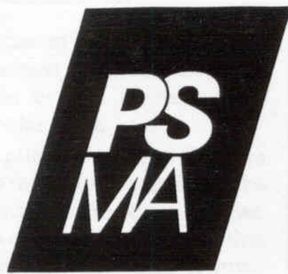


ASCENT

The Newsletter for Dynamic Service Firms

March/April 1990

May/June 1990

Ownership Distribution and the Exercise of Leadership in a Closely-Held AIE Firm: Part I

By Michael J. Hall

This article is about ownership distribution and is published in two parts. The first part explores the theory of stable versus unstable ownership distribution structures and its impact on leadership; the second part provides examples that demonstrate this theory. The second part will be published in next month's issue of the PSMA Newsletter.

It goes without saying that firms with leadership are more successful. However, what is not well recognized is that the distribution of ownership in a closely-held A/E firm is a critical factor in determining whether or not leadership can be exercised. Some ownership distribution structures promote the exercise of leadership while others push an organization toward instability and in-fighting.

In working with A/E firms. I have seen that firms with leadership:

- Can resolve difficult issues and make hard decisions quickly.
- Can orchestrate multi-step plans across several departments or disciplines.
- Are more responsive to market trends and clients needs.

In short, these firms are responsive, balanced and deliberate. They also tend to be profitable.

Firms without leadership are characterized by in-fighting and dramatic power plays. Firms without leadership can develop into fiefdoms where key managers guard their own territory and corporate decision making is complicated by hidden agendas. Political in-fighting drains a firm's innovative energy and causes it to focus inward and ignore client concerns and market trends. These firms are classically "unbalanced" with regard to their overhead and management structure.

STABLE OWNERSHIP STRUCTURES

Whether a firm can exercise leadership is principally a function of its ownership structure. Some structures encourage leadership to blossom, where others promote instability and conflict. In planning ownership transfer, careful consideration must be given to leaving in place a stable ownership structure that pro-

motes the exercise of leadership. This is often one of the most important factors in determining the overall success of an ownership transfer plan. A simple definition of a stable structure is any structure that allows conflicts to be resolved in a consistent and clear manner. There are three ownership structures that work and a very broad category of structures that don't. The three stable ownership distribution structures are:

1. A monarchy.
2. A partnership.
3. A democratic corporation.

A monarchy, also known as a "benevolent dictatorship," is the simplest and most stable structure and one in which leadership can always be exercised. A monarchy exists whenever one person owns 51% or more of a corporation's shares and is unencumbered by any unique options or shareholder agreements.

In this structure it is extremely clear how decisions will be reached. The monarch makes them. In many firms leader-ship is autocratic while in other firms the Monarch remains open to input from key managers and tolerates a fair amount of conflicting opinions about the direction of the firm. So often, it is the secure position of the monarch that allows him to share leadership and responsibility with others.

The weakness of this structure is it's greatest strength, in that "the speed of the leader determines the rate of the pack." Monarchs that are excellent leaders propel their firms forward, others that are limited in their leadership abilities can permanently hamper a firm's growth and development. A partnership can also be a stable form of ownership distribution. By a partnership, I mean a partnership of two individuals. A partnership can take the form of a corporation with two equal shareholders or equal partners in a formal partnership structure.

A good partnership is usually based on a mutual dependence of two individuals to manage the firm. One partner frequently does the marketing while the other focuses on production and finance. The fundamental operating rule which guides a partnership is that both partners must mutually agree. One partner can not overpower the other. This mutual dependence fosters mutual respect. Like a marriage, not all partnerships are good and will last. However. for many situations a partnership is an excellent and stable form of ownership distribution.

