Forgotten Sources of Capital for the Family-Owned Business

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The recent scandals on Wall Street in the banking and savings and loan industries have created a financial crisis for many family businesses, particularly those in smaller towns and cities. The long-standing personal relationships with financial intermediaries have been altered by the loss of these financial organizations and by heightened government intervention and regulation. To manage the finances of a family business successfully, the owners must reassess forgotten sources of capital for their businesses. This article examines these sources of capital for family businesses in the United States.

Family businesses have a variety of unique features associated with them. But the feature that most differentiates the family business is the personal/professional interface between the family and the operation of the family's business. The conversion of roles as manager and family member illustrates the overlapping of the business and family unit. Personal relationships become unique and differentiating characteristics of a family business. To fully analyze the operations of a family business, a holistic framework is necessary, one that views a family business as a complete entity with a structure and organization integrating both the business and family unit (Hollander and Elman, 1988; Kenter, 1989; Flemons and Cole, 1992).

The personalization of the family business is carried over to other business relationships, such as those with suppliers, employees, distributors, customers, and individuals and institutions that provide professional services to family businesses, such as accountants, lawyers, insurance agents, and bankers. It is not uncommon to have these personalized business relationships last for decades, and they may even be passed from one generation to the next if the family succession plan is effectively implemented. (Handler, 1994). One relationship that typifies the personal relationship orientation to family businesses is between the head of the family business and the bank or financial institution.

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The banking relationship for a family business may be based on personal relations more than business rationale. Both institutions base their continuing business on the personal relationship and, to a degree, on the friendship that exists between members of both organizations. Therefore the negative impact on family businesses of the banking and savings and loan industry collapse has been critical, particularly to companies in smaller towns and cities. Many of the personal bonds that were forged between the principals of the family businesses and the management of the local bank or savings and loan have been disrupted if not lost. The banks were closed or, in many cases, taken over by a larger institution that may or may not have been located in the city or state where the family business was located. The collapse of the financial institution's supply of working capital lines and other credit-oriented services, based on a handshake or a historic knowledge and relationship with the family business, has ended for many of the companies. The magnitude of this shift in the banking industry can be seen in Figure 1. The impact on family business could be significant and may continue to influence decision making in these companies for years to come.

As happens so many times, one event in the economy triggers others that continue to create problems for family businesses. There has been a consolidation of entities in the banking industry taking place at the same time local banks were failing ("American Banks," 1994). The number of community banks fell to its lowest level since the 1930s (Atkinson, 1994). Bank mergers and acquisition activity established a new record in 1993 at $22.5 billion, when the average prices paid for banks acquired were an astonishing 168 percent of book value (Mathews, 1994). Consolidation through mergers is going to continue as a trend in the banking industry as banks realize that they must grow to stay competitive. The pressure on banks to merge has accelerated, leading some experts to predict that in the next decade the number of chartered commercial banks will decline from 18,840 to 8,000 (Streeter and Locheo, 1994).

This consolidation, through state and national banking affiliations, has a tendency to depersonalize the banking relations with local bankers who have little control over local lending policies. Banks with assets between $100 million and $1 billion had a consolidation rate of nearly 12 percent between 1989 and 1993 (Dillon and Pitkin, 1994). The family business is treated like any other borrower without a great deal of regard for the history of the business or the past personal relationship; a new banker (bank) does it by the numbers without the benefit of knowing the integrity or reputation of the family that stands behind the loan request. At the same time, new government regulations in banks require more stringent loan parameters, making the loan application process, as well as granting the loan, more tedious, time-consuming, structured, and difficult to receive. The passage of the Relgle-Neal Interstate Banking and Branching Efficiency Act of 1994, which permits interstate bank charters, should also exacerbate the problems created by consolidation for local banks

