Ownership and Control of Private Firms.

Introduction

Business managers as a businesses steadily grows in size, are in the main able to cope, learn and develop new skills. Change is gradual, there are few major shocks. Unfortunately business growth is unlikely to be a steady process, with regular growth of say 5% a year. Instead business growth often occurs as rapid bursts, followed by a period of steady growth, then followed again by a rapid burst in growth..

The change in legal form of business often mirrors this growth pattern. The move from sole trader to partnership involves injections of further capital, move into new markets or market niches. The switch from partnership to private limited company expands the number of manager / owners, moves and rearranges responsibilities, as well reforming the decision making process. When a business floats on the stock market – becomes a PLC, the owners are now distant individual shareholders, or the perhaps not distant enough, institutional investors.

Business growth does not always follow the pattern of changing legal form described above, but what we are concerned with are the problems, inefficiencies and contradictory pressures that can occur within a business, as a firm grows. So in this case the pattern of sole trader – partnership – private limited company – public limited company, is ideal for examining the problems that can occur with transition in size.

Sole Traders

Sole traders are the most popular of business legal forms, owned and often run by a single individual they are found on every street corner in the country. A quick examination of a business directory such as yellow pages, will show that there are thousands in every town or city. There are both advantages and disadvantages to operating as a sole trader, and these are:

Advantages.

- **Easy to set up** – it is just a matter of informing the Inland Revenue that an individual is self employed and registering for class 2 national insurance contributions within three months of starting in business.
- **Low cost** – no legal formalities mean there is little administrative costs to setting up as a sole trader. Also no formal audited accounts are required, though it makes good business sense to keep a full set of business records.
- **Decision making is fast** - no need for consultations.
- **Hire and fire as you please** – the sole trader employs people that they are happy to work with.

Disadvantages.

- **Limited capital** – Sole traders often rely on their own savings and perhaps secured business loans.
- **Limited range of skills** – a sole trader may be an expert plumber, bur is he expert at marketing, managing staff, and controlling cash flow?
- **Immense pressure** – all the decisions and the future success of a business rest with

one person.

- **Unlimited liability** – the sole trader is liable for all the debts of the business, up to and including the value of all assets held, and potential future income.

Sole Trader to Partnership.

Partnerships involve the joint ownership of a business. Normally there can be between 2 and 20 partners, but in certain businesses such as accountancy firms, there can be many more partners than this. Partnerships are often found in the professions, such as between lawyers, accountants , doctors etc, but can be found in any type of business activity. The rules of partnership are laid down in a Partnership Agreement, or the Deed of Partnership.

The Deed of Partnership, lays out such rules of operations as:

- The amounts of capital invested
- The share of profits each partner is to receive.
- The voting shares of the partners
- What is to happen on the death of a partner
- Methods of leaving the partnership
- Rules for dissolution of the partnership

Partnerships are often found in the professions, such as between lawyers, accountants , doctors etc

Should a dispute arise without a partnership agreement giving methods of setting the dispute, then the dispute would be settled according to the 1890 Partnership Act. This is best avoided, particularly were limited liability is involved, as the act states that each partner is equally responsible for any debts. I.e. each partner is 'jointly and severally' liable.

Advantages of partnerships include:

- Wider range of skills
- Greater availability of capital
- Privacy of business affairs (no accounts need to be published)
- Decision making is shared

But becoming a partner does not solve all the disadvantages of being a sold trader.

The major disadvantages are:

- Capital can still be limited
- Unlimited liability of partners (sleeping partners who invest, but take no part in day to day running of the business can have limited liability)
- Partnerships are dissolved on the death of a partner and this can cause complications in re-establishing the partnership.

Although, as we have seen, there are many advantages when partners become involved in a business for the first time (such as increased capital, greater input into decision making, wider spread of skills), new partner's can and do cause strains within a business.

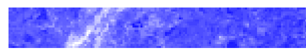
These strains often result from the loss of control of the sole trader over many aspects of business activity. For example suppliers or manufacturing methods may be changed by new partners, the relationships between managers and employees may now be different.

One case study into these pressures examined a small boat yard involved in building handcrafted wooden yachts. The existing owner under financial pressure took on a partner, who wished to introduce more modern methods of manufacture such as GRP moulding. The move from traditional methods of manufacture, to modern batch production methods, meant that

the previous owner felt dis-empowered, his skills that had built the business were in effect redundant, even his relationships with existing customers were not now so important, as new customers brought in the bulk of the business. These problems were only resolved by the original owner learning to adapt his skills to modern working methods.

The loss of customer contact indicated above, can be one of the main problems that arises because of business growth. Customer relationships and personal service may be the keys to success of small businesses.

