FAMILY BUSINESS SOLUTIONS

OWNERSHIP OF A FAMILY BUSINESS

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Contents

INTRODUCTION

Successful family businesses are different in many ways, but they all have at least one thing in common; they are well organised. Their success is achieved through thoughtful planning. Part of their planning involves dealing with some key issues around the ownership of their business.

Some of those key issues that a family needs to consider in relation to ownership of their business are:

1 Are we custodians or value-out owners?

2 Should ownership be restricted to bloodline owners or include spouses?

3 Working owners and non-working owners.

4 Consolidating ownership in branches.

5 The use of trusts.

6 Dividend policy.

7 Decision making by owners.

The decisions made by a family in response to these issues will affect how their family business organises itself.

The examples used are based on a privately owned UK company but the same issues arise for families who own other types of assets or whose companies are in other jurisdictions.

1. VALUE-OUT OR CUSTODIAN OWNERS?

There is a fundamental difference in attitude between two types of owners in a family business.

- Those who expect their investment to produce a market rate of return, mainly in the short to medium term. They can be called value-out owners.
- Those who have a longer-term investment horizon and attribute importance to other "returns on investment" that are not based on personal financial reward; for example, continuing a family legacy to pass to the next generation. This type of owner can be described as a custodian or steward.

Before going any further it is important to stress that one type of owner is not better than the other. The point is that these different attitudes to ownership will have an enormous effect on the way the family business is organised and run, which ultimately has to be to achieve the objectives of the owners. Custodians and value-out owners want different things and measure success in different ways. As a result it is probably wise that they don't end up in business together, which is why it is important that a family who want to continue in business are very clear what type of owners they want to be.

The commitment of a value-out owner to a family business will depend mainly on receiving a satisfactory financial return. If this is not forthcoming then like any other rational investor s/he will want to be able to sell shares and invest elsewhere to achieve a better return.

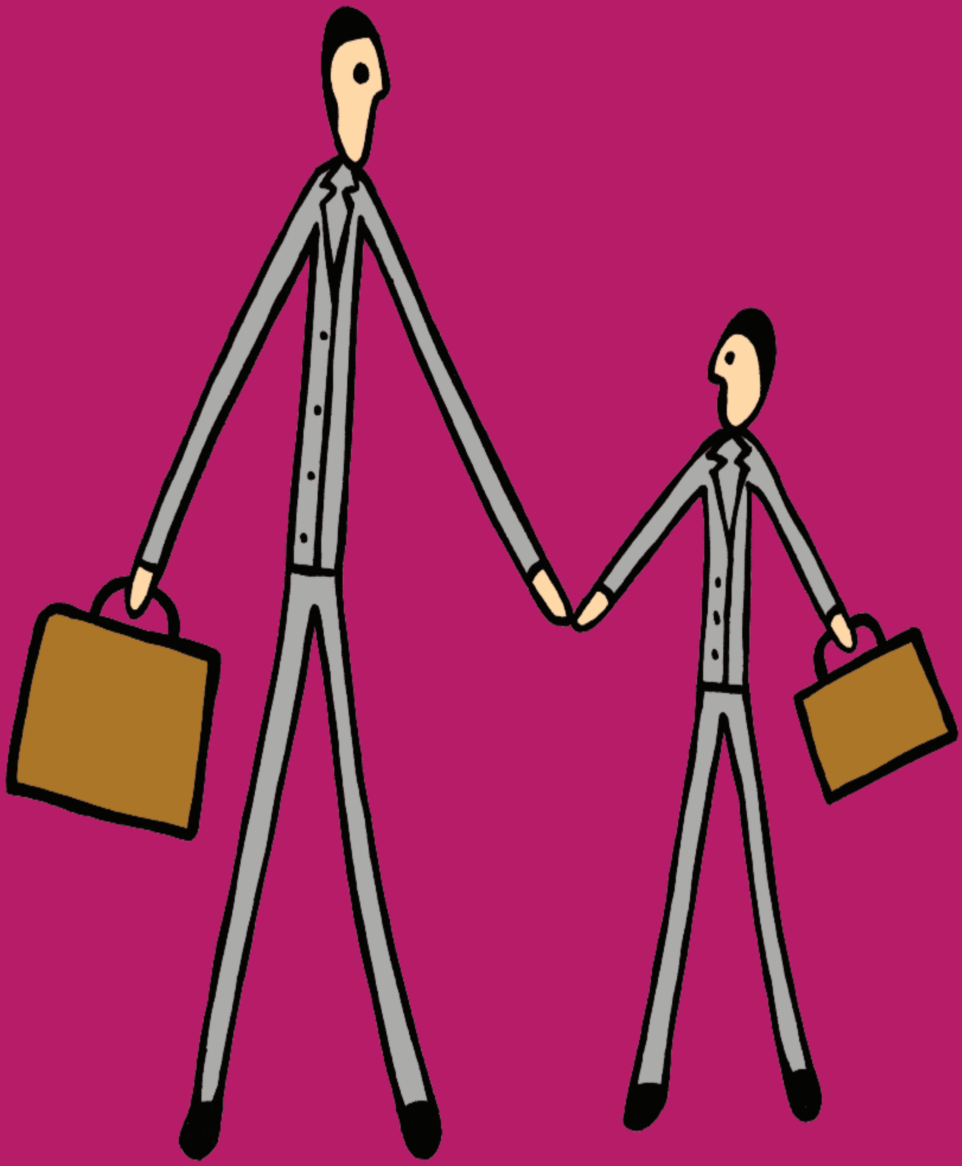
The custodian or steward, on the other hand, is more likely to accept trade offs between personal financial gains and other types of "return on investment". For example, the custodian may attribute value to the task of creating or maintaining a legacy of family ownership to pass to the next generation or in looking after the wider interests of a group of stakeholders, like employees, customers and suppliers. Even if some of these objectives incur a financial cost to the current owners, they still make sense to someone who has this custodian attitude to ownership.