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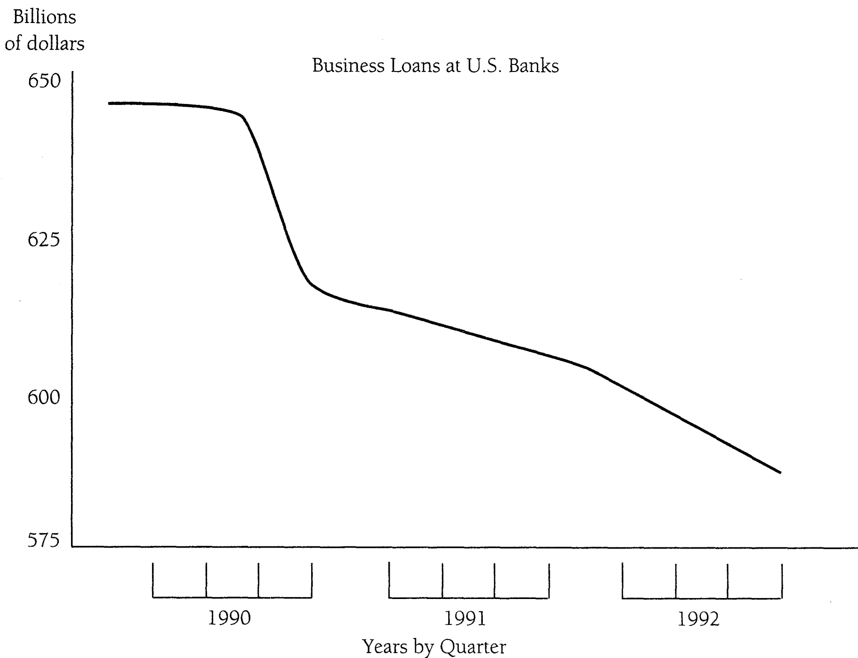
Figure 1. Bank Failures Between 1980 and 1990

Year	Total Banks Closed	Problem Banks [a]
1982	42	369
1983	48	642
1984	80	848
1985	120	1140
1986	145	1484
1987	203	1575
1988	221	1406
1989	207	1109
1990	169	1046
1991	127	1069



[a] FDIC-insured commercial and savings banks considered to be problem banks by supervisory authority, end-of-period.

Source: U.S. Department of Commerce, Economics and Statistics Administration, 1992.

(Simoff, 1994). The advent of interstate banking and rapid consolidation in the banking industry has sparked fears of market concentration and monopoly power in the industry (Shaffer, 1994). Many family businesses were caught in the 1991 recession without adequate sources of capital with which to operate their businesses. The banking scandals and the recession will improve over time; what was lost were the personal financial relationships that the family

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business had relied on for decades. The decision-making process at many local banks has to be altered and discretion to make loans has been reduced (Smith, 1994). More than likely these personal ties between family business and banker will not be as strong in the future, and many would argue that the personal relationships were some of the problems that created the Wall Street, savings and loan, and banking industries' most recent decline (Frieder and Hedges, 1994).

Need for Capital in the Family Business

The need for capital has not diminished in family businesses just because the primary source of capital for family businesses has to be altered. The need for capital may have negative connotations, such as recovering from the economic recession of the early 1990s, or it may be positive, such as taking advantage of new technology or market opportunities. Table 1 illustrates the point at which capital needs of family-owned businesses may be a negative signal or a positive indication of growth and opportunity to a lender. For example, borrowing additional capital to pay off or refinance existing debt or to provide sufficient working capital to operate the company has negative connotations to prospective lenders. When the family business needs to increase its work capital line due to increased demand for its product, or when new plant and equipment are needed to satisfy demand, the prospective lender sees healthy, future-oriented borrowing.

It is obvious that capital needs have either negative or positive dimensions, but it is important to underline this point because, with the modification in the relationship between lending institutions and the family business, the "merits" of the loan request will play a significant part in the approval or disapproval. The more formalized the loan application process becomes, the higher the possibility of the head of the family business becoming more disenfranchised with the process, leaving the family business without a source of capital.

One of the outcomes of the turbulence in the financial institutions' segment of the economy for small business and family business has been that such businesses seek out new sources of capital for their firms (Frieder and Hedges,

Table 1. Uses of Capital in Family Owned Businesses

Uses for Capital	*Short Run*	*Long Run*
Positive	Capture new market segment Begin new distribution of product Increase advertising to stimulate sales Introduce new product	Acquisition Development of new technology for competitive advantage Expansion of plant and equipment Additional technical staff
Negative	Meet new government regulations Settle legal action Provide operating capital	Pay down existing debt Restructure acquisitions made in the 1980s Consolidate debt to reduce rate

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1994). If the personal tie to the local bank was lost or if the local bank was unable (out of business or consolidated into a larger entity) to fulfill the capital needs of the family business, new sources of capital are needed. For many family businesses, this seeking of funds was a new and discouraging venture. Without past experiences in sourcing capital, many family businesses were forced into the trial-and-error search for capital for their companies. The requirements for funding and expectations of the sources of capital are typically radically different from those in dealing with local small banks.

