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THE FAMILY BUSINESS MAP

Assets and Roadblocks in Long Term Planning

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chapter 5

Ownership Design

Designing an optimal ownership structure is one of the most important – and challenging – tasks any family business can engage in. The ownership structure affects the incentives, behavior and ultimately the performance of family members, family managers and other stakeholders in the firm. It determines the distribution of power between individuals within the family and with non-family owners. It is particularly crucial where family members disagree about how to take the firm forward, not least because it determines the allocation of voting rights, the transferability of ownership rights, and how profits and losses are shared.

One of the most striking features of family firms is the variety of ownership arrangements. We begin with examples of old European family firms whose ownership shares have been diluted and compare this to an interesting case of active ownership design in Asia. This leads us to a brief discussion of how ownership design is related to changes in roadblocks. Next we identify the four principal challenges in designing an ideal ownership structure: (1) to raise capital to expand without giving up family control, (2) to counteract ownership dilution as a result of the power of numbers, (3) to go public, listing the businesses either as a whole or in part, (4) to integrate institutional ownership such as trusts and foundations. Given the current popularity of trusts, we reveal some of the pitfalls that can be encountered when using trusts to hold complex assets. We end with four mini-case studies of how ownership can be structured to resolve specific challenges, in the hope that these will inspire families facing such situations.

Variety of ownership structures

In many family firms, ownership is diluted with every new generation that comes along. In Europe there are numerous examples of families where hundreds – even thousands – of members hold shares. More than 200 family members own the German industrial conglomerate Thyssen. Around 600 members of the Mulliez family own shares in the holding company that controls the giant supermarket chain Auchan, the sports retail chain Decathlon, and many other successful retail brands. Almost 1,000 members of the Wendel family own the private holding company Wendel Participation, that owns around 38 percent of the publicly traded Wendel Investissement. In Belgium, the Janssen family counts close to 2,500 family members, who together have a controlling stake in the 150-year-old Solvay petrochemical group.

One typical method that large European firms have implemented to fight the power of numbers is to entrust the ownership of the family firm. Maersk – the biggest shipping company in the world and founded in 1904 – is a publicly traded family firm where the family controls the company through three foundations where two have charitable purposes and one is a family foundation. These foundations control the majority of the voting rights in Maersk and almost half of the outstanding shares.

While these old and successful European families have designed ownership and governance to overcome the issues that arise when individual ownership stakes shrink, not every family is so fortunate. Ownership dilution can eliminate all sense of incentive or individual responsibility, and ultimately end in deadlock between different branches of the family – hurting the family as well as the business. We have seen many examples from all over the world of deadlocks in family firms arising because of opposing interests between family branches. Redesign of ownership structures can be a powerful way of solving such deadlocks, – as the following example shows:

Li & Fung

Li & Fung Limited is a global trading group supplying high-volume, time-sensitive consumer goods. Garments make up a large part of the Li & Fung business, as does the sourcing of fashion accessories, furnishings, gifts, handicrafts, home products, promotional merchandise, toys, sporting and travel goods.

Founded in Guangzhou (Canton) in 1906, Li & Fung is headquartered in Hong Kong, from where it co-ordinates the manufacturing of goods through a network of 70 offices in over 40 countries. While cost considerations have resulted in the concentration of manufacturing activities in Asia, recent years have seen an expansion of Li & Fung's quick-response capabilities in the Mediterranean, Eastern Europe and Central America, areas that are closer to its customers in Europe and the US. Li & Fung is the controlling owner of a number of other public and private firms that together form the Li & Fung Group. Li & Fung Ltd has an annual turnover of USD 12 billion and employs 15,000 people worldwide.

The experience of Li & Fung exemplifies the seriousness of the control issue of ownership dilution, although the Fung family was ultimately able to find a solution. One of few companies in Hong Kong with more than 100 years of history, Li & Fung was listed on the Hong Kong Stock Exchange in 1974. The founder had 11 children, all of whom inherited shares in the business, as did members of the third generation. Before Victor and William Fung took over the leadership in the 1980s, no single member of that third generation had a controlling stake.

Victor had a Masters degree in engineering from MIT and a PhD in business economics from Harvard Business School, where he later joined the faculty. His younger brother William was a Harvard MBA. When summoned home by their father, the brothers quit their jobs in the US and returned to Hong Kong, sensing that the family business had problems. Family members were fighting, branches were divided and it was impossible to restructure the governance of the firm. Thus Li and Fung was in a deadlock when the two brothers returned and their combined ownership stake were not big enough to impose their view on the family.

When China and Britain began discussing the future of Hong Kong in the mid-1980s, some members of the family felt that the impending return of the territory to China would mark the end of Hong Kong; Victor and William saw it as an opportunity. They borrowed billions of Hong Kong dollars from a consortium of banks, used part of the loan to buy out the publicly traded shares in 1989, and the remaining funds to buy back shares from other family members at an 80 percent premium on the share price. After this family version of a management buyout, they re-listed the company on the Stock Exchange in 1992.

To reorganize the ownership of Li & Fung Ltd, they set up a holding company (of which they each held 50 percent) as the sole owner of the original company, which in turn was the controlling owner of the publicly traded retail part of the Li & Fung empire. An interesting feature was the establishment of a family trust, the J.P. Morgan Trust Company (Jersey) Limited, for the family of Victor Fung. Its existence ensured that the future involvement of Victor's branch of the family could not dilute ownership to the extent that he had experienced in his own generation.

The brothers thereby secured a controlling stake to make the necessary changes to the family business. Although reforming the ownership was a painful process, without it they would not have taken the business to the next level, nor would Li & Fung be the successful and respected company it is today. We believe that Li and Fung is a prime example of how visionary family members can design new ownership structures to reinvent the family business.

Roadblocks that shape family ownership

sound ownership design is the key to good governance

Ownership can be active or passive – passive if it is diluted over generations as more family members receive shares. Active ownership can take many forms such as listing the company, introducing trust and/or foundational ownership, or concentrating ownership by buying out other family members. We emphasize that sound ownership design is the key to good governance and the most effective way to minimize the impact of roadblocks, whether they arise in the family or the market, or in the institutional environment. Figure 5.1 illustrates how active ownership design aims at minimizing the cost of the current and future roadblocks that can be identified in the family business.

Family structures and family development is one of the most common drivers for families to redesign ownership structures. As we have seen, ownership diffuses over time as the family extends. Larger families divide into branches and diverging interests often arise. The path towards smaller ownership shares and increasing confrontation emphasize the need to change ownership. There are many objectives that a revised ownership structure aims at fulfilling. Some of the most common include: securing the family's ability to control the firm in the future, allocating control power to the most talented and interested individuals, allowing individual family members to sell shares at will, allowing non-managing family members to sustain a certain standard of living and avoiding future family conflicts.

The family's extension will be influenced by long-term demographic trends – the birthrate, social and cultural values – which have an influence on family size. In China, for example, the one-child policy means that ownership diffusion is less of an issue for family firms. Indeed the main issue they have to contend with is often a shortage of family talent or interest to sustain the business. It has to be assumed that many family firms either hire non-family managers (relinquishing control) or sell the business (relinquishing both ownership and control) sooner than elsewhere in Asia.

In Chapter 3 we discussed how inheritance law and taxes may affect how ownership can be redesigned around succession. In some countries the law

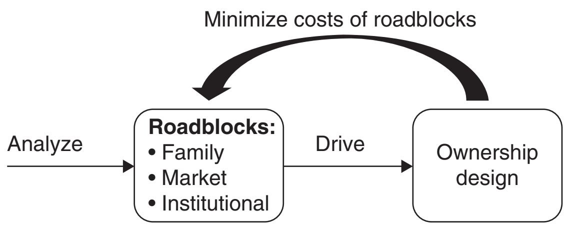

FIG 5.1 **Active ownership design aims at minimizing the cost of current and future roadblocks**

imposes an even distribution of ownership among family members; in others it is more flexible, that is, allowing greater concentration. In North America and Europe, family members receive relatively equal shares of ownership, although those more involved in the business tend to get a bigger share. In countries with high inheritance tax, owners may be obliged to sell off or divest businesses before retirement. Some may choose to transfer ownership to a trust, foundation, or foreign entity which is subject to lower tax rates.