This broad distinction is useful when setting the rules to control sale of shares in a family business. Value-out owners, with an investor mentality, will expect to have an opportunity to cash-in when they want or to sell if they are offered a premium price, perhaps even if that is by a competitor. This, however, would offend the custodian who is concerned about securing longer-term benefits of family ownership and consequently would expect there to be a more limited opportunity to sell.

The different attitudes to ownership also need to be reflected in how the shares are valued for sale, since in a private company there is no external market to do this. The value-out owner is likely to expect full or open market value. This might mean revaluing assets (land and property) to reflect current market rather than book value, taking the goodwill value of the business into account (even if this is not on the balance sheet) and never discounting the share value even if the owner has only a minority stake.

The custodian, on the other hand, would be more likely to accept a valuation that has been reduced below open market value to reflect the fact that selling for personal gain goes against the grain of the custodian mentality which is about the long term and working for the greater good. In this case assets like property and goodwill are unlikely to be revalued to increase the share price for an exiting shareholder.

It is important to understand that a custodian attitude does not mean that the family business can never be sold and that anyone who would consider doing this is always to be viewed as a value-out owner.



1. VALUE-OUT OR CUSTODIAN OWNERS? – Continued

For example, the Smith family business is really struggling due to inherent weaknesses in their business as well as general economic conditions. The family decides that their sense of custodianship can only be respected by selling the business and redeploying the family's wealth into other assets that provide a safer return for current and future generations. To hold on to the business as its value declines would amount to a failure to be a good custodian.

In the same circumstances another family – we'll call them the Greens – are willing to tough it out and accept a diminished return for the current owners as a necessary consequence of looking after other stakeholder interests which they value and which might suffer if the family "sold out"; for example, the family's reputation and the employees, suppliers and customers.

The Green family's sense of custodianship involves accepting trade-offs between financial security for the current family owners and looking after these other interests. The Smiths, however, are about being careful custodians of the family's wealth first and foremost. Both families can be described as custodians even though they behave quite differently in the same circumstances.