Beyond Commercial Bank Sources of Capital

The need to understand the expectation of new sources of capital requires the family business to identify sources and hopefully predetermine the lending parameters of each. To that end, Table 2 depicts the differences between a traditional bank as a source of capital for the family-owned business and general expectations of other traditional lenders. The potential sources of capital are compared with commercial banks, which are normative. These parameters would obviously be tempered by the size of the loan, the length of the loan, and, to a large degree, the reason for the loan (positive opportunity or negative operating experience in the past). This table also provides a road map to the family business owner to determine in advance whether the company and its management are willing to meet the requirements of the potential sources of capital. Some family business owners erroneously believed that the bank lending parameters would be similar to the alternative sources of capital, and they faced problems when they attempted to source capital from alternative institutions or individuals. A brief description of each traditional alternative might provide additional insights into the problems of capital sourcing for family businesses.

Direct Investors. Direct investors have historically been thought of as family, friends, friends of friends, business associates, and, to a lesser degree

Table 2. Traditional Sources of Capital for Family Business

	Sources					
Characteristics	*Bank*	*Director Investors*	*Investment Venture Capital*	*IPO*	*General Finance Companies*	*State/ Local Gov't Funds*
Cost of capital	Norm	Higher	Higher	Higher	Higher	Lower
Length of term	Norm	Longer	Same	Longer	Longer	Longer
Collateral and assets	Norm	Ownership	Ownership	Ownership	Warrants	No ownership
Cash-flow lending	Norm	Integral	Yes	Yes	Yes+	No
Relative risk	Norm	Higher	Higher	Higher	Higher	Less
Ownership	Norm	Yes	Yes	Yes	Warrants	No
Controls and audits	Norm	Less	More	Less	More	Less
Fees	Norm	Less	Higher	Higher	Higher	Less
Activity and availability	Norm	Low	Low	Low	Higher	Low
Overall assessment of source	Norm	Fair	Poor	Fair	Very good	Poor

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for family businesses, professional direct investors. The primary reason for not utilizing the professional direct investor is that ownership is relinquished and, many times, the amount of capital desired by the family business is too little. Silent partners typically have a personal tie to the company that they invest in and continue to stay attuned to the company's operations because of their equity position in the company. Frequently director investors do not participate in the management of the firm but may serve on the board of directors.

A second group of direct investors, informal investors, are high-net-worth, annual-income investors who are willing to take higher risks over extended time to earn higher returns. It has been estimated that this group represents over $50 billion in sources of capital (Wetzel, 1987). Funding direct investors is the primary problem that family businesses have with this group. Social and business networking is the most frequently used method of tapping into this source of funds. The problem is that the family must publicly admit or address its need for capital, a step many families are unwilling to take.

This source of capital was damaged by the recent recession, and many of the tax advantages for investing in small business have been eliminated in the past several years. Although there are still a number of qualified silent/informal investors, their recent experience has made them a more reluctant and difficult source of funding. Coupled with many families' desire for secrecy, this traditional capital source will be limited for some time (Posner, 1988; Lipper, 1988).

Investment and Venture Capital. Professionally managed pools of capital grew to an estimated 475 to 500 firms in the United States during the 1980s. These firms have had a tendency to concentrate in California, New York, Massachusetts, and Texas, and many specialize by industry or level of technology (Vesper, 1993). Some of these venture capital funds focus on seed capital, whereas others concentrate on young companies that need their second or third round of capital infused into the company (Bruno and Tyebjee, 1985; Timmons and Bygrave, 1986; Sahlman, 1991). The cost of capital from venture capital firms normally goes well beyond the financial parameters of the loan arrangement. They frequently expect membership on (and at times, control of) the company's board of directors, monthly financial statements, annual certified audits, substantial life insurance on executives, access to personnel, management and marketing audits conducted on a regular basis, and a host of other requirements (Cherin and Hergert, 1988; MacMillan, Keslow, and Khoylian, 1988; Bygrave, Fort, Khoylian, Vincent, and Yue, 1988; Vesper, 1993). Many of these requests would seem foreign in the privacy of the family business and beyond the willingness of the management to grant to a source of capital. A large portion of venture capital is for acquisitions and not for normal operating funds. The level of venture capital, like commercial loans from banks, has declined in recent years (see Figure 2).

The most discouraging dimension of this source of capital is the relinquishing of equity in the business. The estimates of equity given to venture capitalists in the 1980s was an average of 35.8 percent and the median was 40.1

