CHAPTER 3 - Ownership of an Enterprise Built to Last

Concentrated Ownership
Results in higher overall corporate productivity

The higher performance seemed to be related to the different posture taken by these firms toward diversification and investment in training and development, and research and development

Investments in the Ownership Subsystem
If a family business is going to preserve one of its intangible yet well-documented competitive advantages—its propensity to manage with a long-term horizon—investments in the ownership subsystem is essential

That means investing in:
- The design and execution of an appropriate ownership and control structure
- The education, access to information, and engagement of shareholders
- The creation of institutions that govern the ownership–firm interaction

Shareholder Meetings
*Represent one of the best opportunities to educate owners about their responsibilities and what the company and its management expect of shareholders
*Allow for financial, business, and competitive information-sharing and communication on other issues critical to a family firm in a disciplined and proactive manner
*Represent the best safeguard to a healthy governance of the family's influence on the business and vice versa

Two Missions: Some Alignment

Educating and Informing Shareholders

Family shareholders expecting to fulfill their responsibility of aligning management interests with shareholder priorities and holding management accountable need to have a thorough understanding of financial statements

They need to be able to make sense of what the numbers say about the firm and its competitive condition

Without this knowledge, family-business shareholders can become indifferent and impatient, and can hamper effective operation of the family-controlled business

Responsibilities of Shareholders to the Company

- Define and then demand what are reasonable returns on shareholder equity or invested assets
- Provide the values and principles of doing business and ensure they remain instilled in the company
- Define the owning family's strategy and communicate owning family priorities

Effective Governance of the Shareholder–Firm Relationship

Just as the interaction between ownership, family, and management is the source of what may constitute a competitive advantage, it is simultaneously the source of the biggest challenge faced by family firms: the effective governance of the shareholder–firm relationship

The Role of the Board

- Superior performance in shareholder value is contingent on the composition of the board
- Higher-performing firms are those in which independent directors balance family board representation
- A moderate family board presence provides substantial benefits to the firm
- The role of the board is prominent in the governance of the relationship between a family and its business when the owner–family–business interaction is perceived as a positive-sum dynamic
- Because of the board's importance, next-generation leaders of family companies frequently undertake a critical review and restructuring effort involving their board
- They all come back to the idea that a lot of communication and education needs to take place beyond what is deemed traditional board work and strategic planning processes because of the family's legacy on the board
- The family's identity remains attached to the company's, so if the company is going to change in order to adapt and grow, the board composition has to change

The Role of Shareholder Meetings, Family Meetings, and Meetings of the Family Council
Most of the absolutely essential communication, education, and sharing of financial and strategic information takes place in regularly scheduled shareholder meetings, family meetings, and meetings of the family council
- This keeps the shareholders involved and fulfills the legal requirement to recognize the rights of minority shareholders

In family firms in which the extended family is large and the ownership structure has not been pruned, representative family councils may be a vehicle for educating and informing family shareholders
- These representative councils or committees of the council, sometimes referred to as "asset boards," can also provide the board with input regarding the family strategy and develop policies regarding family participation in the firm

Information, Communication, and Education of Shareholders
The ability to read and understand a financial statement with a high degree of comprehension is a must for shareholders

Shareholders can reach accurate conclusions about what the financial information means and the managerial actions it should prompt only with study, perspective from the experience of others, and information about competitors and others in the industry

As part of their financial literacy, owners should also be able to:
- Understand the capital structure of the firm
- Know debt levels in relation to owners' equity
- Be able to gauge their ability to operate independently or risk influence by banks and other sources of capital in how they run their business

The particularly appropriate measures of profitability for a company in a particular industry, plus measures of return on invested assets, return on shareholders' equity, return on sales and the growth trajectory of the above over time are essential to have and understand

Information regarding the estate plan also needs to be shared with family shareholders

Shareholders who are not sufficiently informed and involved can get suspicious and concerned

Ownership Structure: Leading
Leaders of enterprises find that distributing voting shares equally among shareholders often erodes a next-generation owner-manager's ability to lead

Unlike ownership, the authority to lead is earned rather than inherited

Transferring ownership without an eye toward corporate control makes it more difficult to acquire the authority to lead

Ownership Structure and Classes of Stock
Ownership structures do not transfer well across generations

One approach to this challenge is to redesign the capital or ownership structure of the company by recapitalizing its stock (e.g., recapitalizing the common stock into two classes: voting and nonvoting)

Phantom stock can also be created in order to provide the incentives for key nonfamily management to behave like owners

- Phantom stock mirrors the value of regular company stock but does not dilute the family's actual ownership and has no voting rights

Buy–Sell Agreements
Contractual agreements between shareholders and the company

Typically used by family-business owners to facilitate an orderly exchange of stock in the corporation for cash

Often the primary vehicle through which family shareholders can realize value from their highly illiquid and unmarketable wealth—company stock

The most obvious benefit of a buy–sell agreement is that it allows some family members to remain patient shareholders while providing liquidity to family members with other interests or goals

Multi-Generational Success in Canada
According to many successful Canadian family businesses the secret to success lies in establishing ground rules that turn common sense into common practice.

Some of these ground rules include setting up mutually agreed upon policies that address:

- Who actively participates in the business
- How leadership succession is determined
- Stock ownership
- Concentration