 years, their chain grew from 100 to 7000 employees, many of them with large ESOP balances. The ESOP owned 1/3 of the company and the partners had 1/3 each. However, by this time, all was not well in the executive suite. Rudy and Isaac had conflicting succession goals; and worse, they learned that the ESOP, an instrument of success, was now bleeding the company dry and leading it toward bankruptcy. In fact, the annual ESOP repurchase liability had mushroomed to over 50% of after tax earnings and was projected to triple in 10 years. The financial threat weighed heavily upon the partners as they in turn weighed the realities of succession. Isaac wanted his family to retain interest and eventually inherit his stock; Rudy did not want his family involved and preferred to sell out. The company's COO and CFO were in a quandary but also in agreement - they would never fix their problems with a piecemeal strategy. They had to find a comprehensive solution.

CASE CHALLENGE Unless complex issues were solved, their supermarket chain could not remain independent, almost certainly facing a merger or outright sale. The buy-sell agreement between the company and the partners was essentially obsolete. The agreement made sense when the company was small and could afford to buy stock from Isaac and Rudy. In addition, the partners had major differences in succession plans; and to make matters worse, there was serious conflict between family members. If these issues weren't sticky enough, the company had to deal with the original ESOP distribution policy that allowed for 100% cash outlays to departing employees, a significant drain on operating capital and loss of senior employees. All of these issues had to be faced without adversely affecting employee productivity and morale.

PCC RECOMMENDED ACTION

1. Eliminate the founders' original buy-sell agreement. Create a Voting Trust, wherein the founders and top executives exchange stock for shares of beneficial interest in the Trust.
2. Change ownership and supplement coverage on key man insurance to provide liquidity for the founders' estates without adverse tax consequences to the corporation or stockholders.
3. Design a Senior Management Stock Program for senior executives who would be assuming responsibility for perpetuation of the company. In concert, founders to become Senior Advisors.
4. Coordinate the founders' estate plans with long-term company objectives.
5. Reduce turnover by changing the ESOP distributions to one-year deferral and payments over five successive years, or lump sum payment in the event of death, disability or retirement. The shares would be retired to reduce the ESOP size and future repurchase liability.
6. Install a 401K Plan for the benefit of all employees. Steer from being an ESOP company to one having a retirement plan that includes an ESOP.
7. Conduct a company-wide communication campaign and roll it out in a single week to tell the complex story, squelch rumor and get employee buy-in.

EPILOGUE Despite existing conflict, the coordinated strategies gave both founders a way to achieve their succession plans. The new ESOP distribution policy encouraged long-term employment and significantly benefited cash flows. With a 401K Plan in place, employees felt motivated to work for the benefit of those who stayed, not those who left. The company continued to prosper. Eventually, the founders passed away and their successor trustees replaced them on the Voting Trust. Several years later, the company was acquired by another major supermarket chain. Employees got 24% of the proceeds.

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