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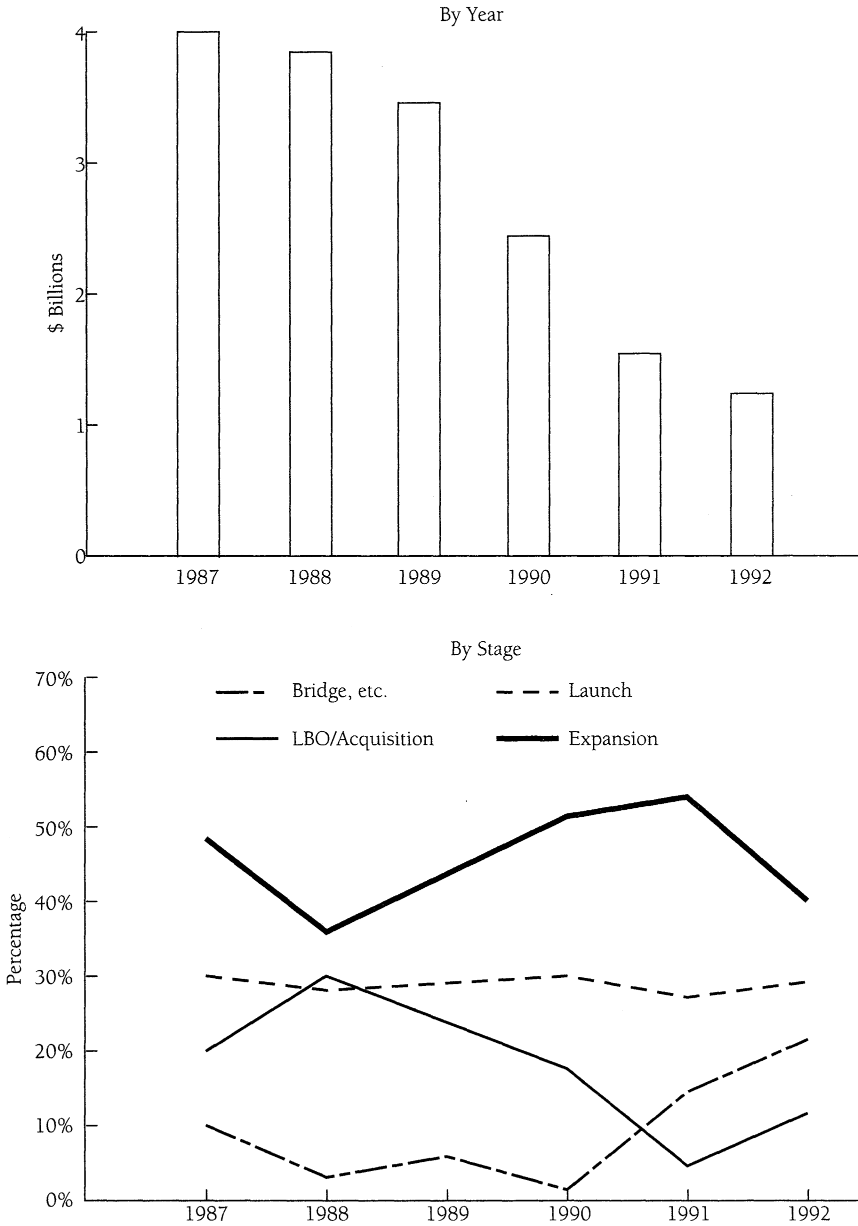
Figure 2. Venture Capital Disbursements



Source: Monroe, 1993.

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percent (Bruno and Tyebjee, 1985; Fried, Hisrich, and Polonchek, 1993). The levels of involvement and contribution by venture capitalists have been a source of debate, but their activity level has diminished since the turn of the 1990s and their demands and controls have increased (Maier and Walker, 1987; Timmons and Bygrave, 1986; Cherin and Hergert, 1988; MacMillan, Keslow, and Khoylian, 1988; Halloran, Benton, and Lovejoy, 1990; Sahlman, 1991; Vesper, 1993).

Initial Public Offerings. Initial public offerings (IPOs) involve taking a privately held company public, with all the positives and negatives associated with that process. Many entrepreneurs used IPOs as a vehicle to cash out of their businesses in the 1980s (Gupta, 1983). This source of capital typically comes after a company has an established track record that can be sold to prospective investors on a stock exchange. The Securities and Exchange Commission's host of legal requirements is one of the costs of the IPO. The cost of preparing to go public can be substantial, involving legal fees, accounting disclosures, development and approval of a prospectus for the SEC, and the marketing and selling cost paid to brokerage firms (Huerta, 1980; Sutton and Post, 1986; Jones, Cohen, and Coppola, 1991). The IPO market was damaged by the junk bond scandals and insider trading in the issuing of new stocks. This source of capital has been used to allow for rapid growth and, as was stated earlier, to sell off ownership in the company over time.

General Finance Companies. As other traditional sources of capital for family businesses became hard to access, one alternative, the asset-based lender, was used by some businesses. These lenders have relatively extensive capital and very stringent reporting requirements. The interest rate change varies but would typically be three to four points above prime plus high initiation fees, including auditing and setup changes and continuing fees throughout the term of the loan. The loans are based on the tangible assets and the cash flow to support the loan. These lenders are considered to be intrusive by management and difficult to deal with because of the reporting requirements and monitoring by functionaries that know little about the business.

