Getting a grip on holding companies

A holding company structure can help families govern their multiple entities and can even strengthen family cohesion. Too few families are aware of the advantages. BY MAUREEN MILFORD

Philip Clemens, retired chairman of the 125-year old Clemens Family Corporation pork-processing company in Hatfield, Pa., knows firsthand that a holding company structure can play a pivotal role in the life of a family enterprise.

Yet, Clemens observes, few family businesses consider this option. A holding company has a controlling interest in various subsidiaries and acts as a parent entity.

That's because holding companies remain a mystery to most business owners. "They don't know a lot about them, and they also think they are just for big public companies," says Clemens, who works with other business-owning families as an adviser or board director. "However, when they understand both the advantages and the reason for a holding company, many are both willing and anxious to move in that direction."

A holding company, which is often a corporation or limited liability company, becomes a useful corporate structure as family enterprises grow and age, adding numerous business segments and family members, says Otis Baskin, senior consultant with the Family Business Consulting Group.

"It becomes very difficult to have a corporate structure for multiple enterprises," Baskin explains. "A holding company-type structure can be very helpful as an efficient way to govern multiple businesses with the same ownership group. I think the efficiency of the organizational structure is the primary reason family businesses are attracted to a holding company model."

Clemens says forming a holding company was "one of the crucial steps in our reorganization from a family business to a business family" — one that puts the needs of the business ahead of family members' personal interests.

Twenty years ago, the Clemens family enterprise, known for its Hatfield and Farm Promise brands, faced a precarious financial situation that appeared to threaten the company's future existence. An action plan was developed that included the formation of the holding company.

Clemens, who was a key architect of the turnaround, says the restructuring played a critical role in the repositioning of the business. The move opened the door to diversification of the enterprise to better handle business-cycle issues, according to John Ward, clinical professor emeritus of family enterprise at Northwestern University's Kellogg School of Management. The name of the holding company, The Clemens Family Corporation, inspired all family members to feel a greater connection to the firm, Ward wrote in a case study on the Clemens business.

"I have worked with other family businesses that are diversified or have multiple holdings within the business. I strongly recommend a holding company as a way of both holding the business and the family owners together," Clemens says.

Risk mitigation

A family business could evolve to hold a broad set of assets, including manufacturing and service businesses, buildings and land, patents and small investments in other businesses. In a holding company structure, these various businesses are organized as subsidiaries under one umbrella. The subsidiaries that make products, sell goods or services, or conduct other business are known as operating companies, notes attorney Sandra Feldman of Wolters Kluwer's CT Corporation, a provider of registered agent services, incorporation services and legal compliance.

Some subsidiaries might hold intellectual property, real estate, equipment vehicles or anything of value the operating company uses, according to Feldman. The holding company could own all the stock of a subsidiary or a controlling percentage.

The subsidiaries have their own boards and management.

"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," Feldman says.

In a family business, people on the board of the parent company may sit on the boards of one or more subsidiary companies.

A parent company can provide human resources and other back-office functions for its subsidiaries, Feldman says.

The parent company's management decides where to invest its money, Feldman says. It can raise funds by borrowing or selling equity interests in the holding company or subsidiaries. Holding companies can also earn money from payments made by subsidiaries, such as dividends, rents and payments for back-office functions, she says.

Rich history

This seemingly modern and sophisticated structure has a rich history in American capitalism. Indeed, legislation that would provide the basis for a holding company organization has been dated to as early as the mid-1800s, Fred Freeland wrote in a 1955 article in *Fordham Law Review.*

According to Freeland, it's generally believed that New Jersey was the first state to pass legislation as the basis for a holding company in 1888-1889. In essence, it allowed one corporation to own the stock of another.

Before long, holding companies acquired a reputation for creating monopolies. Railroads and utilities became associated with taking clever advantage of holding company legislation. The Northern Securities Company, a railroad holding company formed in 1901, led to a landmark federal lawsuit alleging restraint of trade and resulted in the company being broken up.

In the early 20th century, the consolidation of gas and electric utilities under highly leveraged holding company pyramids led to some collapsing when the stock market crashed in 1929. The Public Utilities Holding Company Act of 1935 was enacted to curb abuses.

Some predicted in the 1930s that the holding company structure would die a natural death.

Is your family ready for a holding company?

Here are some indicators that your family business might benefit from a holding company, according to Carrie G. Hall, EY Americas family enterprise leader:

- The desire to operate multiple business lines and/or types of entities under one umbrella.
- The wish to consolidate family investments while allowing the business to grow through acquisition of incubator companies as well as expand the core business operations.
- An interest in facilitating cash movement among foreign operations (via a foreign holding company).
- The desire for tax planning to maximize the rate differential between the corporate and individual rates.