Customs and norms can have a strong say in how ownership is distributed. In Asian countries where the Confucian influence is still strong, sons inherit the lion's share of ownership, while daughters must be content with a minority share – or even no share at all and compensation in the form of a dowry upon marriage. In the Middle East, most family members are included in the business in accordance with custom and Sharia law, where sons get ownership but also have an obligation to take care of female family members. While allowing only male heirs to inherit clearly discriminates against daughters, it serves to slow the diffusion of ownership as well as the family fortune.

Successful family businesses often face the dilemma of how to finance new investment: when new business opportunities come along they lack the internal funds and human resources to pursue them. The option of borrowing or selling shares to raise finance jeopardizes family control. Indeed, many enduring family businesses have resisted the temptation to venture out of their comfort zone (the stable local environment) for this reason. In capital-intensive, cyclical and fast-changing industries or markets, however, families often have to make significant investments to stay competitive. The moment they sell equity to outsiders, they start to lose control of the business. While borrowing from the bank may be preferable to equity financing, it is not necessarily a better option because the bank can abruptly cut off funding if the loan/interest is not paid on time. In extreme cases a family may have to file for bankruptcy and lose the business to the bank.

The four most common challenges in ownership design

As discussed above, the urge for redesigning ownership is often driven by the presence of current or future roadblocks threatening the stability of the firm and the family. In the following chapter we will provide a detailed discussion of the four most common challenges. Retaining control while growing; dealing with ownership diffusion due to the power of numbers; using trusts and foundations; and going public. Each of these challenges can potentially change the involvement of the family, the future of the business, and the relationship between individual family members. For each challenge we will provide examples and discuss advantages and disadvantages of specific ways of redesigning ownership to mitigate the cost.

Challenge 1: 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.

At the beginning of the 20th century, there were around 1,500 primarily family owned newspapers in the USA. As the media industry developed on the product front (from individual newspapers to media .), the market front (from local to national to global media markets) and the technology front (from physical typesetting and printing to electronically delivered newspapers, radio and TV), most of those 1,500 families exited the business. Only a handful managed to find a way to raise enough capital to be able to stay in business without losing control to new investors, being bought by a competitor, or simply going out of business.

In the luxury industry, many family businesses faced a similar challenge in the latter part of the 20th century. In 1977, Henry Racamier took over the management of his mother-in-law's family firm, Louis Vuitton, a manufacturer of luxury luggage and accessories. Like many luxury firms, Louis Vuitton went through hard times in the 1960s and 1970s, when demand for traditional luxury items fell dramatically as the baby boomers came of age. To remain in operation many family owned companies resorted to short-term solutions. While they continued to control design (though not always production), they delegated retailing to specialists in the field, often merely for a license fee. When Racamier discovered to his astonishment that it was the retailers who were making the biggest profits, he resolved to transform Louis Vuitton into a vertically integrated operation.

Racamier's plan required that Louis Vuitton open its own retail stores, cutting out the middleman. His timing was good. In the West, the 'Reagan Revolution' was reviving the taste for luxury after the hippie era of indifference to appearances. Moreover, markets in Asia and the Middle East were taking on a growing importance. In 1978, Racamier opened five outlets in Tokyo, offering Louis Vuitton products at prices comparable to those in Europe.

By 1984 global sales at Louis Vuitton had increased 15-fold, to USD 143 million, with profits of USD 22 million, and a profit margin of 40 percent, nearly double that of its competitors. To finance further expansion Racamier sold stock in the company both on the Paris Bourse and on the New York Stock Exchange. He merged with Moët Hennessey to form a luxury conglomerate, LVMH, which immediately began to acquire other luxury brands.

Since the profit potential of his strategy was clearly going to last into the foreseeable future, Racamier's innovations forced all family run luxury firms to ask themselves the same questions.: Did they wish to remain small family businesses with an elite customer base in Europe, or were they ready to risk entering the global marketplace? And if they chose to do so, how should they design ownership and finance investment to avoid losing control of the business?

From then on, new ownership structures developed in the luxury industry in response to what were essentially market roadblocks. Old companies like Hermès, TAG Heuer and Bulgari, as well as first- and second-generation companies like Donna Karan and Polo Ralph Lauren, went public. Other families sold up or affiliated with powerful luxury conglomerates such as LVMH or Kering (former PPR). Thus the conglomerate luxury business group evolved as a response to changing market roadblocks.

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.

Pyramids. A pyramidal structure is used to preserve control in the family, even when ownership is diluted. The pyramid represents a chain of corporate control, typically with a private family controlled investment company at the top that has a controlling stake in the next level intermediate corporation, that has a controlling stake in a second-level company, that has a controlling stake in a third-level company, and so on. By maintaining a controlling stake down through the pyramid, the family has de facto control over all the corporations in it, even though it is not entitled to a large share of the cash flows from the lower layers.

To see the power of a pyramid to preserve control, imagine a family with an investment company that owns 51 percent of the shares of Firm A. Assume that the remaining 49 percent of the shares are held by other investors, none of them having more than 10 percent. Firm A controls Firm B through an ownership stake of 51 percent, and the rest of Firm B's shares are held by smaller investors. Who receives the returns from Firm B and who controls it?

If Firm B decides to pay a 1 dollar dividend, Firm A receives 51 cents. If Firm A decides to pass this on to its owners, then the family will receive 25 cents, that is, 25 percent of the return generated by Firm B. Almost three quarters of the returns are distributed to the smaller investors in both B and A. Looking at the control side, the family has absolute control of Firm A, since it has 51 percent of the voting rights and there are no other significant shareholders. Furthermore, by controlling the board in Firm A, the family has de facto control of Firm B, since Firm A is the controlling shareholder. Hence the pyramid structure secures absolute control of the firms for the family but financial returns are shared with other investors.

Why would an outside investor invest in either Firm A or Firm B if the family has de facto control? Many investors prefer passive investing because they do not have the resources to engage in actively governing the business they are investing in. This is particularly true of institutional investors. They trust the reputation of the family and delegate control accordingly.

Many family business groups around the world use pyramidal structures to concentrate control. Toyota Motor, Samsung Electronics, Levi Strauss, Du Pont, and so on, are all controlled via pyramidal structures, as are a number of major Canadian family firms such as Bombardier, Bronfman, Desmarais, Irving, McCain, Molson and Péladeau. The Agnelli family in Italy controls its many businesses through a highly elaborate pyramidal structure involving many layers. So does the Korean Shin family that created the Korean/Japanese Lotte conglomerate. The pyramidal structure first evolved as a way to control their business activities in both Japan and Korea but was later used as an efficient way of expanding their global activities.

Dual-class shares. 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 share classes: the superior voting shares carry 10 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. While it is too early to say if Google will ever develop into a fully fledged family firm, dual-class shares are a common vehicle for families that want to float the shares without giving up control, as seen in a number of family based media companies in the United States.

The essence of dual-class shares is simply the different voting rights they carry. Those with superior voting rights are held by the family, while those with limited voting rights are sold to outside investors. This way the family keeps absolute control over the business but shares the returns with the other investors.

What proportion of voting rights do the two classes have each? In practice, this will be partly determined by corporate law, which varies from one country to another. In Northern European countries, for example, where dual-class shares are particularly popular, superior voting shares typically carry ten times as many votes as the limited voting shares. In many countries it is also possible to issue preference shares which have no voting rights but give preference to dividends in compensation.