State and Local Funds. There was a period in the 1980s when state and local funds were used aggressively to attract new businesses to the area. State funding for infrastructure profits and tax abatements were passed to attract major corporations to a particular state. On the local front, municipality Industrial Revenue Bonds (IRBs) are used to finance the construction of plant facilities. It may have attracted interest rates that were two to three points below prime, but as the economy faltered and states fought increasing deficits, this source of capital for family businesses has all but vanished. There are a limited number of opportunities still available to small businesses, but they are difficult to find and to qualify for.

The funding from traditional sources of capital is also based on the stage of development that the family business is in when it requests the capital infusion. The stages of family business identified were (1) seed capital, (2) first-round start-up, (3) second- and third-round start-up, (4) emerging growth, and (5) leveraged buyout. The characteristics of the investor group or institu-

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tion change by the stage of evolution the family business may be in at the time from the amount of risk they are willing to undertake. The seed capital and first-round capital may be for a new business venture that has been developed by the family business. A new technology or process may have been acquired or developed, and the family business may want to embark on a venture that is a departure from the core family business. It is important for the family business management to place its funding expectations into a temporal perspective because the appropriateness of the institution and its risk/return indexes vary dramatically. Table 3 demonstrates the investors' frame of reference for venture capital and more traditional sources for capital. The ideal characteristics are median expectations of lenders and the provision of a benchmark for what lenders' decision criteria will be when the family business owner requests a capital infusion from one of these nontraditional institutions (see Table 3).

Given the high return expectations and the additional requirement of stock ownership, are there other alternatives to traditional sources of capital for the family-owned business? What forgotten capital sources are there to provide needed capital to this most important segment in the business community? Where are the sources of capital for future growth for those that were

Table 3. Overview of Industry Segments: Risk-Return Continuum

	Seed	*First Round Start Up*	*Second–Third Round Start Up*	*Emerging Growth*	*Leveraged Buyouts*
Company Characteristics					
Age	0 years	0–1 years	1–3 years	3–5 years	10–50 years
Stage of product of concept development	Idea	Prototype	First generation product	Second or third generation product	Mature product
Sales	$0	$1 million	$1–5 million	$5–20 million	$20–750+ million
Sales growth rate	0%	Explosive	50–100%	25–50%	10%
Profits	$0	Losses	Break-even	Some profits	Stable profits + cash flow
Management	Founders/ scientists	Founders and some professional management	Professional management	Professional management	Professional management
Public or private	Private	Private	Private	Private or public	Private or public
Capital needs	$5–10 million	$2–5 million	$3–7 million	$5–10 million	$5–50 million
Venture Capital Return Expectations					
RDI	70+%	60–70%	50–60%	40–50%	20–40%
Multiple of original investment (in fifth year)	14x	10x	7.5x	6x	4x

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hardest hit by the recent consolidation, closing, and general decline in commercial banks as sources of capital funding (Atkinson, 1994; Frieder and Hedges, 1994; Streeter and Locheo, 1994)?

Forgotten Sources of Capital

The premises of this section are that family businesses will need capital and that their traditional sources for capital will continue to be limited or restricted in the future, and, after examining the traditional secondary sources of capital available to them, that they are not willing to fulfill the requirements of the alternative lenders, that is, ownership, review, or monitoring of business records.

Five additional alternative capital funding options for family businesses have been identified: "green card" immigration sources, domestic international sales corporations (DISCs) and foreign sales corporations (FSCs), export trading companies (ETCs), employee stock ownership plans (ESOPs), and domestic and international factoring. These alternative sources of capital for the family business will be discussed briefly to highlight their advantages and disadvantages.

The first three sources of capital for the family business involve international funding, whereas the remaining capital comes from within the United States. Table 4 compares and contrasts the five sources of capital.

"Green Card" Immigration Capital. Section 121 of the Immigration Act of 1990 (November 29, 1990) created a new investor immigrant visa category for up to 10,000 individual foreign investors annually. The 1990 Immigration Act was enacted to encourage investments by individuals in foreign countries who desired to immigrate to the United States. Investors would receive a permanent "green card" visa status if they invested $1 million in an existing commercial enterprise that created an increased full-time employment by at least