Yet holding companies survived and thrived. Today, they are accepted as beneficial legal structures for some businesses, says F. Douglas Raymond, a partner at Faegre Drinker Biddle & Reath law firm in Philadelphia.

Growth and change

For many family businesses, generations of growth, diversification and an expanding asset and shareholder base begin to highlight the need for a new structure.

"As family businesses pass down through generations, their core business must evolve to keep pace with changes in the marketplace. This often means selling off some portion or all of the core and reinvesting in new businesses," explains Jennifer Pendergast, a professor of family enterprise and executive director of the Center for Family Enterprises at Kellogg School of Management.

"The result of this evolution is that the family business turns into a family enterprise, with a broad set of assets that often include real estate, passive investments [such as the stock market] and minority investments in operations."

A holding company structure allows a family to pull all the disparate assets under a common governance structure with one group or board providing oversight across the portfolio on asset allocation and strategy, Pendergast says.

"The holding company has one very important role — *especially* if you are a diversified family business," Clemens says. "It has been my experience that when you are diversified, some owners tend to like one side of the business more than others (where they were employed, the original businesses, etc.). Having a holding company allows — forces — you to own all of the parts of the business, not just one."

A holding company is also an efficient mechanism for estate planning and asset transition across generations, Pendergast says.

According to Jonathan Flack, leader of the U.S. family business services practice at PwC, a high percentage of older companies that have been in business for several generations have holding company structures.

"It simplifies governance. It simplifies estate transfer. It simplifies the ability to raise capital," says Flack.

Clear signals

Take the case of the Cowles family business in Spokane, Wash., a fourth-generation family enterprise encompassing paper, timber, real estate, media, insurance and venture capital businesses. For the Cowles family, the need to move to a new structure became apparent 14 years ago as the business empire evolved, says William "Stacey" Cowles, president of the Cowles Company.

The business started corporate life as the dominant morning newspaper in the Spokane region when Cowles' great-grandfather, William H. Cowles, merged *The Spokesman* and *The Review* newspapers in 1894. As the Spokane region burgeoned at the turn of the 20th century, the business grew and W.H. Cowles seized new opportunities.

Holding company pros and cons

Advisers and family enterprise leaders note the advantages and disadvantages of a holding company structure.

ADVANTAGES

Centralization

Carrie G. Hall, EY Americas family enterprise leader, says a chief benefit of a holding company is the ability to centralize management and corporate functions, such as the C-suite, treasury and finance. Holding companies can provide better access to capital markets and economies of scale for the total enterprise, she says.

Transparency and family cohesion

Stacey Cowles, president of the Cowles Company in Spokane, Wash., a fourth-generation family business structured as a holding company, says the biggest advantage is clarity.

"It provides better transparency into our operating entities for managers, lenders, community members and shareholders," he says.

Liability protection

Debts of a subsidiary belong to that company, not the holding company or another subsidiary. If a subsidiary is sued and is faced with a significant financial penalty, or if it is facing bankruptcy, creditors can't go after the holding company.

"A creditor of the subsidiary cannot reach the assets of the holding company or another subsidiary," writes attorney Sandra Feldman of CT Corporation, a provider of registered agent services, incorporation services and legal compliance.

Lower debt costs

Holding companies often have the financial strength to get loans at lower interest rates than their operating business. A holding company could obtain the loan and then distribute the funds to the subsidiary, Feldman writes.

Estate planning

Jennifer Pendergast, a professor of family enterprise and executive director of the Center for Family Enterprises at Northwestern University's Kellogg School of Management, says holding companies allow for an "efficient mechanism for estate planning and asset transition across generations."

Opportunity for innovation

If a family member has ideas for new or emerging business opportunities, a holding company can act as venture capital. "Because operating companies are separate entities, there is less risk in investing in startups or other ventures that seem risky," Feldman says.

DISADVANTAGES

Formation pains

Cowles says the move to a holding company "did create significant administrative headaches in the establishment of a new company and the sorting out of transfer costs for shared services."

Cost

Moving to a holding company can add legal, treasury, reporting and tax compliance costs for establishing the entity structure, Hall says.

Greater oversight

A holding company creates many more companies for which oversight is needed. Feldman says. "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 corporate veil and allowing a creditor to reach assets beyond the debtor subsidiary."

Complexity

A holding company is a more complex legal entity structure to explain to family members, Hall says.

"Optics can create additional complexities with shareholders," she adds.

The mix of businesses can require more complicated structures if not all family members want to participate to the same extent economically in each business, Hall says.