The Wallenberg family in Sweden controls a large number of listed and private Swedish corporations through a combination of dual-class shares and a pyramidal ownership structure. Dual-class shares are used to keep control over their investment company, Investor AB. The A shares constitute around 40 percent of the capital but control around 87 percent of the votes; the B shares constitute around 60 percent of the capital but control only 13 percent of the votes. Through a family foundation the Wallenbergs own a large portion of both classes of shares. Thanks to its voting shares the family is entitled to almost half of the votes even though it owns only a fifth of the capital.

Cross shareholding. This is an ownership structure whereby companies hold stakes in each other (e.g., two family corporations have a 10 or 20 percent share in each other). Cross shareholdings are popular among Japanese business networks and include a large number of firms in the *keiretsu* system. One of the most well-known examples is the Mitsubishi network of corporations, set up by the family with the family controlled Mitsubishi Bank in the centre (known as the Bank of Tokyo-Mitsubishi UFJ after a series of mergers). Its close cross-ownership structure includes big names such as Mitsubishi Corporation, Kirin Brewery, Mitsubishi Electric, Mitsubishi Motors, Nikon, Nippon Oil and others. Another prominent example is the Mitsui family's controlling interest in a web of corporations centered around Mitsui Bank (now Sumitomo Mitsui Bank). Firms in this cross-ownership structure include Fuji Photo Film, Mitsui Real Estate, Mitsukoshii, Suntory and Toshiba.

Cross ownership is not exclusive to Japan. The Shin family use cross ownership in their ownership design of the Lotte group. The Agnelli family has cross ownership between firms in their business group. The late Wang Yung-ching used cross ownership between the four key companies in Formosa Plastics Group to reinforce his control of the group.

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). One of the most popular is to set up a trust or a foundation, which we return to below.

Challenge 2: dealing with ownership diffusion due to the power of numbers

We have seen several examples of how the power of numbers dilutes ownership. In the typical scenario, the founder divides the ownership of the business among his children, and they do likewise, until after several generations ownership is diffused. Although the business remains family managed, there is no single dominant owner. As the ownership circles widens, communication costs increase, along with the problems of 'free riders' and lack of consensus. Shoring up control becomes a matter of urgency. So, what are the options?

Dual planning (early phase remedy). A family board or committee can be set up to elect managers and handle various governance issues. If the business has no board of directors, a family board can take on this function. If it does have a corporate board, the family committee will serve as an additional layer of communication where the members discuss family and corporate issues and reach consensus, thereby facilitating the corporate board's job. It may also bolster the corporate board by freeing up seats to bring in non-family members with outside expertise and unbiased opinions. A family board should include representatives from all branches of the family (typically five to seven people), and meet two to four times a year.

A family board is an early phase remedy, but if the family grows rapidly or there is a lack of communication between members it may be less effective in defending their interests. Problems associated with family boards include conflicts of interest, domination by one branch, and failing to provide unbiased advice. Good communication is a prerequisite for a well-functioning family board, just as conflict and poor communication in a family will undermine it.

Pruning the tree. When ownership dilutes and family governance fails to resolve issues of incentives or conflicts of interest, it is time to rearrange things. Many old families resort to mechanisms of ownership redistribution that allow them to prune the tree either gradually over time or through major readjustment once every generation. The most typical forms of redesigning ownership include unequal transfer of ownership to future generations, the creation of an internal market for trading shares and buying out individual or group of family members.

We saw how the third-generation Fung brothers re-concentrated family ownership of Li & Fung through a family buy-out, but such moves are extreme as well as rare. A modified approach is to set up a family share buyback program to acquire shares held by family members with only a remote interest in the business. In Europe, the Wendel and Mulliez dynasties have established an internal market for buying and selling family shares, which they open for a short time, typically around the annual family assembly. One family we know of has developed an electronic stock exchange where family members can submit, sell and buy offers at any time.

In a smaller owner-managed corporation, the family will often prune the tree once every generation. Remember the Henokiens, whose member companies are at least 200 years old and include the Höshi Ryokan in Japan? Other members, such as the Dutch trading company van Eeghen, the Dutch alchohol producer de Koyper, the Italian confetti company Peligrino, the Italian music company de Mouzini, the French spice company Thiercelin and the Japanese confectionary company Gekkonen – have all found ways to prune the ownership tree, either by conferring ownership on one child in every generation, by buying out less active family members, or by dividing business activities between family members.

One important issue when families establish an internal market for shares or engage in share buybacks is how to price them. If the business is publicly traded, the buyback price can be set at the market price plus a predetermined premium. If it is privately held, then a predetermined method of valuation should be performed to establish the buyback price. We advise family members to take this step very seriously and engage trusted outside advisors. Too often, conflicts over valuation can tear families apart or be a catalyst for future conflict.

An alternative to reducing the number of family owners is to transfer ownership to a trust. A family trust is an efficient way to solve the governance constraints related to the burgeoning family tree and to bind the family's interests together for the foreseeable future, which leads us to the next challenge.

Challenge 3: using trusts and foundations

Trusts play a significant role in societies where common law prevails. There are an estimated 400,000 to 500,000 family trusts in New Zealand. A significant part of the ownership of many large family businesses in the United States, including Wal-Mart, Ford Motors, the New York Times and Cargill, are placed in trusts. In a sample of 216 publicly listed companies in Hong Kong, we found that almost one third were controlled by family trusts, including flagship companies such as Sun Hung Kai Properties, Cheung Kong Holdings, and Henderson Land.

All around the world, trusts are commonly advocated by banks and corporate finance institutions as the standard solution to questions related to ownership design. While we affirm that trusts can be a powerful mechanism to protect ownership, in particular for tax planning, families should be aware of the challenges that can arise.

A trust is a legal entity governed by a charter. The rules of trust ownership are regulated by national laws which vary significantly across countries and even regions. Trusts can be perpetual or they can last for a fixed number of years, and may be costly to dissolve before the stipulated date. Trustees are appointed to govern a trust and to protect its interests. They tend to include capable and interested family members, and/or outsiders with special capacities in the management of trusts and firms. Thus, for a trust that owns a controlling share of a family business, the trustees act as the link between the family and the board and management of the firm. Beneficiaries – those who receive the benefits (payouts) from the trust – are typically family members, but they can include a broader group of recipients. Charitable trusts distribute funds with a social or charitable objective.

Foundations are created to administer a large ownership stake in a particular company, often donated by the founder. In most countries it is impossible to reverse the transfer and there will often be restrictions, such as that the foundation cannot sell the company or dilute its ownership stake beyond a certain limit. Thus it serves as a vehicle for the founder to extend family control after his/her death. The foundation itself is a non-profit entity which has no owners or members. Its board members are often self-elected, constrained only by law and the foundation's charter, which frequently stipulates a broadly defined social purpose – for example, to act in the company's 'best interest' and use excess revenue for charitable purposes. Often, but not always, the founder's family continues to play a role in the management of the company.

Foundations are popular in Northern Europe, where a number of well-known companies have set up such structures, including Bertelsmann, Heineken, Robert Bosch and Carlsberg. Similar structures were not uncommon in the US until 1969, when a law effectively prevented foundations from owning more than 20 percent of business companies.

THE NEW YORK TIMES

When Adolph Ochs purchased *The New York Times* in 1896, it was the beginning of a legendary newspaper as well as a family owned corporation. *The New York Times* had existed since 1851, but was suffering from rising costs. Ochs managed to cut costs in half and increased daily circulation from 9,000 to 76,000 in only in three years. Ochs, originally a typesetter, was also the controlling owner and publisher of a local newspaper in Tennessee, *The Chattanooga Times*. Through a combination of trustworthiness and integrity, Ochs managed to become a respected and successful publisher, unlike his competitors who did not hesitate to distort the truth and invent scandal.