Table 4. Traditional Sources of Capital for Family Business

	Sources				
Characteristics	*Immigrant Green Card*	*DISC*	*ESOP*	*ETC*	*Factoring*
Cost of capital	Low	Low	Moderate	Low	High
Length of term	At least 2 years	Indefinite	Indefinite	Indefinite	Short
Collateral and Assets	Yes	No	Yes	No	Yes
Cash flow	Yes	No	No	No	Yes
Relative risk	Moderate	High	Moderate	High	Low
Ownership	Yes	No	Yes	Yes	No
Controls and audits	No	No	Yes	No	Yes
Fees	No	No	No	No	Yes
Activity and availability	High	High	Moderate	Moderate	High
Overall assessment of source	Very good	Very good	Good	Fair	Good

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ten new jobs for U.S. workers within a two-year period. The act allows the immigrant to obtain green card status if the $1 million investment in the existing business results in at least a 40 percent increase in net worth or number of employees employed by the business. The United States' permanent residence status to immigrant investors is conditional. This means that two years after acquiring conditional status, if the enterprise is still viable and operating, the conditional status should be removed.

Two subsections of the act may have important benefits for family-owned businesses. First, the act identifies "targeted employment areas" (TEAs), which are defined as rural or urban areas that have experienced high unemployment, that is, one-and-one-half times that of the national average. In TEAs the foreign investor would have to invest only $500,000 to qualify for a permanent work visa in the United States. The reduction in capital opens the way for a larger number of potential investors and, at the same time, reduces the control and influence of the investor in the family business. Second, the 1990 act provides special rules for investments in troubled businesses. A family business must have been in business for two years and incurred a net loss of at least 20 percent of the company's net worth. If this decrease in net worth has occurred in the last five years, the investment does not have to create ten new jobs if the investment can show, through a comprehensive business plan, that employment will be maintained at the current level for two years.

The source of the capital that the foreign investors put into the family business does not have to come form abroad. The capital may be borrowed domestically as long as the investor is personally liable and the debt is not secured by assets of the family business. This might be the case of foreign families with high family net worth sending one of their children to the United States to gain a work visa. The family wealth would guarantee the loan to be invested in the family enterprise. Additional provisions of the act allow capital to be cash, equipment, inventory, other tangible property, and "indebtedness" secured by assets owned by the alien. More than one foreign investor can qualify for an immigrant visa by establishing or co-opting a single new commercial enterprise. This would allow several investors to pool their investments. Purely passive investment by foreigners will not qualify. However, it appears that the INS will utilize a very liberal standard for determining what constitutes active involvement by the foreign investor.

The first question that a family member asked would be, "How can I identify a potential foreign investor with that kind of money?" This would be closely followed by the second question, "How can I qualify this person?" (Juillard, 1986). There are a variety of means to generate names of potential foreign investors, such as banking contacts, lawyers, accountants, and International Chambers of Commerce, but one source stands out as having the highest potential: present foreign suppliers.

Many family businesses have some contact with foreign suppliers of subassemblies or products to their firm. If this is the case, the prospective investor

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list is already in-house, and the evaluation of the investor could be based on the family business's past experience with the supplier's products and services provided through the years. The supplier may not have to provide capital but rather access to products that could by sold in the domestic market. For example, a small wholesaler of promotional baseball caps who is located in a small midwestern town could have its supplier provide it with $500,000 worth of products on consignment. Many foreign suppliers are required to give "dating" to domestic buyers due to the time lag in shipment, clearing customs, and transshipment to the purchaser before the product can be sold. This revolving inventory loan would qualify for a rural targeted market area investment, and the foreign investor may qualify for a permanent green card visa in the United States. As long as the investment was in the family business for at least two years, the foreign investor would qualify for a permanent work permit. This may be very attractive to foreign investors who want to expand their businesses in the domestic market by having one of their children qualify for a work permit in the United States and later citizenship. The cost to the family business would be negligible, and they would have the infusion of capital through the inventory that they needed.

Domestic International Sales Corporation (DISC)/Foreign Sales Corporation (FSC). There are several nonfinancial institutional approaches to obtaining capital for the family business. One means of self-financing is accomplished by taking advantage of tax deferrals that are given on export profits. In 1971 the Revenue Act, a part of President Nixon's "New Economic Program," was passed and established a new corporate entity entitled the domestic international sales corporation (DISC). This act allowed domestic businesses to establish a DISC whose primary focus would be export sales. The DISC could be as little as a separate set of books to validate that the parent company sold its products to the DISC, which in turn sold the product to a foreign purchaser. The self-financing aspect of the DISC is fulfilled in that one-half of the income from the export sales was deferred from taxation. For example, if the family business that formed a DISC had profits of $100,000 at the end of the first year, the tax liability in year 1 would be the corporate rate on $50,000 of profit, in effect, a tax deferral on 50 percent of the export income. What can be done with the $50,000 accumulated in the DISC? For one thing, the DISC may make a parent company loan, that is, capital infusion to the family business. The rate and the timing of the repayment of the loan are determined between the two entities. If the family business is already exporting products, it may be able to generate deferred tax money to do its own banking and provide the capital needed in the company. In 1984 the DISC legislation was all but abolished because the General Agreement on Tariffs Treaty (GATT) considered the tax deferral as an export subsidy, giving the United States exporters unfair competitive advantage. What remains is an interest change DISC with some limitation on tax benefits, and it is available only for small exporters. The official definition of a small business exporter is "one which is independently owned

