

Ten Rules of Ownership



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Most construction company owners have an operational background and thus, many ownership issues are not dealt with effectively. The following are the 10 most important rules of ownership for construction companies.

RULE 1

Be Very Selective Regarding Who Obtains Company Ownership

One of the most challenging issues contractors face in a transition is who will be an owner. The decisions create a cultural divide between owners and non-owners and the decisions must be made carefully, keeping the following in mind:

- The employee should be a key member of the company's management team who has had a clear and positive impact on the company's profitability.
- The employee would be difficult, if not impossible, to replace.
- The employee's age does not preclude ownership because they are close to retirement.
- The employee is one of the current or future leaders of the company.

In other words, we are suggesting that future ownership should be limited to those who are strong candidates for an ownership transition.

RULE 2

If You Have Minority Owners as Partners, Recognize your Fiduciary Duties

When an owner of a privately-held company sells, gifts, or grants some of that ownership to an employee, the majority owner is getting partners in the business. Partners, even minority partners, have certain legal rights associated with their ownership; these rights can vary from state to state. Before transferring even one share or one dollar of ownership, make sure you understand what kind of legal rights a minority owner is entitled to, and ensure that you understand your fiduciary responsibilities.

One of these fiduciary responsibilities is to ensure that your compensation is appropriate compared to that of senior managers in the same positions at like companies. A like company means a company that is roughly the same size in terms of total revenue, works in similar markets, performs similar work, and

makes about the same profit. We have seen situations where a minority owner (or relative of a minority owner) has sued a majority owner for breach of this fiduciary responsibility. In some of these legal actions, the minority owners or their relatives have prevailed.

Another responsibility of the majority owner is to share company financial information with minority owners. Most state laws require that all owners, even those with very small ownership interests, have access to all company financial information. This is another reason we caution you to be very selective about who obtains ownership.

RULE 3

Compensation Should Not Be Tied to Ownership.

One of the tenets of proper compensation management and ownership is that an employee's salary or wage should have nothing to do with the fact that they have company ownership. An employee's salary or wage is based on the employee's position and responsibilities within the organization. An employee's performance bonus should be based on the company's financial performance, where they work in the company, and their individual performance. An employee's compensation for ownership is based solely on the dividends or profit distributions that are allocated after the end of the fiscal year.

We have seen situations where an employee's salary/wage or bonus became inappropriately large simply because they owned some stock in the company. One favorite example is that of a safety manager for a small road builder in the Midwest who was receiving a salary 50 percent larger than safety managers at like firms because he owned one half of one percent of the company's stock.

RULE 4

Families and Ownership Often Do Not Mix Well.

If your family members or other relatives do not work for the company, they should not be sold, gifted, granted, or willed ownership of the company. We have seen too many examples where ownership of a company has passed through an estate to a family member or other relative who has no interest in being involved or is not competent

to be involved in the management of a company. This situation usually leads to an unhappy ending. Associated with this situation is the fact that absentee ownership does not work well in the construction industry. The company's employees may resent that the company is owned by a non-employee. Furthermore, the profit margins in the industry are too thin to have a non-employee owner receiving compensation or profit distributions. Competent managers will move on rather than put up with this situation.

Even if a family member or other relative works for the company, this does not mean that this person will be a good candidate for ownership. We believe that owners should also be the leaders of a privately-held company. Proper estate planning can allow family members or other relatives to eventually obtain the economic benefits of your ownership, and then let the next generation of company leaders actually own the company in the future. These types of decisions are often difficult for existing owners, but our experience has shown that the company will benefit in the long run and your family members or relatives will ultimately be happier for it.

RULE 5

Always Have a Shareholder or LLC Ownership Agreement Signed Before an Employee Receives Even the Smallest Amount of Ownership

We have heard many times the phrase, "we meant to get to that" in regard to having a shareholder or LLC ownership agreement signed for new owners. The potential results of not having such an agreement in place prior to employees obtaining ownership can be catastrophic. What happens if one of the shareholders suddenly and unexpectedly dies? Alternatively, what happens if a new owner is terminated or suddenly quits? What is the value of that ownership piece? Who gets first crack at purchasing the ownership? How should payments for the ownership be structured? Will you have to deal with that former employee's family members who do not understand the value of that ownership or the importance of keeping ownership within the company? Without a shareholder or LLC agreement signed by all owners, the answers to these questions are often settled in court.

Oftentimes, a structured ownership transfer process where ownership is transferred internally may take a number of years to fully implement. When a company does not have a shareholder or LLC agreement in place to guide the disposition of ownership should the worst case scenario occur, the ownership transfer process may blow up and the process must be started again from scratch with someone else. This situation is demoralizing for the existing owner, confusing for the company employees, and should be avoided at all costs. Proper ownership contingency planning, including having a shareholder or LLC agreement in place, is critical to handle these unfortunate situations.

RULE 6

Ownership Transfer and Estate Planning Is Not For Do-It-Yourselfers

Creating an ownership transfer plan, estate plan, or a shareholder (LLC) agreement involves many complex issues. There are considerable tax, legal, accounting, corporate governance, management, and other issues that must be identified, resolved, and ultimately crafted into a document. Most business owners do not have the background or expertise necessary to understand and resolve these varied issues.