The critical difference between the Smiths and the Greens is that they are in business for different reasons. The Smiths are focused on looking after the interests of the family. They are concerned that in future there will be an increasing number of family members looking towards the business for careers opportunities and money. The current generation of owners must ensure that the family business grows to meet these predictable and understandable needs and failure to do this would be treated as a dereliction of duty.

It is important that the idea of custodianship is not narrowed to include only the likes of the Green family. They feel responsible for others who are not family members and they are willing to accept some reduced financial returns in order to achieve these other "returns on investment" to which they attribute value. That's good for them, but the Smiths are still stewarding assets; they are just a different type of custodian.

While the Greens and the Smiths express custodianship differently, they must share some common attributes if both are going to be described as custodians or stewards. What they have in common is:

- a long-term perspective in their decision-making; and
- a willingness among individuals to act altruistically in the interest of the common good and not just to act in their own self-interest.

Long-term perspective of custodians

Custodians do not focus on short-term returns in the same way as a value-out owner. They expect performance to be measured in terms of how well the family's assets have been carefully grown over a longer period, which is often over a generation of the family.

The owners and executives in the Greens and the Smiths share an interest in creating long-term financial security for the family owners. This common interest and outlook will impact on their decision-making in similar ways. For example, both families might decide it makes sense to reduce or even eliminate dividends in the short term in order to increase the strength of the business through funding longer-term capital investment or building up a war chest to fund acquisitions. The owners are also likely to accept the logic that there must be a restricted opportunity to sell shares, because they are meant to be building value for the long term.

Altruism among custodians

The other characteristic shared by custodians is the willingness to act altruistically. This means doing what is necessary without the need for others to reciprocate or without the expectation of reward. The custodian does what is needed to look after the common good because it is the right thing to do – that's it. In contrast, the value-out owner is far more about personal gain and autonomy.

However, the Greens and the Smiths clearly have different thoughts and feelings about what is covered by "the common good".

The Smith family believes that the common good extends to looking after their direct family. They are proud of what their family has achieved through being in business together and how this has profited others, but they do not feel responsible for an extended group of stakeholders in the same way as they feel responsible for the family. Nor do they, for that matter, feel a particularly strong attachment to the type of business they are involved in or the place it is currently located. In the case where their business is struggling, the Smiths, reasonably enough, decide that their sense of custodianship can only be respected by selling and reinvesting in other assets that provide a safer return. To hold on to the business as its value declines would amount to a failure to look after the common good of the family.

The Greens are as passionate as the Smiths about looking after the family, but they also feel a keen sense of responsibility for others who have a stake in their business, especially the customers, employees and suppliers. Unlike the Smiths, they are attached to the particular type of business in which they've always been involved mainly because the family name is also the corporate brand, which means the family's reputation suffers if anything bad happens to the business.

Hence in tough times, when faced with the same travails as the Smith family, the Greens might be more willing to accept a diminished return for the current owners as a necessary consequence of looking after their idea of the common good, meaning not just the family owners but also the other stakeholder interests that they value and which might suffer if the family "sold out".

The relevance of all this is that it illustrates how subtle a family's attitude to ownership can be and it pays to explore this in detail before plunging into detailed ownership structures and policies.

2. BLOODLINE OR SPOUSES?

This can be a difficult topic for a family to broach and so it might be helpful to set out the issues in a relatively clear and straightforward manner.

Those in favour of spouses becoming shareholders would make the following points in support of their view.

- The shares could help provide financial security for a spouse and his or her nuclear family, especially where the shares represent a significant part of that family's wealth and income.
- Allowing spouses to own shares communicates a strong signal about spouses being part of the family and the business.
- The alternative is that spouses might feel excluded, which could dilute the "glue" that bonds the family to each other and to their shared investment in the business.
- Spouses are parents of the next generation and, if they are shareholders, they are more likely to pass on positive messages about the business to their children.
- In the event of marital separation or divorce from a family member, rules can be put in place to provide that any shares held by a spouse should automatically be gifted back to the bloodline family member.
- Permitting the transfer of shares to spouses opens up options for more tax efficient planning in respect of income and capital.