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and operated and not dominant in its field of operation" (Scarborough and Zimmerer, 1991); therefore the DISC option could be used by a large portion of the family businesses in the United States.

The Deficit Reduction Action of 1984 attempted to circumvent the GATT criticism of DISCs and permitted domestic organizations to form foreign sales corporations (FSCs, or "fisks") to encourage export sales (Lee and Bloom, 1985). FSCs have more stringent requirements than DISCs have in that the FSC cannot be a paper corporation as many DISCs are. From the tax authority perspective, a FSC can gain a tax exemption of 15 percent to 32 percent on sales generated by the sale or lease of exported products if its products have 50 percent United States content.

The FSC must be incorporated in a foreign country and have one board member who is non-American, and the foreign office must be of economic substance; that is, it must carry out some normal business operations, billing, and sales from the foreign office. The foreign office must account for at least 50 percent of five of the direct costs, which include advertising, order processing, transportation, invoices, and credit risk. Foreign taxes paid on FSC's revenues are not eligible for tax credit deduction in the United States. Therefore the location of the FSC office should be in a no-tax-law tax jurisdiction such as the U.S. Virgin Islands, Guam, American Samoa, or the Cayman Islands.

Although the FSC is more cumbersome to establish and operate, it does provide for a tax exemption that can be used to assist financing of the family-owned business. If the family business is already involved in export sales, with a minimum of organizational discomfort, they can save 15 percent to 32 percent on taxes of export sales. It is important to note that small exports may use a FSC without meeting some of the export activities text. This gives the family business latitude in managing its export sales and at the same time provides smaller generated funds through the tax exemption.

Export Trading Companies. The Exporting Trading Company Act (ETCA) of 1982 was passed to encourage exporting of United States' manufactured products. The act addressed two issues perceived as restraining United States exports: (1) undercapitalization—many manufacturers were perceived not to have adequate capital to embark on an international selling effort—and (2) the antitrust ambiguity associated with cooperative efforts, that is, strategic alliances in the international marketplace. Section 5 of the ETCA allows domestic banks to invest up to 5 percent of their consolidated capital (up to $10 million) into an ETC, providing it is not controlling interest. Not since the 1930s, with enactment of the Staggers Act, have banks been allowed to participate from an ownership standpoint in commercial ventures. The second provision relative to antitrust immunity (Title Two) is less significant for most family businesses, but the act allows for alliances and coalitions of businesses to form without fear of antitrust laws. The most important aspect of the act for family businesses is that their hometown bank can be an equity partner in their company—capital infusion without a debt repayment schedule.

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If the family business has a track record in international business, it may be able to partition that element of the business off in an FSC and have the bank finance the growth of the operation. In the meantime, the family business may use its own capital to fuel the growth of domestic business. The Office of Export Trading Company Affairs (OETCA) is responsible for a Contact Facilitation Service, a clearinghouse for matching U.S. suppliers of exportable products with companies that provide trade facilitation services. Therefore the entire exporting process can be shifted outside the family business, not requiring additional staff or sales personnel to manage the export sales.

Employee Stock Ownership Plans (ESOPs). A defined contribution plan designed to invest in the family business, such as an employee stock ownership plan (ESOP), can provide capital for expansion or remedial strategies to deal with problems that have occurred. The sequence of events in developing an ESOP for the family business is as follows (Juillard, 1986, p. 35):

1. ESOP is adopted and a related trust is established by the employee corporation.
2. ESOP borrows the needed cash from lender/employee corporation, guarantees the loan/makes commitment, assures repayment . . . company may borrow the dollars and make "mirror" loan to ESOP . . . shares may be used for collateral for the loan.
3. ESOP pays the cash to company/shareholder in exchange for stock of equal value.
4. Company makes annual tax-deductible cash contributions to the ESOP trust sufficient to amortize the loan.
5. ESOP pays back the lender as it receives contributions.
6. Securities are held in suspense account; they are released to participants' accounts as the loan is repaid.