Ochs incorporated his personal principles in the *New York Times*. He separated news from editorial and political opinion and dropped the price of the newspaper. By the 1920s daily circulation had risen to 400,000. Ochs's daughter Iphigene had married Arthur Hays Sulzberger, who began working in the company and succeeded Ochs when he died in 1935 as publisher and president.

Under the management of Arthur Hays Sulzberger from 1935 to 1961, *The New York Times* diversified into radio, expanded across the entire USA and to Europe, and saw circulation increase to 713,000. As publisher he continued the principles of his father-in-law and was a strong advocate of press freedom and democracy. In addition to its financial success in the period, the *New York Times* won the prestigious Pulitzer Prize for outstanding journalism in the USA several times. Today it is the newspaper that has won the most Pulitzer prizes and is regarded by many as the finest newspaper in the world.

The New York Times is, in our view, one of the most inspiring cases of trust ownership. To mitigate the consequences of the power of numbers, Adolph Ochs established a family trust owning 50.1 percent of the common shares before his death (1935), the remaining shares being owned by his spouse and children. The charter stipulated that the trust would hold the controlling stake until the death of Adolph's daughter Iphigene, after which the shares should be evenly distributed among her four children. The trustees were Iphigene, Arthur (Punch) Sulzberger, and Julius Ochs Adler, his nephew.

For Adolph Ochs, the trust was a commitment to continuing family ownership and family management at least for the next generation. By concentrating control in the trust and allocating the shares to his grandchildren after it ended, he ensured that de facto control of the firm would remain in the hands of the Ochs-Sulzbergers for at least 50 years. The trust was also a commitment to give the four grandchildren (and their future offspring) an equal opportunity to be involved in the *New York Times*, since no individual could take over the corporation.

In the 1960s, new roadblocks arose as a result of developments in the newspaper industry, and new capital was required to fund its expansion. Once again, a re-design of the ownership structure was the key to raise capital without losing family control. In 1961, Arthur Sulzberger listed the *New York Times* on the New York Stock Exchange. The power of the family was asserted by issuing dual-class shares, with the trust retaining the superior voting shares, leaving little power in the hands of the new minority investors.

The trust was reorganized in the 1980s (Iphigene was by then in her nineties), when Punch initiated the formation of four new trusts, one for each of his siblings and himself. When the old family trust was dissolved upon the death of their mother, the holding would be distributed to the four new ones, each to remain in effect for 21 years after the death of the last of their 13 children. Furthermore, the family committed to vote unanimously on any matter that could potentially entail the loss of its control over the newspaper. The agreement went into force four years later, when Iphigene Ochs Sulzberger died in 1990, at the age of 97.

Notice that with the new trusts, history repeated itself. Control of the *New York Times* was left firmly in the hands of the four siblings, and would remain there for the next two generations, implying that all 24 grandchildren of Iphigene Ochs Sulzberger had secured an ownership stake in the global media empire built upon the world's most influential newspaper.

The New York Times is a fascinating illustration of how to use a family trust to perpetuate control within the family and to counteract governance problems arising from the natural dilution of ownership. It is also an example of how powerful individuals (Adolph Ochs and Punch Sulzberger) were able to preserve family control for half a century beyond their own lifetimes.

Pros and cons of entrusting controlling ownership

Around the world, service providers promote trust ownership as a powerful solution to almost any challenge that families face with respect to an increasing number of family members, diverging interests, and the issue of careful tax planning. Obviously, it is worth asking if trust and foundation ownership is superior to direct shareholdings by individual family members. In the following paragraphs we discuss some of the advantages and disadvantages of trust and foundation ownership. Through this discussion we will discover that there are indeed many roadblocks that can be mitigated with the help of trusts, but that such ownership structures also have the ability to prolong existing roadblocks or create entirely new ones.

Let's imagine that, as retirement approaches, a founder wants his three sons to take over the family business. He hopes that the brothers will stick together and the family business will not be broken up. How should he transfer the controlling ownership? Should he set up a trust and appoint the three brothers as managers? Or should he divide and distribute the ownership among them?

As mentioned, there are several advantages of giving a trust or foundation a controlling ownership share. First and foremost, it ensures family control of the business. Trusts and foundations are governed by a charter, typically drawn up by the founder (or the current majority owner) who can stipulate under what conditions the trust can be dissolved and/or exit from ownership. Indeed it's possible to stipulate that the trust or foundation will always (or at least for a number of years) be the controlling owner of the family firm.

Second, it opens up an opportunity for the separation of ownership and control, the appointment of non-family professional managers, and the introduction of governance by a board of trustees. This is a powerful mechanism because it allows family members to be beneficiaries without being responsible for managing the firm. Hence, only the capable and interested family members will be selected to manage the trust, and thus control the firm. It is also possible to appoint expert outsiders to be trustees. In other words, the founder may appoint trustees on merit, or from the head, and designate beneficiaries from the heart.

Third, in most countries a family or charitable trust is a powerful tool for tax planning in general, particularly during a succession. If controlling ownership is transferred to a charitable trust or foundation, the transfer is typically tax exempt. Thus, entrusting ownership can be even more attractive in countries with high inheritance tax.

For these key reasons trusts are becoming increasingly popular in many countries. Given that financial advisors aggressively promote them as a solution to almost any roadblock, it's essential that families understand the limitations and constraints involved in entrusting ownership of their business.

it's essential that families understand the limitations and constraints involved in entrusting ownership

The deadlock problem. The first challenge is the lack of flexibility to resolve conflicts. A pre-condition for a family trust to work is for sound family governance to be in place to secure long-term family harmony. A trust prevents ownership transfers between family members as these are restricted. A trust also prevents one family member acquiring the ownership shares of other family members. So if there is conflict the firm and the family risk ending up in deadlock, with it becoming impossible to make changes in the way the firm is operated because any new initiative is blocked by opposing parties within the family. Such situations can have severe consequences for family businesses. The Kwok brothers, who belong to one of the largest property development groups in Hong Kong, offer an interesting illustration.

KWOK FAMILY TRUST AND SUN HUNG KAI PROPERTIES GROUP

Sun Hung Kai Properties (SHKP) is the second largest business group in Hong Kong. From its core business of property development, it has diversified into telecommunications and other non-property ventures.

Kwok Tak Shen, the founder of SHKP, transferred his 43 percent controlling interest to a trust before he died in the 1980s. Four family members – his wife and three sons (Walter, Raymond and Thomas) – were beneficiaries in accordance with the trust deed. The trust was understood to be non-dissolvable and the entrusted ownership non-transferable, apparently in accordance with the founder's wish to ensure perpetual family control and for the three sons to work together to sustain the group. The trust elected, and the board of directors appointed, the eldest son as the chairman of SHKP, while the other two were appointed vice-chairman and managing director respectively.

After Kwok Tak Shen's death, SHKP continued to prosper under the second generation. The business broadened out, taking control of a number of cell phone and transportation companies. Together the three brothers became the third-richest business family in Hong Kong, and duly ascended the Forbes list of the world's richest families.

The peaceful days of the Kwok family ended abruptly in 1997 when Walter was kidnapped by an infamous gangster, Cheung Chi Keung, known as 'Big Spender', and was held blindfolded in a cage for more than a week. He was released without police involvement after the family paid a ransom believed to be around HKD 600 million. After his arrest, Cheung Chi Keung confessed to having held Walter in a wooden cage for several days. The ransom was delivered in HKD 1,000 notes packed in 20 containers.

Walter returned to Sun Hung Kai Properties after his release but was badly shaken. He kept his position as Chairman of the Board and CEO but left much of the day-to-day management to his younger brothers. These traumatic events may have been the incident that triggered the family fight that exploded in public 10 years later. But the origin of the fight relates back to Walter's youth when he felt in love with an ambitious lawyer, Ida Tong Kam-hing. His father disapproved of the relationship and forced him to enter an unhappy marriage that only lasted a year. Walter subsequently married his current wife Wendy Lee.