The alternative view, opposing the idea of spouses becoming owners, would favour the following arguments.

- The shares might provide a relatively modest income return, especially if there is a custodian attitude to ownership, and so their value should not be overestimated.
- For the same reasons, there may be limited opportunity to sell shares because of restricted rules governing share sales.
- There are alternative ways to protect the financial security of spouses in the event of the death of a bloodline shareholder, for example life insurance.
- Transfers to spouses leads to further fragmentation and dilution of ownership and more minority interests to be managed by the company.
- Too many spouses owning shares would dilute the sense of "familiness" rather than strengthen it.
- The feelings of inclusion could be addressed through spouses being involved in other aspects of overall governance, for example in a Family Assembly.
- It would open up the prospect of a significant amount of wealth and power being transferred outside of bloodline family.
- Tension may be caused if some shareholders transferred shares to their spouses, while others did not.
- In the event of marital breakdown there will always be scope for a dispute over the valuation of shares and the provisions requiring automatic transfer back to bloodline shareholders.

Families also need to consider who is a spouse for the purpose of ownership? Some families permit transfer to a spouse only after a period of marriage, say five years. It is also necessary to decide what the family feels about transfer to unmarried partners or to civil/same sex partners, bearing in mind any background legislation in relation to discrimination.

3. WORKING AND NON-WORKING OWNERS

Some families strongly believe that owners must work in the family business and if they choose another career they will not be allowed to own shares.

Underlying this view is the belief that ownership is a reward for hard work. Since most family businesses start as owner-managed and might remain in this form for more than one generation it is easy to understand where this view comes from; however the alternative view is that capitalism is posited on the separation of ownership and management, and you don't need to have an ownership stake in a business in order to work for it, or vice versa.

A rule restricting shares to working owners can have unintended consequences. Family members who decide to pursue other careers or lifestyles and are cut out of ownership may feel they are also being cut off from the family, especially if the family business represents a significant portion of the family's overall wealth.

Alternatively, they might decide to take a career in the family business in order to qualify for ownership, but feel they are being bound by "golden handcuffs" and resent the fact that they were forced to give up on their life aspirations in favour of a job in the family business in order to become an owner.

Working and non-working owners can collaborate successfully in a family business like any other business, where owners provide capital and the workers provide the labour. All that's needed are clear rules; for example a dividend policy for all owners and a remuneration policy for working owners that together make clear who gets what from the family business. It would also be worth clarifying if any decisions need to be made by working and non-working shareholders together, rather than just by the working owners, for example decisions that involve a significant risk to the family's wealth or reputation.

