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## USING A HOLDING COMPANY-OPERATING COMPANY STRUCTURE TO HELP MITIGATE RISK



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Business owners are always looking for ways to protect their business’ assets. And over the years a number of strategies have been developed to help them do so. One of the most effective is to divide the business into several business entities all owned and controlled by a single holding company. This article will take a closer look at this time-tested and popular strategy for helping to mitigate risk.

### WHAT IS A HOLDING COMPANY?

A holding company is a parent business entity—usually a corporation or LLC—that doesn’t manufacture anything, sell any products or services, or conduct any other business operations. Its purpose, as the name implies, is to hold the controlling stock or membership interests in other companies. Some of the subsidiary companies it owns actually do manufacture, sell, or otherwise conduct business. These are called operating companies. Other subsidiaries hold real estate, intellectual property, vehicles, equipment, or anything else of value that is used by the operating companies.

The holding company can own 100% of the subsidiary, or it can own just enough stock or membership interests to control the subsidiary. Having control means it has enough stock or membership interests to ensure that a vote of owners will go its way. This can be 51%, or where there are many owners, it can be a much lower percentage.

Each subsidiary has its own management who run the day-to-day business. The holding company’s management is responsible for overseeing how the subsidiaries are run. They can elect and remove corporate directors or LLC managers, and can make major policy decisions like deciding to merge or dissolve. The people running the holding company do not participate in the operating companies’ day-to-day decision making.

### HOW IS A HOLDING COMPANY FINANCED?

The holding company’s management is also responsible for deciding where to invest its money. The holding company can obtain the funds to make its investments by selling equity interests in itself or its subsidiaries or by borrowing. It can also earn revenue from payments it receives from its subsidiaries in the form of dividends, distributions, interest payments, rents, and payments for back-office functions it may provide.

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## HOW IS A HOLDING COMPANY USED?

Holding companies are used by businesses of all sizes and in all industries. Many of the best known publicly traded corporations are actually holding companies and many of the people buying their stock don't even realize they're investing in a holding company and not the operating company.

A holding company structure is popular with large enterprises with multiple business units. Take, for example, a large corporation that manufactures and sells several different consumer goods, including hair care products, skincare products, baby care products, and others. Rather than using one corporation with different divisions, this enterprise could be structured with one holding company and several subsidiaries. Each business unit could be operated as a separate subsidiary in which the holding company owns a controlling interest. The company's trademarks, equipment, and real estate may also be placed in separate subsidiaries, with the operating companies paying to use the trademarks, lease the equipment, and rent its offices.

## NOT JUST FOR LARGE BUSINESSES

Holding companies can also be used by much smaller businesses—even by single entrepreneurs. Take, for example, a person who wants to buy an apartment building for the rental income. Two business entities could be formed: an LLC that would own the apartment building and a holding company that would own the LLC.

Now let's say that entrepreneur wants to expand operations. He or she sells shares in the holding company and with that capital buys a fast food restaurant and a thoroughbred horse farm. A new subsidiary can be formed for each new investment.

In addition, the holding company structure could be useful for the socially conscious entrepreneur. The holding company and its subsidiaries could be formed as benefit corporations, benefit LLCs, public benefit corporations, or public benefit LLCs. Each subsidiary could be formed to provide a different specific benefit. One could be formed to protect endangered animals, another to end gun violence, another to find a cure for Alzheimer's, and so on. Each subsidiary could have investors who are dedicated to the beneficial cause being promoted. The social entrepreneurs owning and managing the holding company would still have control and the ability to make sure the subsidiaries are being operated in a socially responsible and sustainable manner.

## WHAT ARE THE ADVANTAGES OF THE HOLDING COMPANY-OPERATING COMPANY STRUCTURE?

There are different reasons why holding companies are used. Below are a few:

### 1. Liability Protection

Placing operating companies and the assets they use in separate entities provides a liability shield. The debts of each subsidiary belong to that subsidiary. A creditor of the subsidiary cannot reach the assets of the holding company or another subsidiary.



**“Holding companies and operating companies are used by businesses of all sizes and in all industries. Doing so has several advantages, including helping businesses mitigate the risk of losing assets to creditors.”**

Say our entrepreneurs' horse farm is struggling and has been unable to pay its trainer and veterinarian. They can sue and reach the assets of the subsidiary that owns the horse farm but not the assets of the subsidiaries that own the restaurant and apartment building, or the holding company.

### 2. Control Assets for Less Money

A holding company needs to control its subsidiaries but doesn't necessarily need to own all shares or membership interests. That allows the holding company to obtain control of another company and its assets at a lower cost than if it had acquired all of the subsidiary's ownership interests.

### 3. Lower Debt Financing Costs

A holding company that has financial strength can often obtain loans for a lower interest rate than its operating companies could themselves, particularly where the business in need of capital is a startup or other venture considered a credit risk. The holding company can obtain the loan and distribute the funds to the subsidiary.

### 4. Foster Innovation

Because operating companies are separate entities, there is less risk in investing in startups or other ventures that seem risky. In fact, when Google restructured and formed Alphabet as its holding company, one of the reasons cited for doing so was that Google shareholders were concerned about the company's investments in areas like robotics, Google glass, life sciences, and medical research. By restructuring, those

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investments were separated from its core and profitable functions such as its search engine and YouTube businesses.