Our advice is to use the best advisors possible to help you create these plans. These advisors include consultants, attorneys, accountants, and insurance agents who are experienced in these specific areas. CPA's should be used to provide expert advice on tax and accounting issues. Attorneys should be used to provide expert advice on certain legal issues and to draft shareholder or LLC agreements with the next generation of owners. Experienced insurance agents should be used to help purchase the right type of life and disability insurance policies to fund an ownership contingency plan.

Ownership transfer consultants should be used for expert advice on organizational and management succession issues, as well as to help the current and future owners select the best ownership transfer technique. Consultants can help to create a plan whereby the company may continue unencumbered with the next generation of leaders at the controls.

Our experience has shown that it is best to start with an ownership transfer consultant to develop goals and objectives for the process and to discuss and resolve "big picture issues". Other advisors may then be used to answer detailed questions and to draft final documents. Consultants experienced in this type of planning can be effective at coordinating the work of other advisors, thereby keeping the process on track.

Using these various experts may have a higher cost on the front end; however, these costs would be considered a bargain compared to the potential litigation costs associated with a poorly crafted ownership transfer plan.

RULE 7

Communicate the Rights and Obligations of Ownership before Getting an Employee Involved

Many employees do not understand the risks, rights, and obligations associated with company ownership. The uninitiated think that ownership equates to considerable wealth but the reality is that ownership is also associated with considerable risk.

We recommend that each new potential owner go through a course called Ownership 101 — a frank discussion concerning the risks, rights and obligations associated with company ownership. The following are a few topics that should be covered:

- The concept of separating ownership and compensation ownership may not lead to any short-term increase in compensation.
- The possible sacrifice of some current income during hard times.
- The possible personal indemnification of bonds and personal guarantees of bank loans.
- The lack of voting control for a minority interest in company ownership.
- The lack of liquidity associated with ownership of a privately held company.

RULE 8

Start the Ownership Transfer and Management Succession Planning Process Early.

The typical employee does not have large amounts of cash lying around that can be spent buying company stock. They may have limited access to credit markets due to their personal financial situations.

Because this is often the case, most ownership transfer plans involving employees use future company earnings to buy a majority owner out of the company. There are various techniques that can be utilized for this overall approach.

Regardless of which type of plan is used to transfer ownership, most construction-industry companies require seven to 12 years to complete the transition process. It is imperative then that the planning process for the ownership transition begin early enough to allow the plan to be fully implemented and for the existing owner to retire at the desired age.

It is also our experience that existing owners do not do a good job of attracting and developing future leaders for their company. The same time frame used to transition ownership can be used to mentor, develop, and train new company leaders and to get them familiar with banking, bonding, operational, and business development responsibilities.

RULE 9

The Most Important Job of an Owner is to Find His/Her Replacement.

An owner must be cognizant of the issue of management succession. Management succession is an issue that rarely goes away for most companies. Thus, one of the most important functions of an owner (particularly the majority owner) is to find, train, and ultimately empower his/her replacement.

This is a difficult task for many owners. Not only is it difficult to find high quality employees in the first place, but to train and empower a replacement is an admission of the owner's mortality. While we would all like to think that we will live forever, actuarials tell us otherwise.

Without a suitable replacement, a business continuity plan has zero chance of success. Indeed, finding suitable replacements should be a high priority for the company's entire senior management team.

There are other benefits to implementing a solid management succession plan. What is good for management succession is good for the company. In other words, finding quality employees, training them, and eventually putting them in leadership positions helps to ensure that the company will achieve long-term financial success.

RULE 10

Do Not Lose Sight of Business Basics During the Ownership Transfer Process.

Although crafting and implementing an ownership transfer and management succession plan is a very important function of management, the number one goal of the business still needs to be making money.

The ownership transfer period can be a distracting time for a company. The company is breaking in a new management team, key responsibilities are being transitioned to different employees, and most of the free cash flow of the company is dedicated to the ownership transfer process. We have seen companies "drop the ball" during this transitional time. The company still needs to be profitable. In fact, if the process is using future earnings to transfer ownership, it is critical for the company to generate solid earnings over this period.

It is also critical for the company to aggressively fund executive and incentive compensation plans during the transfer period to retain and to motivate those key employees who will not be involved with ownership. Finally in these days of changing surety industry conditions, solid earnings during the ownership transfer period will go a long way to allay any concerns that the bonding company may have.

CONCLUSION

How a company handles these ten rules will help determine the success of its ownership transition plan. Managing this process is a daunting task and there are many forces trying to pull owners in the wrong direction, which is why FMI highly recommends that owners seek experienced advisors to help take some of the difficulty out of the transition process. By overcoming the challenges inherent in this process, you can ensure that your company survives well into the next generation.

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FMI delivers innovative, customized solutions to contractors, engineers, architects, environmental firms; manufacturers and suppliers of building products and construction equipment; construction materials producers; private owners, government agencies, utility companies; surety companies; and trade associations.

FMI's experienced consultants can assist your business with compensation planning, leader and organizational development, business development, strategic market information, acquisition integration, mergers and acquisitions, ownership transition, private equity financing, project delivery improvement, management and field-level training, strategic planning, strategic sourcing, and productivity improvement.