After recovering from the abduction, Walter brought his former love Ida Tong Kam-hing into the company, where she became increasingly influential and had a large say in management.

On 8 February 2008 the family fight exploded in public when a press release announced that Walter would take a temporary leave of absence for personal reasons. During the following months, the feud unfolded in the media on daily basis. Walter was voted off the board of directors and removed as chairman by his brothers, citing mental issues. He took his case to court in Hong Kong, claiming that his brothers had set him up by luring him to a doctor, who had prescribed medicine that he did not need to take. The court eventually dismissed the case.

Walter was definitively removed from the chairmanship and replaced by his then 78-year-old mother, Mrs Kwong Siu-hing. Shortly afterwards she ceded the chairmanship to the two younger brothers. But the family crisis did not end there. The Hong Kong Independent Commission Against Corruption, tipped off by an unidentified source, prosecuted the brothers in 2012 for corrupt land deals. Walter was suspected of being the person who passed the commission sensitive information.

The outcome of the legal process is still pending. In 2012, Mrs Kwong removed Walter from the beneficiaries of the family trust, apparently unhappy with her eldest son. But given the trust structure, it would prove to be extremely complicated to divide the holdings between the brothers or to buy out the eldest brother since he did not have personal ownership. In the absence of a trust holding, the family could have bought Walter out of the business, or they could have split the business such that he would own his own part and the mother and the two younger bothers the rest. However, this was not possible because ownership was vested in a trust that was believed to be non-dissolvable and to have no legally specified end. The ensuing deadlock during recent years has resulted in enormous loss of value for the owners of Son Hung Kai shares.

Ownership by way of a trust is common property. Family members are no longer the direct owners of the business; they are beneficiaries of the trust. The voting, dividend and transfer rights of the beneficiaries are allocated according to the charter, and enforced by the board of trustees which comprises key family members, lawyers and accountants. Family members do not hold a known percentage of family ownership they receive a set of 're-packaged' non-transferable rights.

The risk of deadlock is especially high when a founder sets up a trust in perpetuity, specifying in the charter that under no circumstances can the trust be dissolved or the assets transferred, which can limit operational freedom. Due to unforeseen circumstances the feasibility of such a provision may be challenged or may need to be reinterpreted. For example, the more than 100-year-old charter of the Carlsberg Foundation stated that the Foundation should always be the dominant owner. If this had been interpreted as meaning that the foundation should always hold at least 50 percent of the shares, it would have blocked the possibility of Carlsberg buying up other breweries and reaching the size it has today. Since the family no longer exists, the Carlsberg company had to challenge the provisions of the charter in court to be able to re-interpret it in a way that did not constrain the expansion of the firm's activities.

Common pool problem. Trust ownership has 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 employees of a state-owned enterprise; they prefer the business to distribute dividends, employ friends and relatives, sponsor interesting non-business related activities, and so on. Moreover, they may be reluctant to spend corporate funds on investments that do not promise a near-term payoff.

Both the deadlock and common pool problems of trust ownership become more serious when the size of the family increases. In our research on Hong Kong firms controlled by family trusts, we found that among large families, businesses paid 62 percent of earnings as dividends when ownership was held in a trust, compared with only 43 percent of earnings as dividends when ownership was held by individual family members. The family businesses under trust ownership spent 9 percent of revenues on long-term investment, while those under direct family ownership reinvested 11 percent of revenues. When family size was large, trust ownership was associated with slower sales growth and slower growth in job creation relative to that of individual ownership. Thus, this shows that trust ownership in Hong Kong seems to dampen firm performance among large public traded firms.

Trust ownership performance (measured by market capitalized value divided by book asset value) is on average no different from that of firms controlled by individual family members. However, there are specific situations in which trust ownership underperforms, particularly when the family is large and when the business is in financial distress or in a period of turmoil.

Trust governance problem. Dispute resolution depends on the board of trustees. Since the board is typically dominated by family members, there is a lack of unbiased third-party arbitration. The board of trustees may be dominated by a single family member (typically the manager or a senior member) and his/her allies, and therefore their decisions may be self-serving at the expense of the interests of the family as a whole. Non-transferable ownership heightens the tunneling incentive when disputes go unresolved or when the dominant individual is in a desperate situation.

Who's-the-boss problem. Over the years, as family members lose interest in running the family business, the managing role is taken over by non-family professionals. Family members cease to serve on the board of trustees and are replaced by non-family individuals with varying degrees of competence in running a business. The family can end up being passive owners, while the professional managers have all the power. In extreme cases, the owners' influence is eliminated and the firm is managed as if it had no owners.

To sum up, entrusting ownership has clear advantages for many families, but there are considerable risks involved. Careful design of trust charters will reduce but not eliminate such risks. Some guiding principles for founders to consider when entrusting the ownership of their firms in this way are:

Flexibility on transferability. Founders should be aware of the drawbacks of giving a trust or foundation a controlling interest. While the desire to protect assets and preserve control within the family is understandable, non-dissolvable trusts and non-transferable ownership do not guarantee business continuity, as we have seen. Founders must build in flexibility, for example by making the trust dissolvable in the foreseeable future, say, after 20 or 30 years. Descendants then have the opportunity to form new trusts if they agree to continue the family business venture. *The New York Times* is an excellent example of such flexibility.

Strong family governance. Good family and trust governance are critical for trust ownership to function. Are there strong family values binding the current and future family members together? Do (and will) they find common ground on basic values? Are they sufficiently loyal to these values to be responsible to the family and the business when making decisions and interacting with other members? Do they defer to a common authority to resolve their differences? Are they accountable to future as well as current members? Only with strong family coherence can families survive the roadblocks; formal ownership and governance mechanisms alone won't work. The case of the Kwok Family Trust and Sun Huang Kai Property Group is a stark reminder that a trust cannot save a family business when family coherence has been blown to pieces. In such cases the trust becomes a roadblock that makes it difficult to rearrange ownership in a way to stop infighting.

Trust governance. Trust governance needs to be in place to allocate and enforce ownership rights. In principle, cash flow rights are divided among beneficiaries according to the charter, which is enforced by the board of trustees. In addition to implementing cash distribution, the trust board designates corporate directors to exercise the voting rights of the trust, one of whom will serve as the chairman of the board, as well as taking other decisions based on the stipulations of the charter. For example, in the case of the *New York Times*, the charter stipulates that decisions have to be approved by six of the eight beneficiaries. It also sets out the rules regarding subsequent modifications to the charter, such as a change in the beneficiaries. Thus the trust board has real power, so it is indeed crucial to find and incentivize trustees who are capable and engaged in their job.

Let's return to the SHKP-Kwok foundation. After its restructuring in 2012, the new distribution rule was probably divided three ways: a third to Walter's branch (except Walter himself), a third to Raymond's branch, and a third to Thomas's branch. The restructuring in effect deprived Walter of the right to receive cash flow interest from the trust. The board of trustees holds the Sun Huang Kai shares and ensures that income is distributed according to the charter. However, from the actions taking by the family members, it is clear that the board of trustees do not have real power. The real power of control lies with the mother and matriarch, Mrs Kwong. She organized the ousting of Walter and took over as chairwoman. It is interesting to note that officially she is only a beneficiary of the trust, not a trustee, according to information disclosed by the Hong Kong Stock Exchange.

Hence, while control is officially allocated according to the charter, in reality it is essentially in accordance with custom or norms. It is the mother who is the ultimate decision-maker, not the trustees. This is not uncommon among Asian family trusts. But a serious question remains. After the mother dies, who will replace her as the new authority, and upon what rules will that authority be based?

