ST. LOUIS TRUST
& Family Office

The Controlling Owner Concept

By Spencer Burke, Principal

> â€œThe kartha system is a unique and flexible Hindu leadership tradition. In it, the kartha is the male family leader in charge of guiding and choreographing the course of the family. Among other things, he is responsible for directing the education and work paths of individual family members. Major family business decisions must also be blessed by him. On behalf of the family, he encourages and utilizes membersâ€™ individual strengths and supports weaknesses, even subordinating himself when others are better suited for the leadership of particular tasks and roles. However, when the family is under stress, the kartha serves as the general, around whom family members rally and submit. Until the early 1800s, a familyâ€™s kartha would name his successor based upon whom he felt was the most acceptable family leader, regardless of birth order.â€•
> *J. Ward, Kellogg School of Business, â€œThe Murugappa Groupâ€”Centuries-Old Business Heritage and Traditionâ€•, Case Study (2002)*

There is no ambiguity in a founder-led company as to who is in charge and â€œwhere the buck stops.â€• As time passes, the founder may cede control to the next generation marking the initial evolution of a family business. As this evolution continues, and the company becomes truly multi-generational, leadership ambiguity may creep in and can lead to the break-up of an otherwise successful family business. How can this risk be mitigated?

One option is to designate a â€œcontrolling owner.â€• This is a standard practice for many of the largest manufacturer/distribution company networks in the world as a pre-condition of becoming a dealer for them (think dealer equipment distributors, auto dealers, beer distributors, etc.). These businesses prefer to work with private companies, many of them family owned, but want to limit their downside exposure to family dysfunction.

The â€œcontrolling ownerâ€• designation creates a legally enforceable business relationship between the company and the owner of the family business. It typically comes with the requirement of the establishment of a voting trust in favor of the controlling owner and the completion of comprehensive tax planning to minimize the estate tax risk to succession of ownership. The manufacturer has only one person to talk to, negotiate with and hold responsible for meeting the terms of the related distribution or franchise agreement. The estate tax risk to ownership transition is eliminated and family succession issues must be resolved to the satisfaction of the manufacturer. If dysfunction arises or contract terms are not followed, termination and replacement of the dealership can be pursued by negotiation or arbitration. The manufacturer, not the family business, holds all the cards.

Professional sports teams insist on using this structure for their ownership groups, many of which are family owned. The current public dispute regarding the controlling owner of the Denver Broncos is instructive. In this case, the team owner, Pat Bowlen, entered into a trust arrangement whereby three independent trustees could step into his shoes in the event of Patâ€™s incapacity or death and designate the successor controlling owner. This arrangement was approved by the NFL in 2007 at Patâ€™s request because of his concern over his familyâ€™s history with Alzheimerâ€™s. Six years later, Pat was declared incapacitated and the trust became the controlling owner. It has the power to designate other family members as such, as well as to sell the team outright if it determines that it is the right thing to do. The trustâ€™s role went unchallenged until recently.

Bowlen has seven children from two marriages and now both branches of the family are warring with the trustees and the NFL over the designation of the â€œnextâ€• controlling ownerâ€”each branch of the family has put forward its preferred candidate. The family has sued to void the trust and the trustees have countersued to stay the litigation and force arbitration per the terms of the trust.

The trustees insist that the proposed family members do not meet the succession requirements specified in the trustâ€”having extensive football management experience and holding an advanced degree, among other requirements. Once this battle is resolved, the designation of the next controlling owner, if any, will be subject to approval by the other NFL owners. The NFL holds all the cards.

Can you imagine how the Broncoâ€™s situation would be handled had there been no controlling owner requirement or trust set up to resolve this? The ownership group would be in chaos and the NFL would be hostage to a family group that canâ€™t get its act together. Incapacity, such as that caused by Alzheimerâ€™s, is not all that uncommon and when it happens, there is tremendous uncertainty and opportunity for mischief. This is just one of the many circumstances that can lead to ownership succession issues.

Requiring a controlling owner is but a part of the overall relationship that many manufacturers have with their family-owned dealers. In a rare public discussion of this, the former CEO of Caterpillar had this to say about its family owned dealers:

â€œContinuity reinforces mutual trust, limits disputes, encourages sharing of information and generates larger gains for everyone. To that end, we prefer to work with privately held enterprises, which typically enjoy longer-term management continuity than public companiesâ€¦

â€œOn average, our dealerships have remained in the hands of the same family or company for more than 50 yearsâ€¦ From the companyâ€™s early years, we have believed that an individual with most of his or her wealth tied up in a Caterpillar dealership is going to do a better job than somebody who has little or nothing at risk.

â€œWe actively help dealers keep the business in the family. For example, when the principal of a privately held dealership is about 50 years old, we hold seminars for the family on tax issues and succession planningâ€”both financial and management. These seminars are held two or three times during the principalâ€™s active working life to ensure that the next generation is ready.

â€œWe also take proactive steps to try to interest children of the dealership owners in the business.

We recently held a conference in Peoria that was attended by 20 to 25 sons and daughters, who ranged in age from 15 to 23. The idea was to introduce them to Caterpillar, to get them interested in the business, and allow them to meet their peersâ€¦ we also encourage owners to involve their kids in their dealerships from an early ageâ€¦ when the principals are ready to retire, we have seen enough of their children to know what they can do and which ones are capable of taking over the business.â€• Vernon Fites, Caterpillar CEO, HBR (March-April, 1996).

Imagine if every family business owner had access to this kind of education, mentoring and discipline in running its business and planning for ownership succession?

The â€œkarthaâ€• description included at the start of this piece is very similar to the controlling owner concept. It arises naturally from Indiaâ€™s so-called â€œhonor culture,â€• in which family members respect and value greatly the family leader and where family and business are inseparable. A formal kartha practice is no longer operative there but, given its religious and historic origins, vestiges of it remain â€œbaked intoâ€• the Indian DNA.

By contrast, the U.S. has an individualistic cultureâ€”I think we all know what that means. Is it any surprise that we have many more ownership and succession disputes within family businesses in this country? Even when not mandated by a third party, the practice of designating a controlling owner may help reduce these disputes. Having a process and discipline in place by which family members can agree upon a controlling owner is a good thing.