Tax issues

Each company also is likely to have its own compliance and tax obligations. That can create additional administrative burden, says Shari Forman, U.S. Private Company Services tax leader at PwC.

"If you look at it entirely from a tax perspective, it adds some complexity," Forman says.

Hall explains: "Depending on the tax classification of the legal entities, cash movement and liquidity events could require additional complications or create tax leakage."— *Maureen Milford*

"W.H. Cowles reinvested earnings from his newspapers in downtown retail real estate and, as the majority bond holder, ended up owning his local newsprint supplier when it went bankrupt during the Great Depression," Cowles says. "He bought 1,300 acres of land in the Spokane Valley as a long-term value play. His sons and grandsons led efforts to expand vertically and horizontally into farm magazines, insurance sales to farmers, radio, television and timberland. His great-grandchildren who now run the company expanded the television franchise, doubled paper production and launched the region's most significant growth capital fund and are actively developing the land holdings."

By 2006, the family began getting "clear signals that the heyday of newspapers was over" — and the timberland and real estate were eclipsing the value of its operating businesses, Cowles says. Up until that point, the newspaper company was the parent and the corporate name was Cowles Publishing Company.

"As part of our annual exercise of reviewing our long-term corporate strategy, we woke up to several facts that led us to change our corporate name and structure," Cowles says. For example, most of the employees work in the family's television and print media businesses, but the enterprise is primarily a forest products and real estate company in terms of value.

With the restructuring, the parent was renamed Cowles Company. The Cowles Company, which is a C corporation held by a series of trusts, owns 100% of the stock of each of its many entities. The newspaper and other print media were combined into a subsidiary called Cowles Publishing Company, Cowles says.

"We also had in mind a shared services model for our smaller companies that should operate independently of the newspaper," Cowles says. "The shared services idea was that by consolidating accounting, payroll, human resources, benefits, building services and, to some extent, information technology, we could reduce costs or improve effectiveness for the companies involved."

Now, nearly all real estate and building services are consolidated under the real estate division. Payroll, insurance, benefits and human resources are centralized for the operating companies, except for a few holdings.

"Creating Cowles as a holding company helped get us organized so that we could think strategically about our assets because we could more easily compare results with peers and potentially package them for sale," Cowles says. "We could implement borrowing strategies tied to specific industry practices and more easily convey to our shareholders where value is being generated in the company."

"The new name gave us a better banner to market the whole company behind as we engage in community development and investment. It gave the parent some independence from the newspaper and television, whose reporters and audiences like to see separation between corporate management and journalism."

Keeping the family together

Family business owners and advisers say a holding company model can be a key to keeping the family and business together for future generations.

"Often in family business, they tend to continue with structure that has always been there, even though the enterprise has outgrown the old structure. When the business reaches a certain size, when you have more owners that work in the business, you need to give more attention to governance," Baskin says.

Good oversight leads to greater family harmony, Baskin adds.

"The biggest advantage of the holding company is it provides better transparency into our operating entities for managers, lenders, community members and shareholders," Cowles says.

What's more, the structure can promote the consistency of family values and policies across the holdings. For example, a holding company's staff could enforce common policies, such as performance reviews, Pendergast says.

"Since all but one employee handbook are produced by our centralized human resources department, this definitely helps with consistency of policies across the company," Cowles explains.

Still, Will Lyles, senior director of California-based Lyles Diversified Inc., cautions that moving to a holding company structure is a complex journey. Lyles Diversified is a family enterprise that includes construction, real estate development and rentals, agriculture and investment partnerships,

The change requires "significant consideration of legal, tax and organizational issues," Lyles explains.

Lyles should know. Lyles Diversified has been at it for more that 30 years.

For the Lyles family, the journey began in the 1980s when the original C corporation, W.M. Lyles Co., was converted to the holding company Lyles Diversified Inc. (LDI). Under that, a new W.M. Lyles Company was created to continue the legacy construction business.

"A driving purpose was the recognition that our growing real estate and legacy construction operations were separate businesses, and should be approached as such," Lyles says.

In 1999, the family created two holding companies that are S corporations. One held the construction business, real estate partnerships and other investments. The other held the agriculture and manufacturing businesses. Once the manufacturing business was sold in 2007, the proceeds were retained by a new LLC, which was split into two LLCs five years later because of differing accounting practices, Lyles says. Lyles Diversified now acts as the operating manager for both LLCs.

Now, Lyles Diversified is in the process of "ReOrg 2020," which could result in additional changes to the organization's structure and processes.

There could be a new framework involving a holding company.

"Once started, it is never done," Lyles says. FB

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