The continuity of the business is closely associated with trust governance. The board of trustees should be structured and should function to ensure decisions are taken in the interests of all beneficiaries. It may be beneficial to appoint neutral non-family member(s) to the board of trustees in addition to family members. All branches of the family should be represented on the board rather than allowing one branch to dominate, just as rules and procedures should be transparent.

The case for charitable trusts/foundations. Transferring a controlling ownership stake to a charitable organization offers the obvious advantage of tax exemption. It also projects a positive image of the family and the business to society. Charitable ownership also has an important impact on business continuity.

In Chapter 1 we saw how Wang Yung-ching, founder of Formosa Plastics Group (Taiwan), transferred his controlling ownership stake to a charitable foundation. He did not write a will before his death at the age of 92; instead he wrote an open letter to his children indicating that he had decided to leave his business empire to the community. Wang's decision was inspired in that it combined a philanthropic gesture and avoidance of the 50 percent inheritance tax rate effective in Taiwan at that time. It was a product of his legendary persistence in 'getting to the root of the problem' by asking the right questions. Whose business is Formosa Plastics? Should I maximize the value of the business or the value of the family? Are the two conflicting? He must have decided that the business should remain within and serve society, and that his children and grandchildren should earn a living elsewhere or prove their ability before being elected to manage the business. Ultimately, he believed that leaving the business to society was best for the Formosa Plastic Group and for his family.

Every successful entrepreneur has to ask and answer similar questions. Wang Yung-ching spent a lifetime building a successful business empire, but his family was built less coherently: he had 4 wives and 13 children. Creating a sustainable family culture and values is very difficult in such a context. Without them, the business would lack the stable foundation to survive after his death, so instead of consigning it to the battleground of a family feud, he left it to the community.

Charitable ownership offers an opportunity to introduce formal governance to family business. The board of directors of the charitable organization can include family members as well as non-family managers and outsiders. By bringing in outsiders with no particular business experience, charitable trusts enlarge the who's-the-boss problem we discussed above. Trusts laws often require a minimum number of outside trustees for a trust to qualify as charitable; these can be prominent individuals, community leaders or charity experts. For example, the board of Chang Gung Memorial Hospital (the institution that controls Formosa Plastics Group) is composed of one-third family members, one-third non-family managers, and one-third outsiders, in accordance with Taiwanese law. Trustees in the Carlsberg Foundation – the controlling owner of the Danish beer group Carlsberg – are for the most part distinguished individuals with a scientific or cultural background but little business experience. As a result, it is often the case that the controlling owner ends up being a passive owner leaving actual leadership to the executive management.

Challenge 4: going public

Many family owners are tempted to float the company (make shares available) on the stock exchange. This may seem an attractive way to raise capital to finance new investment or to generate cash to distribute among family members. However, we have seen many cases of family owners who have been unpleasantly surprised after going public. Some are so disappointed that they end up delisting the family business – a costly process which may require the support of banks or other investors. The process of listing and delisting the family business could in many cases have been avoided if the family entrepreneur had better understood the challenges involved before embarking on the listing process.

Let's begin by looking at some of the many benefits which potentially can be achieved through listing the family business:

First, it can provide a significant amount of cash which can be used to finance larger investment projects in the firm. Raising funds through listing on the stock exchange is often the key to finance future growth. To keep control, families can choose only to list a minority of the shares or use control-enhancing mechanisms such as shares with different voting rights, keeping those with superior voting rights within the family.

Second, going public can also provide a significant amount of cash to increase the personal spending power of family members and allow them to invest in other projects. A related point is that it makes the shareholdings of individual members more liquid. In a growing family there will be diverging opinions about selling shares; listing the company allows each member to make their own decision about selling. Some will want to sell, either to spend the money or to diversify their investments. In private firms it can be complicated to find family members who are capable of and interested in buying other family members' shares, whereas in a publicly traded firm individuals can choose to sell their shares on the stock exchange, which makes it much more flexible.

Third, listing the firm provides the family with a clear valuation of their ownership stakes. Valuation of private firms is difficult. There may be opposing interests in establishing the true value of the company. A lower valuation will be in the interests of those seeking to minimize wealth tax. A higher valuation will be in the interests of those who want to exit the business, but will also drain resources from family members who stay in, or from the company itself if it ends up buying back shares from exiting family members. It is our experience that valuation of shares in private family firms often generates significant conflicts that can tear entire families apart.

Fourth, going public may be a first step towards exit. If roadblocks multiply and family assets are less crucial to the business, then in accordance with the *FB Map* the family will move towards exit. Going public can support that process because it provides a structure that allows the family to gradually reduce its role in the firm both on the ownership and the management side.

Indeed, given the benefits of going public it may be difficult to understand why an initial public offering (IPO) is not the ultimate goal of all family businesses. In a nutshell, there are three main reasons why listing is often a disappointment for the family. First, being a publicly traded firm is very different from being a private firm. Corporate legal requirements are much stricter for publicly traded firms. They need to hold shareholder meetings, appoint a board, deal with minority owners and so forth – all in a highly regulated fashion. If the founder is used to running the firm like a dictatorship or through board meetings over Sunday lunch, it can be a real shock to have to deal with the board of a publicly traded company. In many countries there are strict regulations about what, how and to whom information can be delivered. We have met numerous entrepreneurs who find dealing with the board and the new owners of the business extremely cumbersome. Indeed they often feel that the new owners contribute little on the strategic side but constrain the flexibility of management on the governance side.

Second, even if the family retains a majority stake, the new owners have a voice and will want a say in how the family runs the business. They may start to contest the leadership: Are they managing the firm well enough? Are they working for their own interests or in the interests of the owners as a whole? Are they able to create shareholder value or could others do better? Since publicly traded firms are more visible, unhappy minority owners may use the media to criticize the family. We know many entrepreneurs who have been hugely disappointed with the new investors, including some entrepreneurs who attempt to ignore the existence of those investors and continue to run the firm like a closely held family business.

Third, the family's control of the company may ultimately be challenged. Even when ownership is carefully designed, going public may create long-term dynamics that threaten the family's control – either in the immediate aftermath or years later – but which are not foreseen at the time of the IPO.

going public may create long-term dynamics that threaten the family's control

One illustration of the long-term consequences of going public is the Cadbury chocolate empire, whose Quaker-based family assets we discussed in Chapter 2. As the *FB Map* predicts, over the years the ownership structure was re-designed several times in response to changes in family, market and institutional roadblocks. The first significant change to Cadbury's ownership profile came at the end of the First World War, when Cadbury merged with its main rival for almost a century, the Quaker firm Fry, partly to save Fry and partly to block the entry of Swiss and Dutch rivals into the British chocolate market. Officially it was a merger of equals, but in reality Fry became a subsidiary of the stronger partner Cadbury. The merger had the effect of doubling the number of family members who held shares in the firm but were not actively involved in management.

Fast forward to 1945, when there was growing pressure from the Cadbury and the Fry families to take the company public. The ownership structure was already complicated and there were more than 200 individual family members altogether. True to their Quaker values, the second-generation Cadburys, Richard and George, had given much of their fortune away to charitable trusts that owned most of their shares. Many of the Frys had seen little income from their shareholdings, yet their capital had been tied up in the business since 1919 without a market for the shares. Faced with the challenge of supporting poorer family members (who were only rich on paper) they had three options: (1) they could continue without making changes and leave family members to find their own ways to earn income, (2) the managing family members in Cadbury could prune the tree and buy out family members from both sides who wished to sell, (3) the family could list the company, which would provide an objective valuation of the shares and allow family members to sell at will.

Option (1) was difficult because of the pressure from non-managing family members who wanted to sell and because of real concern for the Fry family's situation. Option (2) was not possible because almost all the wealth of Richard and George had been transferred to charitable trusts, so they did not have the resources to buy out members who wanted to exit. Only option (3) was left. Fortunately, it happened to coincide with the ambitions of the young managing family members who wanted new capital to support additional growth of the company.