### 5. Day-to-Day Management Not Required

A holding company can own businesses in a variety of unrelated industries. It doesn't matter if the owners and managers of the holding company don't know about those businesses because each subsidiary has its own management to run the day-to-day operations.

## WHAT ARE THE DISADVANTAGES OF A HOLDING COMPANY-OPERATING COMPANY STRUCTURE?

There are some drawbacks to using a holding company and subsidiaries as well, including the following:

### 1. Formation and Ongoing Compliance Costs

The holding company and each subsidiary that is formed require the payment of formation fees. There will also be, in most cases, annual report and franchise tax obligations. Each will also have to comply with the governing corporation or LLC statute and its individual governing documents. Using a single operating company avoids these additional per-entity compliance obligations and their associated costs.

### 2. Management Challenges

As noted, a holding company does not have to own all of the subsidiaries' ownership interests. That can be both an advantage and a disadvantage. Where it does not own 100%, it will have to deal with minority owners. Sometimes conflicts arise when the interests of the minority owners are different from those of the holding company.

The fact that the holding company's management does not have to be experts in the operating companies' businesses can be both an advantage and a disadvantage. It can be a disadvantage because the holding company's management may be overseeing and making major policy decisions for businesses or industries in which they are not particularly familiar.

### 3. Complexity

The use of holding companies and subsidiaries adds an element of complexity not found in the single entity structure. When a publicly traded corporation uses a holding company structure, for example, it can be very complex, with many subsidiaries to keep track of. For enterprises like that, a good entity management system can be an invaluable tool in

keeping track of all the important information, records and due dates for all of the companies.

But even for much smaller enterprises it is important to keep the records, assets, liabilities and properties of each company separate from each other. Failure to do so can increase the risk of a court [piercing the veil](#), and allowing a creditor to reach assets beyond the debtor subsidiary.

## HOW DO YOU CREATE A HOLDING COMPANY-OPERATING COMPANY STRUCTURE?

Once the decision has been made to use a holding company-operating company structure, the next question is how is this structure formed. For a new business venture, this requires the formation of at least two business entities and maybe more. For each entity to be formed a number of important decisions must be made. This includes the following four key decisions:

### 1. What Type of Business Entity Should Be Formed?

Whether to use a corporation, LLC, or other entity type for the holding company and its subsidiaries will depend on a number of factors. Although corporations and LLCs both provide the key characteristic of limited liability they differ in other areas like how they are managed, how they can split financial interests, and how they are taxed.

### 2. How Should the Entities Be Taxed for Federal Income Tax Purposes?

This generally means, should it be a separate taxable entity or a pass-through entity. Once again, the answer depends on many factors.

### 3. Where Should Each Entity Be Formed?

Any state can be the formation state. And the holding company and its subsidiaries do not have to be formed in the same state. In making this decision it is important to remember that each company that is doing business in a state other than its formation state will have to qualify to do business in that foreign state.

### 4. What Name Should Be Chosen for Each Entity?

The name of each company must meet the requirements of the governing statute. The statutes typically require certain words or abbreviations that indicate the entity type, restrict certain words or phrases, and require that the name be distinguishable on the records of the filing office from the

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names of other domestic and foreign business entities. Checking the availability of the desired names, and reserving them before filing the formation documents, are always a good idea.

### **5. Who Should Be the Registered Agent?**

Less talked about but just as important is the choice of Registered Agent. That is the agent required by statute to be appointed by a corporation, LLC or other business entity to receive service of process and official communications. An important decision is whether to select an individual—like an employee, owner, or lawyer—or a professional Registered Agent. A professional Registered Agent is a service company that provides the Registered Agent to many business entities and has expertise in doing so.

### **BECOMING A HOLDING COMPANY THROUGH A MERGER**

In addition to forming a new entity to act as a holding company, an existing operating company can restructure itself to become a holding company through a merger. In the case of a corporation, the merger would generally require a meeting and shareholder approval. Delaware and a few other states have a provision under which a publicly traded corporation can become a holding company without a stockholder vote.

Under the Delaware provision, for example, (Sec. 251(g) of the General Corporation Law), the operating company must merge with a direct or indirect subsidiary in a merger in which each share of stock in the operating company is converted into an identical share of stock in the holding company.

Once the transaction is completed, the operating company's stockholders will hold shares in the holding company and the holding company owns the stock of the surviving operating company. There are additional protections in place for the stockholders. The aforementioned restructuring of Google into Alphabet is one example of a holding company merger accomplished pursuant to Sec. 251(g).

### **CONCLUSION**

To sum it up, a holding company is a business entity that does not produce any goods or services or conduct business operations. Instead, it owns and controls other companies. Holding companies and operating companies are used by businesses of all sizes and in all industries. Doing so has several advantages, including helping businesses mitigate the risk of losing assets to creditors.

Keep in mind, it is a complex structure and not right for every venture.

Nevertheless, it is an option business owners and lawyers may wish to familiarize themselves with if they have not done so already.