As the business grows, then the original owner/manager may find that his or her time is being taken up with administration, staff management and paperwork. Working relationships that have brought the business success, may be difficult to maintain. Often partnerships, when founded, are based upon the sole trader re-establishing the roles that made the business successful and passing the less customer orientated tasks onto the new partner, or partners.



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From Partnership to Private Limited Company (Ltd)

Private limited companies, are incorporated bodies. They are established through the issue of a Certificate of Incorporation. This is issued by the Registrar of Companies, based at companies house Cardiff. The issue of a Certificate of Incorporation follows the completion, and submission of two documents. These are:

A Memorandum of Association, which provides details of the companies name, statement of Limited liability of the shareholders, company registered office address, and a description of the business activities of the company, (for example the retailing of furniture).

And secondly **the Articles of Association,** which provides details of the roles of the Directors, the voting rights of shareholders, dividend policy, formal procedures of the Annual General Meeting, methods of calling an Extraordinary General Meeting.

the situation where owners may take little interest in the ongoing management of a firm, really starts to occur in limited companies.

Setting up a Limited Company is not complex, companies can be bought "off the shelf", for around £60, and the relevant details inserted, or they can be registered and incorporated on-line, with just a simple fee to be paid, and only 2 shareholders needed.

The owners of limited companies are of course shareholders. The minimum number of shareholders is only 2, and it is not unusual to find limited companies with just £100 of issued share capital, two shareholders, with one holding 99 shares the other 1 share. In this situation the owner is very likely to be the manager. This type of limited company is often bought 'off the shelf', at a cost of perhaps £60.

Limited companies (both Ltd's and PLC's), are incorporated. This means they have a legal existence separate from that of the owners of the business. Limited companies can own property and other assets, can enter into con-

tracts, and sue and be sued. They survive the death of owners, and can borrow and lend money.

When establishing a limited Company, two documents are required, these are

- ***A memorandum of association***
- ***Articles of association***

What is a memorandum of association?

This document sets out:

- the company's name,
- where the registered office of the company is situated (in England, Wales or Scotland); and

what it will do (its objects). The object of a company may simply be to carry on business as a general commercial company.

Other clauses to be included in the memorandum depend on the type of company being incorporated. The form of memorandum for each type of company is set out in a set of tables called The Companies (Tables A to F) Regulations, 1985.

What are articles of association?

This document sets out the rules for the running of the company's internal affairs. The Articles deal with internal matters such as general meetings, appointment of directors, issue and transfer of shares, dividends, accounts and audit.

Limited Company status has one major advantage over sole traders and partnerships, that is the owners (shareholders) have limited liability. This means that they are liable for the debts of the business only up to the amount of capital invested.

There are exceptions to this limited liability status. If shareholder directors are found to have traded when they new or should have known that the business was not financially viable, then they can be held liable for debts that have accrued after the time they should have or did know. Also if directors acted in a foolhardy way, creating debts and liabilities, then in these circumstances, they can be held liable as above.

Private Limited Companies also have the advantage of potentially accessing greater amounts of capital through the sale of shares, but they are not allowed to advertise shares for sale, only being able to sell through word of mouth. There is though no limit to the number of shareholders in a private limited company (Ltd), but the restrictions on how shares can be sold, mean that shares must be offered to sale to existing shareholders before they can be sold outside the current shareholders. This prevents loss of control by existing owners.

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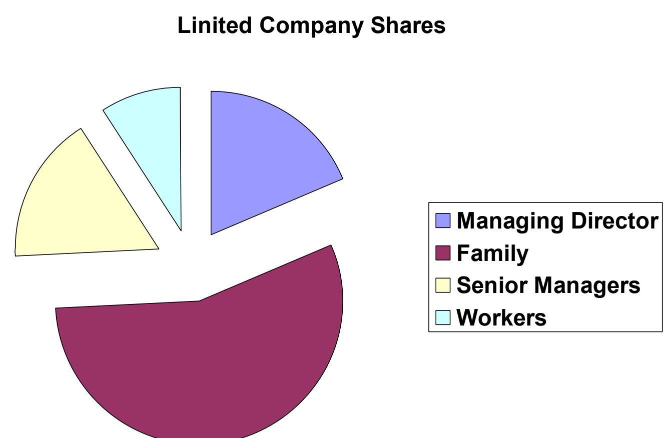
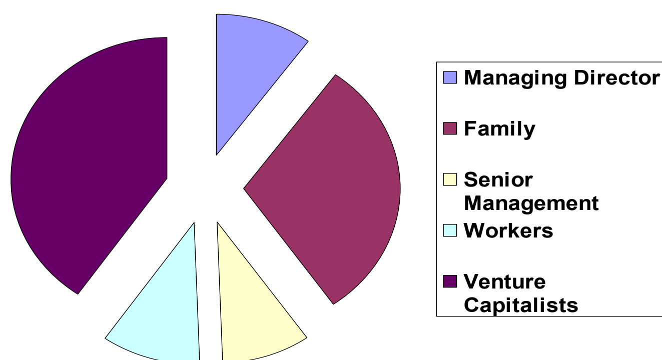
There are also disadvantages, to Limited Com-



pany status. Firstly Accounts must be published. For Private Limited Companies this means making full copies available at Companies House, where they can, for a small fee, be viewed by anyone. Also accounts must be audited, by an independent accountant, and there can be high costs to this.