Cadbury – or *The British Cocoa and Chocolate Company* as it was officially named after the merger with Fry – was floated in 1962. At that time, little thought was given to the issue of control in the future. After all, the family and the trusts were majority owners with more than two-thirds of the shares, so how could their control be challenged? In 1969, Cadbury merged with Schweppes (partly to protect Schweppes from being taken over by even bigger players), creating one of the largest confectionery companies in the world. Over the decades of rapid global expansion that followed, there was a sharp reduction in the ownership stakes of the family. The charitable trusts and foundations sold their shares to reduce the risk of being over-dependent on one company.

In January 2010, KRAFT bought Cadbury in an uninvited takeover. We describe the process of this takeover in details in Chapter 7. For now it suffices to say that the loss of Cadbury was a result of the dynamic changes in the structure of ownership over a period of 50 years after the firm was listed.

The loss of Cadbury as an independent company was a shock to the family and to the British public. But in retrospect, it was simply a logical consequence of the way ownership had been designed and developed over time. The successful Quaker entrepreneurs in the second generation had given most of their wealth to trusts and foundations. The merger with Fry increased the ratio of passive owners to active managers. Ambitious growth plans had to be financed with new capital – the main reason for going public. Further expansion, seen as a key to staying independent, triggered the merger with Schweppes. When the trusts disinvested to reduce their company-specific risk, the family's direct and indirect control through ownership vanished. Speculative investors forced the de-merger of Schweppes and Cadbury. Ultimately the hedge funds played an active role in the takeover process, paving the way for Kraft's success.

Clearly the Cadbury family could not have foreseen the loss of the company when they took the decision to list in 1962, but the case provides a powerful example of how ownership is a dynamic concept; going public can, over time, set in train unforeseen changes in ownership and control. Having thought that the company was safe in 1962, disinvestment, a forced de-merger, and 40 years of aggressive expansion, made it vulnerable to a hostile takeover.

Could the Cadburys have held on to the company if their ownership stake had not been diluted over time? Probably, but even a big family stake may barely be enough to protect family ownership of a publicly traded company. This is the experience learned by the Hermès family, whose strong family assets we also discussed in Chapter 2.

Like other families in the luxury segment, the descendants of Thierry Hermès chose to raise capital from an IPO in June 1993, in part to enable the company to pursue its own style of vertical integration, but also to allow dissatisfied heirs to liquidate their company shares. Hermès listed all its shares but around two-thirds remained in the hands of the more than 50 family members. The IPO was very successful, and the initial offering was oversubscribed more than 30 times. Since the family still controlled two-thirds of the company, the leadership felt they were safe despite the listing. Surely there was no way an outsider could threaten their control?

They were in for a surprise.

In October 2010, CEO Patrick Thomas was interrupted by a telephone call during a bike ride in the Auvergne. It was Bernard Arnault, head of the luxury conglomerate LVMH. Thomas was shocked to learn that Arnault had acquired a 17 percent stake in Hermès and wanted to buy more, as he was planning to announce at a press conference a couple of hours later. The first thing that went through Patrick Thomas's mind was that this was no way to do business: Arnault had not even requested a meeting prior to the move. It was, he concluded, 'ungentlemanly'.

Most of the family agreed that Arnault was an unwanted interloper whose methods and style would ruin the unique culture of Hermès. He was, they feared, not only ruthlessly aggressive like an 'American businessman', but his formula for success mixed glitzy advertising and outrageous publicity stunts with a continual search for designers with a cult following – a blend entirely unsuited to Hermès. Arnault insisted he was no threat to the autonomy of the company or its brand – he only wanted to help, to make Hermès more profitable.

How could Arnault be a threat to the Hermès family who jointly owned more than 70 percent of the shares? The key to understanding the situation is that ownership was diluted even further after the 1993 IPO and the family shares were now held by more than 70 family members, each of whom had very small shares. Even if they seemed united, Arnault was planning to negotiate with every potentially interested member who would sell. In such a big family, he reasoned, there would always be individuals willing to sell at the right price. Not only did Arnault have the cash, he was willing to be patient. And he was given some encouragement when one branch of the Hermès family publicly advocated collaborating with him.

What could Hermès do to stop Arnault? Since trading in family shares was not restricted, there were two possible actions: either the family could buy up all the outstanding shares and de-list the company, or they could make Arnault a counter-offer and pay him a premium to leave the company alone. Neither option was attractive: de-listing would require a lot of cash, and the family was reluctant to pay Arnault a large premium to leave the firm.

The solution they found centered on the tradability of the family shares. In response to the threat the family created a holding company that had first right to buy any family shares. Through this mechanism they could prevent at least 51 percent of the shares of family members being transferred (to LVMH) for the next 20 years. For the time being, the holding company would keep 73.4 percent of the shares in the hands of the descendants of Thierry Hermès.

But while this solution offered powerful protection of the family's interests, it would be seen as costly for minority investors who might have expected a large premium if Arnault had been successful or the firm had de-listed. Though LVMH appealed against the measure, arguing that it was not in the interests of shareholders, a court upheld the legality of the arrangement.

The Hermès family had protected themselves by creating a holding company. But they (and other family entrepreneurs like them) learned a hard lesson. And although the holding company was legal in France, it may not have been legal in other countries like the UK or the USA. Re-designing the tradability of publicly traded shares has a significant cost for minority shareholders who originally invested under a different set of rules. In this case they were not compensated. Would the French courts have come to the same conclusion if Hermès had not been an icon in the luxury industry of France, and Bernard Arnault's aggressive tactics had not strained his relationship with the French government? This is an interesting question, subject to speculation, but one that we will never know the answer to. What is clear, however, is that the family's control of Hermès would have come under severe pressure if the courts had reached a different conclusion.

It is worth pointing out that the family could easily have protected themselves in 1993 when the company first went public. If the holding company or other control protecting mechanisms had been in place at the IPO stage, new investors would have known this when they invested, and the price of the shares would have incorporated the lack of a potential takeover premium.

The Cadbury and Hermès stories are dramatic illustrations of how going public can have long-term implications for a family's ability to control the business. They teach us how control of even the biggest family businesses can be lost if the listing process is not carefully designed.

Four inspirational cases in ownership design

As indicated at the beginning of the chapter, the goals of ownership design are to secure control, provide incentives, and mitigate conflict. Below we examine several real life cases of ownership partition. We hope these examples provide inspiration for family entrepreneurs engaged in the process of re-designing ownership, as well as an opportunity to learn from their successes and failures.

Case 1: effects of critical minority shares

Founded by Kam Shui-fai (甘穗煇) in 1942, Yong Kee evolved from a modest food stall in to an internationally renowned restaurant in Hong Kong. Famous for its roast goose, it was ranked by *Fortune* magazine in 1965 as one of the top 15 restaurants in the world, and was the only Chinese restaurant on the list. Yung Kee is owned by Yung Kee Holdings Ltd, a private holding company.

Following the founder's retirement, his two sons Kam Kin-sing (甘健成) and Kam Kwan-lai (甘琨禮) took over and successfully ran the business. After the chairman passed away in 2004, the shares were divided among his children. Kam Kin-sing and his younger brother Kam Kwan-lai each received 45 percent, while their younger sister Kam Mei-ling received 10 percent (a share that was first given to a third son who was terminally ill).

The younger brother Kam Kwan-lai was later found to have secretly acquired the 10 percent holding from his sister, thereby accumulating 55 percent to his brother's 45 percent. His attempts to secure control of the company triggered a bitter dispute between the two. In March 2010, Kam Kin-sing applied to the High Court for liquidation of Yung Kee Holdings Ltd if Kam Kwan-lai refused to buy out his stake. In 2013, the Hong Kong courts finally approved Kam Kin-sing's application to liquidate Yung Kee Holdings Limited, ruling that it would not affect the shareholders, customers or employees. However, the court was not able to enforce the ruling because the holding company was registered in the British Virgin Islands. Just weeks before the ruling, Kam Kin-sing suddenly passed away. Press reports claimed that his death was related to the family business woes.