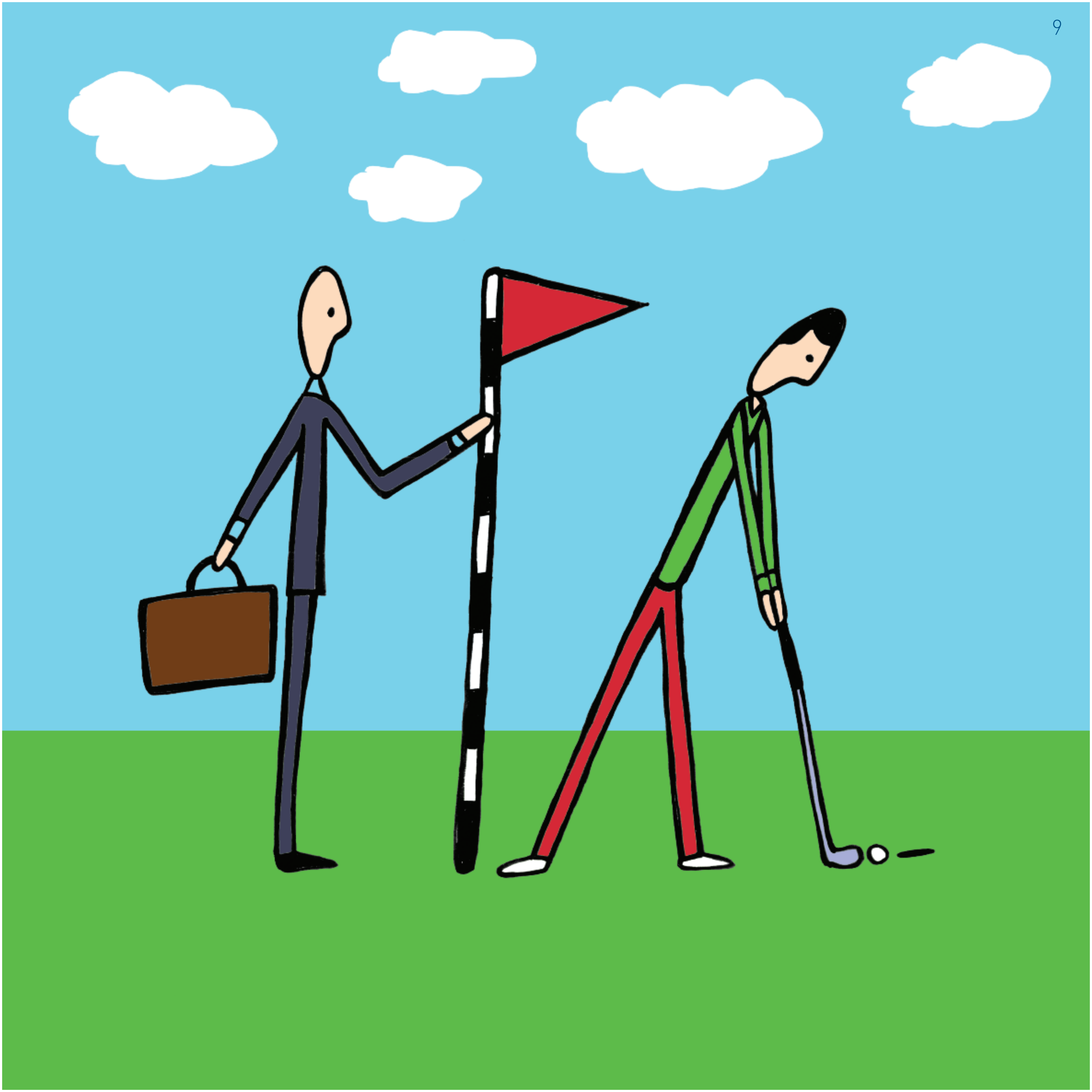
However, if a family favours working owners, it is necessary to consider what happens if a working owner leaves the business or when a relative joins the business. Do the former have to sell their shares and how do those who join the business acquire shares?

Some families use different classes of shares to try to address these scenarios. By whatever name the shares are called, this essentially involves separating voting/control rights from the economic rights of ownership; for example working owners control the votes and non-working owners are entitled only to economic returns. This, however, can mean that the shares need to be reclassified every time someone joins or leaves the business.

It can also unintentionally result in a small group of working owners having disproportionate voting power. For example if the number of shares held by non-working owners is greater than those belonging to working owners, the non-working owners carry the risks of ownership but control is in the hands of a small number of working owners.

The choice between bloodline and spouses and between working and non-working owners will affect the constitution of the company. If ownership is restricted to bloodline or those who work in the business, the number of potential purchasers if shares come up for sale will be more limited than if spouses/partners and non-working family members were allowed to buy shares.

Also if ownership is to be restricted to bloodline or those who work in the business, the personal wills of shareholders must not contain any bequest of shares in favour of a spouse/partner or someone who does not work in the business. If this is overlooked it can result in a distressing conflict between a deceased's will and the company's constitution prohibiting this transfer from being registered.



4. CONSOLIDATING OWNERSHIP IN FAMILY BRANCHES

As families grow, ownership tends to fragment and dilute as it passes down the generations. Having a number of minority owners is frequently perceived as a problem in terms of the cost of managing a large shareholder group and the feeling that conflict is more likely to erupt among shareholders as their number increases. The equation seems to be more owners = more conflict, but is that always so?