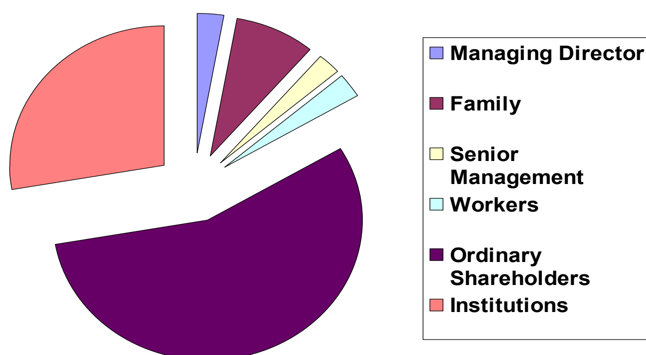
Limited Company with Veture Capital



Divorce of Ownership from Control

The move to limited company status is likely to be the first stage of growth when there is some degree of divorce of ownership from control. Although sleeping partners may exist in a partnership (sleeping partners take no part in day to day business management, but benefit from limited liability), the situation where owners may take little interest in the ongoing management of a firm, really starts to occur in limited companies.

Shareholding of PLC



Limited companies are often family businesses, which often include other key members of staff as shareholders. The main shareholders may take an active part in the business, or may be on the fringes of day to day business activity. If the shareholders are not engaged in managing the business, then we see the divorce of ownership and control occurring. Ownership is in the hands of shareholders, but day to day control is in the hands of managers.

This separation of ownership and day to day control is one of the reasons why limited liability in necessary. When large amounts of capital were first needed for business ventures (around the time of the industrial revolution), large scale investment was limited by the risks inherent with unlimited liability. The development of joint stock companies, where investors risk's were contained by the use of limited liability and incorporation, allowed firms to raise the large amounts of capital required.

Because there can be perhaps hundreds of shareholders (though more likely to be less), boards of Directors are appointed to oversee the management of the business. In smaller Ltd's the Board of Directors are often managers, but in larger Ltd's, it is likely that many members of the Board are not involved in business management.

Operating in a within a new culture brings new demands in regard to market research, promotion and product development.

From private to publicly quoted. Ltd to PLC.

When a firm becomes a PLC, then instead of being a 'family run' business, we switch to a situation where the major shareholders are often financial institutions, such as venture capital companies, pensions funds, or insurance companies.

How can a private company convert to a PLC?

A private company limited by shares (a Ltd.) can re-register as a PLC,

A private company must pass a special resolution that it be so re-registered and deliver a copy of the resolution together with an application form to the Registrar of Companies. The resolution must also:

- alter the company's memorandum so that it states that the company is to be a public limited company;
- make any other alterations to the memorandum so that it conforms to that required for a public limited company;
- make any required alterations to the articles of association of the company

British firms may be able to predict patterns of trade resulting from changing levels of economic activity in the UK, but this will be much harder in unknown or little understood foreign markets.

There are also requirements in regard to publishing of accounts and providing fully audited accounts before the change occurs.

Public Limited Companies are often the largest type of business. Perhaps with millions of shareholders, they may be worth £50 billion or more. Some, of course, are much smaller, but what they all have in common is a requirement for full disclosure of accounts, which must be made available to the public at large.

In the case of PLCs we see the situation arising where there can be a full 'divorce or ownership from control'. This means that those who own the business have little or no say in the day to day running of the business.

To see how this divorce of ownership and control arises we can follow, a simple pattern of growth.

Stage 1. With Private Limited companies, we often see a development of shareholding as illustrated below.
Stage 2. Control (day to day management) and ownership initially rests in the same hands, but as further capital is raised (in this example from venture capital company), we see some loss of control from the majority shareholders. The Venture Capital company may appoint senior management, and have one or more seats on the Board of Directors.

Stage 3. The true impact of divorce of ownership from control is only felt when a company goes public. Now there are likely to be 10's of thousands of shareholders, but these will not be all small investors, there will also be institutional investors as well. These institutional investors, for example insurance companies, pension funds, and unit trust managers, may have a great influence over how the business is run, but the small investor, perhaps in the majority when they are all taken together, may have little or no influence, on the strategy, or objectives of the company they own.
In the case of PLCs it is the role of shareholders to appoint the Board of Directors, who must act in the best interest of the shareholders. The Board of Directors is made up of:

Chairman – the titular head of the business, The Chairman can be no more than a figure-head, or alternatively the real driving force behind the company.
Chief Executive – the senior manager of the business. The Chief Executive often runs the business, deciding on overall objectives and strategy.
Executive Directors – department or division heads.
Non– Executive Directors. Outside appointments, with no departmental responsibilities. These non-executives are appointed as the independent voice of shareholders.

