
How Much Control Should You Have Over Your Firm?



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Family ownership can vary from thousands of family members to just one single owner. How to choose the right number for your family business?

The Belgian Janssen family counts close to 2,500 family members who together have a controlling stake in the petrochemical group, Solvay. Contrast this with a sole owner structure typical in Japanese firms and it is clear variety abounds in ownership arrangements across the world.

As a firm's ownership structure affects the incentives, behaviour and, ultimately, the performance of family members, managers and other stakeholders in the firm, it is therefore essential to get the formula right. Designing a sound ownership structure will resolve the allocation of voting rights, the transferability of ownership rights and set out how profits and losses are shared. It is the most effective way to minimise the impact of roadblocks in a family business. When designing an ownership structure it's most important to keep the arrangement flexible, so changes can be made

over time as the family and business grows.

It may sound simple, but there are four challenges to bear in mind when looking at your ownership design.

1. Raising capital without giving up control
2. Dealing with ownership diffusion due to the power of numbers
3. Using trusts and foundations to your advantage
4. Going public and still retaining control

Retaining control while growing

Control and ownership go hand in hand in the early life of a family firm. The entrepreneur sets up a firm and keeps ownership in the family. Even if outsiders are invited to invest, the family typically retains a majority share, giving them absolute control over decision making. The need for external capital to finance new business activities can threaten that control, particularly when markets increase in both size and geographical spread.

Careful ownership design allows families to balance the need for growth and control in fast-growing business ventures by creating control-enhancing mechanisms and severing the direct link between investment and control. In rethinking the relationship between the right to a return (income) and the right to a say (votes), they manage to concentrate control in the hands of the family while sharing the returns with a broader group of investors. There are many ways families can disentangle the right to a return from the right to a say, keeping the latter in the family's hands.

The pyramid effect

A pyramidal structure can be used to preserve control in the family, even when ownership is diluted. The pyramid represents a chain of corporate control. Typically a private family-controlled investment company at the top retains a controlling stake cascading down through a series of subsidiary companies. In return for retaining control, the family forgoes a large share of the cash flows from the lower layers, which may be paid out as share dividends to the other investors. This system has worked successfully for many large family corporations including Samsung Electronics (South Korea), Toyota Motor Corporation (Japan), ABB (Sweden), Fiat (Italy) and Bombardier (Canada).

Other companies have found it preferential to float some limited shares...

Refusing to share and share alike

Larry Page and Sergey Brin founded Google in 1998 and took it through an IPO a mere six years later. Google floated in 2004 with two class shares: the superior voting share carrying ten times as many votes per share as the limited shares. Today, the founders are estimated to hold around 30 percent of the outstanding stock but have absolute control over the corporation since they own most of the voting shares.

Alternatively family firms may choose to hold stakes in each other [often 10 or 20 percent] to reinforce control of their corporations. Typically this type of cross ownership structure is popular in Japan and includes big names such as Mitsubishi Corporation, Nikon and Kirin Brewery.

Besides pyramidal structures, dual-class shares and cross ownership, other mechanisms include voting caps (no shareholder regardless of size can hold more than a certain fraction of the votes), golden shares (shares with specific rights that, for example, can block the sale of the company), and staggered boards (boards cannot instantly be replaced when majority ownership is traded).

While these are all successful strategies at retaining control during growth periods, they don't address the issues that arise as the size of the family increases.

The power of numbers

As the family grows, ownership is diluted by the repeated division and distribution of shares to new members. In the typical scenario, the founder divides the ownership of the business among his children, and they do likewise – so there is no single dominant owner. An ever-increasing family circle brings with it challenges of increased communication costs, “free riders” and lack of consensus.

A family board can be an effective first step at handling various governance issues but sometimes this measure is not enough to overcome conflicting interests within the family. In this case, it is necessary to “prune the tree” – either gradually over many years – or with a major readjustment of ownership redistribution which is typically done once every generation. Here, family individuals or a group of family members are given the

opportunity to sell shares if they wish. Both the **Mulliez** and **Wendel** families in France have established an internal market for buying and selling family shares which they open for a short time. In this way their businesses are assured in having members who are committed to taking the business forward.

Another option is the transfer of ownership to a family trust.

Trusts and foundations

While trusts can be a powerful mechanism to protect ownership, particular for tax planning, challenges can arise. Because trust ownership prevents one family member acquiring the ownership shares of other family members, if conflict exists within the family, there is a high risk of the family ending up in deadlock. This is what happened to the Kwok brothers, who belong to one of the largest property development groups in Hong Kong, the Sun Hung Kai Properties Group. A very **public family feud** that has only recently been resolved, ignited because it hadn't been possible to buyout the eldest brother due to a trust ownership that was believed to be non-dissolvable and to have no legally specified end.

Additionally, trust ownership can have a profound impact on the incentives of family beneficiaries. Because they share in a common pool of assets and have no right to sell their shares or to exit, they behave somewhat like “free riders” and prefer the business to distribute dividends rather than spend corporate funds on investments in the firm.

Examples are plentiful of families that have successfully incorporated trust ownership into their structure – the New York Times family trust was set up in 1935 by the founder Adolphe Ochs who sought to ensure that his four grandchildren would get an equal opportunity to be involved in the business. When this trust was dissolved upon the death of their mother, the new trusts ensured that family control would continue in the hands of the four grandchildren and two subsequent generations thereafter. In this way, at different stages of the media group's growth, powerful family individuals were able to preserve family control of the business for half a century beyond their own lifetimes.

For your own family business, a sensible approach is to have procedures in place for dissolving a trust and to be careful in choosing competent trustees.

Having looked at the first three challenges, the challenge of going public will be the subject of a subsequent blog post. Understanding the potential dangers involved in this action will ensure that your knowledge of designing sound ownership will be complete.

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