As ownership dilutes as a result of an expanding group of owners, so does the control or power each of them exerts. The scale of their stake may make them feel less passionate about their interest and more likely to entertain compromise as the only effective way to proceed. It has to be acknowledged that while this might mitigate the capacity of a shareholder to cause havoc through the irresponsible exercise of significant ownership power, they may still cause that in other ways using personal means, but the point about power shouldn't be overlooked.

Sensible planning and good company administration can reduce the risks associated with growth and expansion of the shareholder group.

For example, it is essential to ensure that the owners all share a common understanding of why they remain in business together given that this is likely to be an inherited condition as much as a deliberate life choice. If any owners want to cash out, they should be able to do so on terms that are consistent with the family's overall attitudes to ownership as mentioned earlier. The larger number of shareholders and hopefully the larger resources of the company should provide a more liquid market for these shares compared to earlier days when resources – cash and potential buyers – were more limited.

However families and advisers who are worried about the threat of dilution or fragmentation of ownership might still prefer to take action to avoid this happening and the two most often used devices are to move from individual share ownership to branch ownership and/or the introduction of trusts.

Family branches

Families who have reached the stage where ownership is about to be or is already distributed among siblings need to decide if future transfers must preserve this balance of power among family branches. The alternative is to allow ownership to dilute and fragment in each generation (depending on how many children are in each branch and how the current owners decide to distribute their shares) and leave individual owners to act in whatever way they choose, including forming alliances with members of family branches other than their own.

If the preference is to "concrete in" a branch structure, this will need to be reflected in different parts of the overall governance. For example transfers of shares (by gift or sale) will be restricted to within branches so that the overall or aggregate power of that branch is preserved.

When it comes to share sales, this process will likely result in different amounts of liquidity occurring in each branch unless each branch has exactly the same number of members and the same amount of wealth to buy the shares coming on the market.

The mechanism for "concreting in" branch power could be a voting agreement among owners of each branch or even a branch trust in which the beneficiaries are all future members of a particular branch of the family.

5. THE USE OF TRUSTS

If shares are placed in trust, it introduces a new type of ownership interest.

It is very important to consider issues like appointment and removal of trustees and communication between trustees and beneficiaries to ensure that there is the desired balance of power between the trustees – the legal owners – and family beneficiaries who are very likely to consider themselves to be the "true" owners. Otherwise the family can start to feel distanced from their wealth and disenfranchised when it comes to making important ownership decisions. The risk of this gap can be illustrated by the following example.

A generous offer to buy the family business is received, but the individual family members want to refuse it for any number of reasons, not all of which are entirely financial. For example they want to retain the family's legacy of attachment to the business and they feel a keen responsibility to the other stakeholders, such as employees, suppliers and customers who would all be affected by a sale; in other words the beneficiaries think and feel that they are custodians.

Unless the trustees were so directed in the trust deed, they are less likely to be influenced by sentiments that motivate family members to decline the offer. Their judgement would be based on what is in the best financial interests of the beneficiaries, possibly including future generations of the family who are among the class of beneficiaries. The trustees' perspective might be that their legal and fiduciary duties leave them no option but to accept the offer, whatever the wider family want.

Trust law and regulation focus on the financial dealings of trustees and their fiduciary duty to protect the value of the trust's assets for the beneficiaries. If the trustees somehow destroy the value of the assets they hold in trust, the beneficiaries may seek to recover their loss from the trustees, or to replace them. Thus trustees tend to be financially cautious, and want current returns and to increase the investment value of their shareholding.

It is also important to consider the level of involvement expected of trustees who hold shares in a family business. This may be affected by the size of shareholding. Where the trust property includes a controlling interest in a company it is generally the duty of trustees to keep a close eye on the company's affairs. Trustees with this level of holding should not sit back and rely only on the likes of statutory accounts and an annual general meeting as the sole means of discharging their duties. However, if trustees have only a minority stake this duty to take an active interest is reduced even though the trustees can still exert significant influence when they control enough shares to block resolutions of other shareholders.