The institutional investors can and often do have a very different set of priorities to those of the existing management. Institution fund managers (the people who make the decision to invest), are often driven by the need to see short term performance returns. This performance may relate directly to the level of dividends paid, or short term increases in share prices.

As the institution objectives can be very different from those of existing management, we may therefore see two groups of owners with different views. One (institutional investors) targeting short term aims, the other, (existing management), trying to focus on long term goals.

This conflict can have direct, and material effects on the business. These effects include:

- Conflict over objectives – diverting management time from day to day business management
- Weakening of strategic objectives – loss of long term plan
- Payment of increasing dividends means less capital remains available for reinvestment, this in turn can lead to increased gearing.
- Pressure to maximise returns on existing products – which may be done through sweating assets or squeezing brands.
- Loss of ethical objectives as profit becomes the overriding priority.

National to International.

When a business moves into overseas markets for the first time, there are number of problems that can arise which are separate from those indicated by change in size or form of ownership.

The first of these problems is related to marketing. Operating in a within a new culture brings new demands in regard to market research, promotion and product development. To give one simple example, around 10 years ago a Swedish drinks manufacturer attempted to move into the UK market, with a fizzy drink, named psschitt (the sound made upon the opening of a bottle). Obviously there were problems!

Secondly, distribution networks need to be established or distribution agreements negotiated or signed.

Thirdly a business operating in international markets for the first time will come up against problems resulting from currency conversion. Fluctuations in exchange rates can make trading unprofitable or force rethinks on pricing strategies. Hedging currencies can reduce these risks. Also not all countries allow free flows of capital across borders, profits made in one country may not be easily transferable back home.

Economic factors affecting trade abroad can also cause problems. British firms may be able to predict patterns of trade resulting from changing levels of economic activity in the UK, but this will be much harder in unknown or little understood foreign markets.

Also, technological factors also play an important part in success in overseas markets. Foreign countries may have different safety standards, (although most standards in the EU now harmonised), and there will be costs involved in meeting these safety standards. Also different regulations may apply. Sales of MG cars in California, an important overseas market, were finished by tougher pollution laws which could not be met.

Finally, competition, the numbers of, and methods used by competition might be misunderstood.

British firms, operating abroad have a tendency to buy up existing firms, or use established methods of distribution. This method of expansion can help overcome many of the problems of a move into international markets, but it is an option open only to larger firms.

Social Enterprises.

"A social enterprise is a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners." - UK Government Definition. (Surpluses are normally profits).

Social enterprises share common characteristics:

- **Firstly they are Enterprises** – they are like other businesses directly involved in producing goods or providing services to a market.
- **Social aims** – they have explicit social aims such as job creation, training or the provision of local services. This is not just talk ,these aims are clearly laid out. Their ethical values may include a commitment to improving the local community and the skills of the people who live there.
- **Their profits are principally reinvested** to achieve their social objectives. Or alternatively profits can be distributed as profit sharing to a much wider range of stakeholders than just owners and workers, for example profits can be used to benefit of the community, or returned to customers, or suppliers.
- Increasingly social enterprises **measure their social impact**, through preparing documents such as a Social Audit..
- Many social enterprises are also characterised by their **social ownership**. They are autonomous organisations whose management and owner ship structures are normally based on participa tion by stakeholder groups such as employees and social investors or by trustees or worker directors who control the enterprise on behalf of a wider group of stakeholders.

Workers Co-Operatives.

Worker Cooperatives are a form of business ownership where the employees in a for-profit firm directly own and control the business on the basis of "one person, one vote." Each

member has an equal say. Typically all workers, including management, are eligible to be worker-owners after working for a certain period of time perhaps 6 months and paying a membership fee.

In a worker cooperative, ownership and control of the business derive from working in the company, rather than from simply investing capital in it. So it is not the providers of capital who are the most important stakeholders, but instead the thinking is that labour employs capital, rather than capital employing labour, so the workers are the most important stakeholders.

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The normal worker cooperative structure prevents non-workers from holding voting shares, and so keeps control of the firm within the workforce, preventing takeovers and outside influence.

Profits and losses from the business are shared amongst worker-owners according to either the hours worked or gross pay. Skill and seniority determine wage rates, which are often set by an equitable ratio between the highest and lowest paid worker-owners. This means that instead of huge differences between pay levels between the most senior and junior members of staff , pay differentials throughout the levels of seniority and responsibility may be as low as 50%.

Notes.