

"Dual class shares: aristocracy or meritocracy?"



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Marc Jobling is assistant director to the Association of British Insurers.

Tom Davidow says:

Family businesses always have to balance the importance of family harmony against making decisions that are best for the business. While family needs should bow to what is best for the business, unless family values and relationships are addressed, the force of family dynamics can overwhelm and potentially cripple the business.

Given that the family business is usually the family's biggest asset, the challenge facing the senior generation (owners) is how to share it fairly amongst family members, while protecting the management/operations from the distractions of family dynamics.

A relatively simple solution is to assign two tiers of stock - one involving only equity, or the value of the asset; the other including both equity and the capacity to vote or control the stock.

The two tier stock solution that separates control from equity is a more flexible hybrid. It allows the business to function with

a clear decision-making process, thereby providing maximum opportunity for its ongoing success, and ensuring the value of the family's largest asset/investment; it also gives family members the chance to participate financially and to share the family's legacy.

While it is necessary for management to have clarity of authority in order to run the business effectively, the non-voting stockholders will need to have a voice in order to avoid the distraction of family conflict.

I strongly recommend putting a structure in place that allows for communication among all family stockholders. This structure should include a minimum of an annual meeting, where family (voting stock) management shares the state of the business and invites family/shareholders to provide their feedback and ask questions.

The structure can be designed either as family governance with informal input, or as a more traditional governance, with a board of directors consisting of outsiders, and with a seat reserved for family member/s who represent the non-voting stockholders.

Further suggestions include:

- Share your estate plan as well as its rationale with all members of the next generation. Starting with the identified successor/s, ask them if they are willing to have control/responsibility for the ongoing success of the business, while sharing future equity with other members of their generation.
- Explain to those members of the next generation who will possess the voting stock that they perceive the non-voting family stock holders as investors.
- To be eligible for voting stock, a family member must be part of the senior management team. Leaving the family business or being removed from senior management will require forfeiting/selling their voting stock.
- Attach specific rights and limits to the voting stock. For example, the controlling shares provide management operational freedom, but do not allow family members with voting stock to sell the business. Either all stockholders, or a defined percentage of them, voting and non-voting, should be included in that decision. Conversely, under certain conditions, a defined percentage of

stockholders should be able to initiate a sale.

At the end of the day, success in family businesses lies not in an idea or a particular structure, no matter how elegant, but in the family's ability and willingness to communicate.

Marc Jobling says:

The first question to be asked when debating the merits of dual class share structures is "why not have the one share one vote principle at your company?" Two of the most commonly cited reasons for not adhering to the principle and adopting a Control Enhancing Mechanism (CEM) such as a dual class shares structure are that:

- The family wants to enjoy the benefits of a listing but doesn't want the organisation to be susceptible to perceived short-termism by the market.
- The family wants to keep control of the company's long-term fate in the hands of family members.

However, such perceived benefits can come at a cost. Investors put a real value on voting rights, and this is reflected in the fact that those companies that have traded voting and non-voting shares find that their non-voting shares trade at a discount.

Therefore, as shares without voting rights are worth less, the subsequent cost of equity capital is greater. This can have a real effect on the financial efficiency of the business.

Furthermore, by disenfranchising shareholders you change their view of the investment. An investor with voting rights is a fully paid-up owner and has the associated responsibilities of proper stewardship.

An investor without voting rights is not able to influence the company's strategy to the same extent and therefore may instead see the investment as a trading proposition.

In effect, disenfranchising may create a short-term approach by investors rather than negating it.

The case for keeping control of the company to within the family also creates problems. For one, who's to say that the talent of one generation will transfer through to the next? Surely experience has taught us that this is far from guaranteed.

A director's suitability to run or control a company should be based on their merits as individuals. If a member of the founding family is the right person to run the company then they should not need the protection of a CEM.

CEMs entrench management and ultimately perhaps lead to a sclerotic decline as they become shielded from the rigours of competition.

Surely the best way to help an organisation succeed and endure is by letting it be run by the best person for the job. Put simply, isn't a meritocracy preferable to an aristocracy?

The potential for a company to make strategic mistakes is high if it is able to make itself unaccountable to all its shareholders by means of a CEM.

We have seen this time and time again when an individual's or small group's interests mean that a company makes a strategic mistake or makes a so-called "vanity acquisition".

Finally, of course, the hardline view would be that when a family business goes public, it ceases to be a family business.

But there is no reason why a family cannot continue to help steward responsibly the business they founded without resorting to a dual class share system or similar.

A democratic shareholder system acts as a useful check and balance for the company's management and board. This is an incredibly

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useful mechanism that companies miss out on if they fail to provide a one share, one vote system. If the longevity of your family's wealth and company is your goal, it's my belief that dual-class shareholder systems can actually harm your chances of achieving it.