As a matter of practice, the level of involvement expected of trustees is often deliberately diminished in the trust deed so that they do not need to enquire into the conduct of the family business and may treat the shares like any other investment. Professional advisers who act as trustees are in fact often expected to be passive investors and their role is mainly providing technical advice and services in relation to trust administration.

Hence it seems that trustees are more likely to act and think like value-out investors unless the trust documentation directs them to do otherwise. Family members who are trustees might be tempted to behave as custodians but their fiduciary duties are likely to restrict them from doing so in many circumstances.

6. DIVIDEND POLICY

A dividend policy is appropriate where family owners want some transparency about return on their investment.

This may be particularly desirable where there are working and non-working owners in order to avoid any suspicions that the working owners are restricting distributions to shareholders while enjoying generous remuneration packages and perks. Such suspicions might be completely unfounded, but still have the potential to generate the type of anxiety that can brew up into open conflict.

A policy can also help shareholders to plan for their private lives, which is obviously far more difficult when there is uncertainty over the income they will receive.

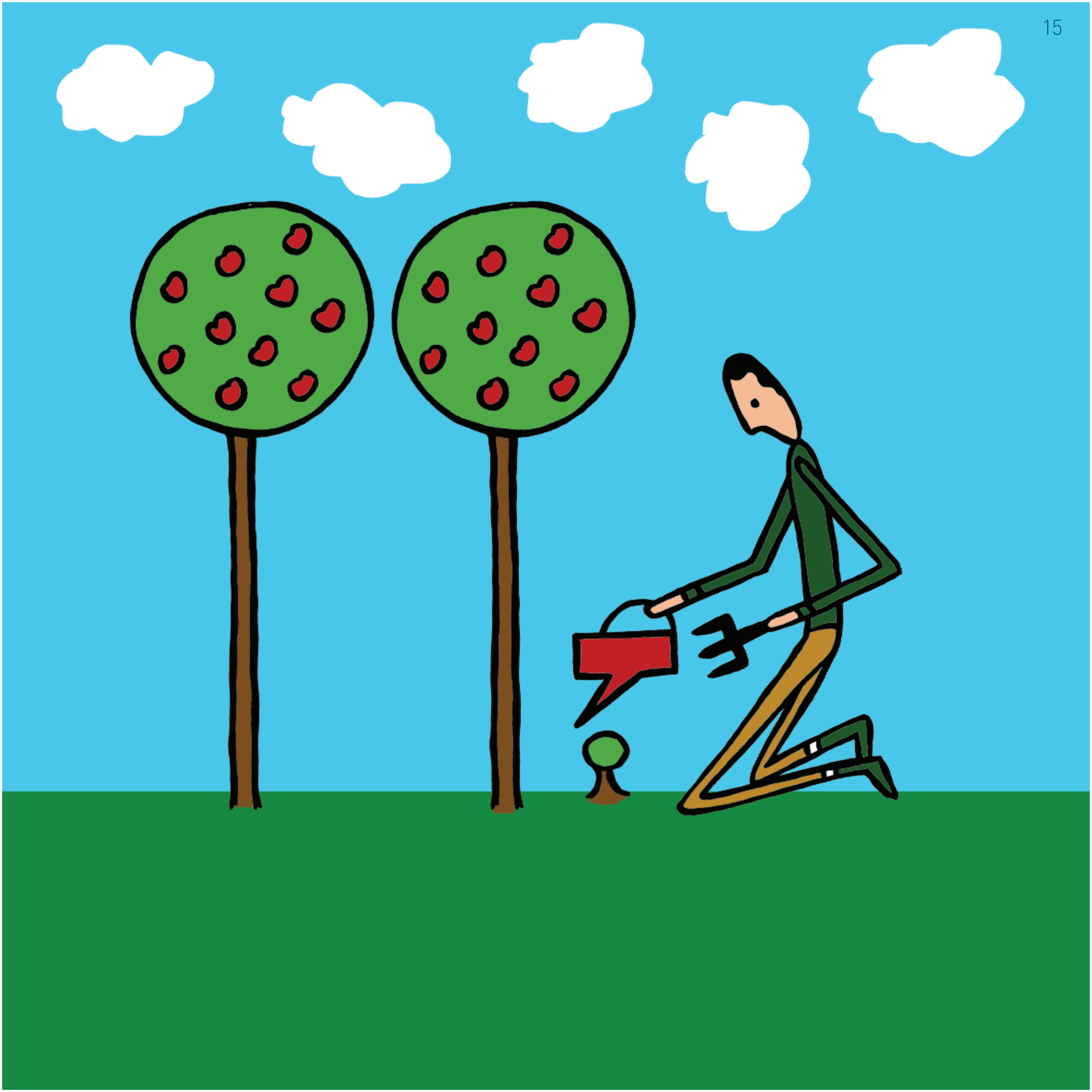
The detail of the policy will need to accord with the family's basic attitudes to ownership mentioned earlier, in particular the distinction between value-out owners and custodians.