The founder had given 45 percent, 45 percent, and 10 percent to his three children in the hope that the brothers would work together and jointly make business decisions while taking care of the younger sister. This division resulted in an unintended outcome. There are several lessons to be learned here. The first is that (45–45) equal share ownership design does not guarantee family harmony or prevent family fights. The second is that the ownership division weakened the control of the enterprise and exacerbated the effects of the conflict on the family business. Third, minority family owners (like the sister) often have an incentive to sell family shares and exit (as the saying goes, 'a bird in hand is worth two in the bush'). In short, an unbalanced ownership partition like the 45–45–10 split is not sustainable in the long term.

However, there was a positive feature of this arrangement. Family ownership was quickly re-concentrated within one branch of the family (the younger brother). In less than two years of taking the dispute to court, the holding company was liquidated and his ownership of the restaurant was secured. This highlights ownership transferability as an important mechanism for family conflict resolution. The swift conclusion contrasts with the slow progress made by the Kwok family, whose controlling interest in SHKP was held in a family trust, thus preventing resolution by ownership transfer.

The founder of Yung Kee chose not to follow the Chinese tradition of giving majority ownership of the family business to the eldest son, perhaps for good reason. But the cost of the ownership structure, at least in the short term, was soon apparent – disruption of the business by a family feud. If business stability is the prime consideration, he should have given one of his sons at least 50 percent of ownership to secure effective control, for example a 51 percent-39 percent-10 percent split.

Case 2: dual-class family ownership

Before his retirement, a founder divides and distributes his sole ownership of a significant business to his wife and six children. Two classes of shares are created, one with voting rights, the other with no voting rights but rights to cash flow. The only son (and successor CEO) receives 48 percent voting rights and 20 percent dividend rights. The five daughters each receive 7 percent voting rights and 15 percent dividend rights. Finally, the mother receives 17 percent of voting shares and 5 percent of dividend rights.

By observing the pattern of the resulting voting and dividend rights, we can guess that the founder designed the dual-class ownership structures with two considerations in mind: control and equality. The son (and future CEO) has almost half of the voting power. His business decisions are almost uncontestable unless all the other family members unite against him. The allocation of dividend rights is more even among the six children, with the mother receiving a much smaller share. The dividend distribution is primarily based on ensuring equality among the children.

In this example, the dual-class structure enables the founder to separate voting rights from dividend rights, since the two are based on different criteria. Voting rights are allocated to promote efficiency in corporate decisions while giving right of veto to the rest of the family. Dividend rights are allocated such that all family members can obtain enough income from the company to enjoy a decent standard of living. A potential drawback is that the son, as the new CEO, may have an incentive to use his voting power to 'tunnel' cash for his private benefit while refraining from paying a dividend. Since the son is a residual claimant for one-fifth of the value created in the company, he may choose to enhance his private consumption through the company, for instance by letting the company pay for houses, cars or holidays. Or he could make the company invest in other business activities that would give him a larger share of the outcome. Such activities have the potential to create family conflict. Where serious family conflict arises, it may be urgent to re-design the ownership structure again. One possible option would be for the son to buy back the minority ownership of the other family members.

Case 3: interlocking ownership

Now let's consider a family with 80 years of business history, currently managed by the third generation. The founder has four sons, all entrepreneurial. The firm diversified into four different businesses in the 1970s and early 1980s, all under one roof. It was understood by the four branches that each branch owned 25 percent of the business.

It so happened that one branch of the family was more successful than the other three, and that there were disagreements among the four branches. They tried creating a family board in the 1980s, but failed because it was dominated by one branch. Eventually, the family firm was broken up into four businesses and a cross-ownership structure was implemented in which each of the four branches owned 75 percent of the business they respectively managed, and collectively owned 25 percent of each of the businesses run by the other three (Figure 5.2).

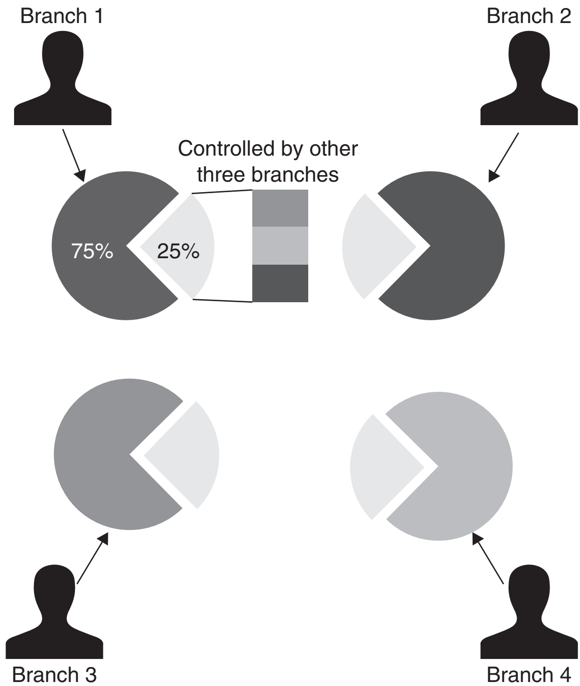

FIG 5.2 **Cross ownership within a family with four branches**

The family hoped the cross-ownership design would provide autonomy in each of the four businesses while giving all members an incentive to uphold family values and share resources. To date, the family has maintained this ownership structure. We find this is an interesting case of providing incentives for each branch to develop their own businesses while keeping the overall family cohesion. Hence, we believe this cross-ownership model can be an inspiration to other families where different branches are managing separate business divisions in the business group.

Case 4: family holding company

A founder has a controlling ownership of a holding company, which in turn has sole or majority ownership of four subsidiaries, each managed by his three sons and a son-in-law. Neither the sons nor the son-in-law have a stake, or only a minority stake, in the subsidiary he manages. The founding father wants ownership of the holding company to be divided among his four children after he dies.

Under the holding company structure, the sons and son-in-law are in effect subsidiary managers, receiving a salary as compensation. They have an additional incentive to maximize the value of the subsidiary, hoping to get a larger ownership stake of the holding company after the father dies.

One advantage of the holding company structure is that each of the subsidiary managers benefits from a common pool of family assets. They may even enjoy full autonomy if the father delegates decision-making power. In addition, if any family members are in dispute, the subsidiary in question can be carved out from the holding company and sold to the respective manager (a son or the son-in-law). The downside of the holding company structure is the risk of breaking up the business after the father dies, with the four each obtaining their share of the holding company. Therefore, the holding company structure is not a stable structure unless the family shares strong values and has robust family governance.

Discover more

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Highlights

- The ownership structure affects the incentives, behavior and ultimately the performance of family members, family managers and other stakeholders in the firm.

- Sound ownership design is the key to good governance and the most effective way to minimize the impact of roadblocks, whether they arise in the family, the market or the institutional environment. Flexibility is important since it is likely that the optimal structure will have to be readjusted over time as the family and the business grow.
- The four most common challenges in designing ownership structures in family firms are:
  1. to raise capital to expand without giving up family control
  2. to counteract ownership dilution as a result of the power of numbers
  3. to institutionalize ownership using trusts and foundations
  4. to go public, listing the businesses either as a whole or in part
- Given the current popularity of trusts in Europe and Asia, it is important to understand that trusts and foundations can raise additional challenges such as deadlocks and free-rider problems.
- Our recommendations are to have procedures for dissolving a trust and to be careful in choosing competent trustees.

We now turn to the topic of family succession. We will discuss the biggest challenges that family firms around the world face during the transition from one generation to the next, and how long-term planning can help overcome them.