ESOPs provide the financing vehicle for corporate growth, going private, increasing working capital, financing acquisitions, and shareholder buyouts. Again, with this source of capital there are distinct advantages that accrue to the owners of the family business: (1) the sponsoring company can pay off the ESOP loan with pretax dollars; (2) an ESOP provides a market for stock in a closely held corporation; and (3) selling shareholders will normally receive capital gains treatment. Other tax advantages include partial exclusion of interest income from ESOP loans, deferred recognition of gain on the sale of certain stock to an ESOP, and deductions for certain dividends paid to ESOPs and assumption of certain estate tax liabilities by ESOPs. Contributions used to pay loan principal are deductible up to 25 percent of covered payroll, and allocation to individual participant accounts may be the lesser of 25 percent of the participant's compensation or $60,000. Employees share in the profits of the company, which may improve motivation, productivity, and work attitudes.

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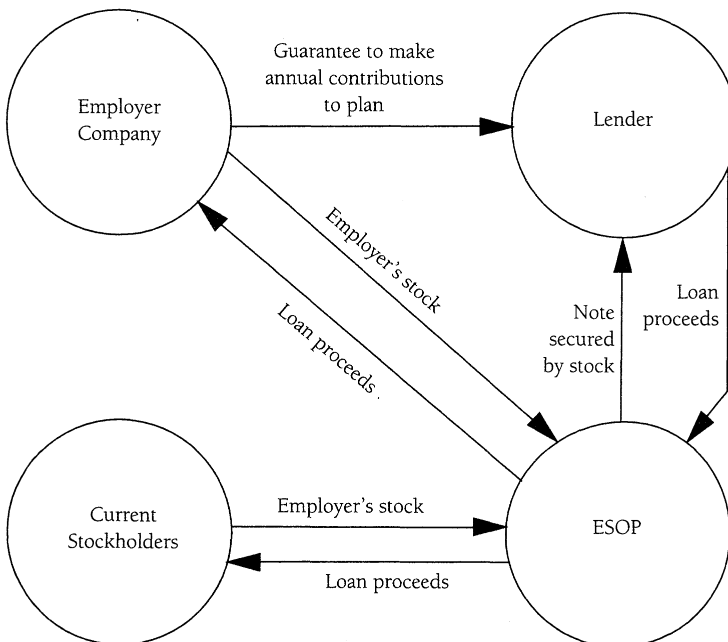
Figure 3 outlines the basic steps in a leveraged ESOP. The ESOP concept is not without some problematic issues, but, properly managed by the family, it can inject the working capital needed by the business when more traditional sources of funds are not open to the company. The ESOP can be revised if the family does not want partial ownership by employees, but this may be one of the better means to tie professional nonfamily managers into the company.

Factoring. The concept of factoring has been available to small businesses, including family businesses, for decades, but the creative application of factoring can be helpful to the family business. Factoring is the purchase of receivables for a discounted price, ranging from 3 percent to 8 percent, as well as a reserve of 25 percent of the resumables held by the factorer. The discount rate varies depending on the product and the customer (creditworthiness) as well as the factorer itself (Currier, 1983).

The creative application of factoring could be employed by the family-owned business opening international markets. Using a factor for its export sales provides two important advantages to the family-owned business: (1) it enables the family business to receive payment immediately, and (2) it relieves the family business from collection of the accounts receivable, that is, if the management with the factor is without recourse. The important consideration

Figure 3. Leveraged ESOP



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is that a new marketing strategy, international sales, may provide the capital for the family business to allow the growth needed in the company.

Summary and Conclusions

Personalization of relationships has been a hallmark of family business. The family members are the business to many of its key stockholders, such as suppliers, accountants, employees, and channel-of-distribution members. But some of the key personal relationships of many family businesses have been those with their sources of capital and lending, typically a local bank. Due to the recent disarray of the bank industry and to the consolidation of lending institutions, the personal relationship between bank and family business may be a historical artifact. With a lack of experience and, in some cases, an accurate frame of influence, family businesses have not used other traditional sources of capital effectively. One of the major determinants of using alternative capital sources has been the relinquishing of some ownership in the family business.

This article explored sometimes overlooked sources of capital for family-owned businesses. Although several of the sources of funding have an international dimension, they provide alternative means to fuel the growth of family businesses as the economy recovers from the recession of the early 1990s. If the family business is attempting to expand sales volume through the international markets, several of these funding alternatives may be attractive. Particularly attractive is that no ownership has to be given up and fundraising is done more or less internally, through tax reduction and deferral.

Family businesses are a significant aspect of business in the United States today. If they do not explore alternatives and sometimes unique sources of funds, their viability in the economy may be stunted. Without a healthy family business sector, prospects for a robust economic climate in the United States are doubtful. Without capital, neither future looks prosperous.

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