Dividend cover in a particular sector or industry may be used as a benchmark to measure the proportion of profits that should be distributed to shareholders each year. The value-out owner will expect cover to match the sector, while the custodian may prefer that a smaller proportion of profits be distributed annually to shareholders.

Yield is likely to be a less reliable measure of dividend performance when a family business is a private company because there is no market price against which the yield can be measured. The value-out owner, however, might still insist that a regular valuation of the company is carried out in order to check whether continuing to invest in the family business is a wise decision when the return is compared to alternative investment possibilities.

If a custodian family favours a modest dividend and a restricted market for sale of shares which can only take place at a modest price because of the sense of stewarding the assets, it may be worthwhile including, as part of the dividend policy, an opportunity for payment of an additional or super dividend, say every 3-5 years. This occasional harvesting of wealth to give shareholders access to the value that is being created in their business can help to maintain a mutually beneficial relationship between the company and its shareholders, in particular long-term stable and affordable capital for the business.

Value-out owner	**Custodian/steward**
Expects a "market" return	What can business afford?
Use distributable reserves if annual profits are low	Based on annual profits
Borrow to fund dividend payments	Pay from positive cash flow



7. DECISION MAKING BY OWNERS

Legislation governing the balance of power between owners and executives generally gives the board of directors power to run a business on behalf of its owners and other stakeholders subject to various legal duties.

In a family business which is an owner managed business this distinction usually doesn't make much difference in how the business is run, although that view may not pertain where the mangers have different sizes of ownership stake and there is a wish not to proceed on the assumption that the manager with more ownership should exert more executive power.

The conventional balance of power between owners and managers might not suit a family whose business is family owned but not family run. They might want to be able to influence decisions that pose a significant financial or reputational risk for the family, a view that might be shared by management after they reflect on the risks of taking decisions that could unexpectedly provoke a critical reaction among the family owners.

The decisions which family owners might want to reserve power to make can, generally, be grouped as those that represent a significant financial and/or reputational risk to the family.

Hence major capital investment or borrowings or the grant of security might all require shareholder approval. The owners might also want influence over the appointment or removal of directors and to approve their remuneration and incentive packages.

These financial controls are akin to the situation in companies whose shares are publicly listed or those with private equity or venture capital investors on board. In those cases the interests of the owners are protected via listing rules and governance guidelines or in investment and shareholder agreements. Similar contractual arrangements can be applied to a family business.

The idea of reputational risk is perhaps more germane to a family business. For example the family might want owners to approve any change to the corporate brand or its use in sponsorship or advertising, especially where the corporate brand is the family name. The family might also prefer owners to have the final say in relation to closure of any part of the business or the making of redundancies because of the effect such decisions might have on the family and their reputation.

In specifying the decisions that are reserved for owners it is realistic to acknowledge that it is not possible to prescribe in detail every type of decision that should be reserved.
A governance policy in this area needs to be implemented with sound judgement by those in the key governance roles of owner, board member and senior manager based on a clear understanding of the overall governance structures and processes in the family enterprise. It is the duty of these key players to understand those processes and to interpret them reasonably, rather than becoming distracted from the spirit and purpose of these provisions by a forensic analysis of the language used to express the family's objectives.

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