The monarchy and partnership forms of ownership distribution characterize most small firms. However, as firms grow larger, there is often a need to bring more individuals into the ownership structure. The only stable ownership structure that incorporates more owners is a democratic corporation. In a democratic corporation. a president is elected by his peers and a Board of Directors oversees the firm's policy and direction. A democratic corporation represents a broad range of ownership distribution structures in which the following principles are at work:

- Elected leadership.
- A balance of power.
- An open forum for decision making .
- A healthy self-interest.

The litmus test of whether or not a firm is a democratic corporation is the formal election of a chief executive officer. If a chief executive officer could be elected without his own vote, then a democratic corporation clearly exists. The chief executive officer is supported in his role as a leader by, his peers and has a mandate to chart the course of the firm's direction. Individuals not elected are expected to go along with Ithis diretion or to withdraw gracefully. The balance of power is inherent in the fact that the Board of Directors has veto power. It is possible for a decision to go against the CEO if he takes a position that is unsupportable. This veto power provides a check on the leader's power to keep him cognizant of the need to lead by persuasion and not as a dictator. A I democratic corporation uses the Board of Directors actively to address issues and formulate policy. This open forum provides the opportunity for multiple points of view. This can significantly improve decision making. The final factor in a democratic corporation is a healthy self interest on the part of each shareholder. Decision making works best if each individual is actively concerned about his own position. The principles of democratic leadership are not at work when a individual can afford to be gracious in supporting an alliance against his own best interest.

UNSTABLE STRUCTURES

An unstable organization is any organization where there is a possibility of a struggle for power that could result in a : new leader or one in which leadership can not be exercised. Often an unstable form of ownership distribution is an egalitarian partnership. That is. a partnership 0£ more than two individuals where each partner is considered an equal to the others and no one is allowed to manage or lead.

Unstable firms seldom have an election to identify a leader and consequently there is no clear mandate to lead. Also, no one is vanquished and this provides the environment £or internal struggles. For a CEO. di££icult decisions become impossible when an alliance can be £ormed in exchange £or protection. Many times an organization needs the capital 0£ each key shareholder to support the practice. The objective 0£ a power struggle is not to dominate a partner and drive him out of the business, but instead to subvert the partner's leadership while preserving his participation and the use 0£ his capital. How a firnl responds to an unstable structure is a direct result 0£ the values and desires 0£ its key managers. Some individuals are more inclined to take advantage 0£ an unstable structure. struggles occur most often when two or more key individuals desire to take the lead. However, in almost any unstable situation, "one bad apple can spoil the bunch" and drive and organization into a struggle.

THE NEED TO PLAN

There is a large dif£erence between the ownership arrangement 0£ a monarchy or a partnership and a democratic corporation. A broadening 0£ ownership must be accomplished for a firm to continue to grow into future generations. Broadening ownership requires care£ul planning and about 10 years to implement. Principals 0£ an AlE £irm need a clear vision 0£ the £uture structure and must move £orward in a deliberate £ashion. I encourage principals of AlE firms to look ahead at the likely structure they will leave in place and take the steps necessary to reach a stable structure. Next month this article continues with examples 0£ how stable and unstable ownership structures in£luence an organization's ability to exercise leadership.

About the Author: Michael Hall is President of Hall and Company, a management consulting firm to architects and engineers. He has been a speaker and seminar leader for Consulting Engineers Councils. The Professional Services Management Association. The American Institute of Architects and the financial Managers' Group. Mike has an MBA from Harvard Business School and a Civil Engineering degree (summa cum laude) from the University of Washington.

OWNERSHIP DISTRIBUTION AND THE EXERCISE OF LEADERSHIP IN A CLOSE-HELD AIE FIRM: PART TWO

By Michael J. Hall

Last month's article examined stable versus unstable ownership structures. It defined a stable ownership structure as any structure in which conflicts can be resolved in a clear and consistent manner. An unstable ownership structure is one in which an internal power struggle could result in a change of leadership. As described in detail in part one, a stable ownership structure can be accomplished within three structures: a monarchy, an equal partnership of two individuals or a democratic corporation. There is a great difference between the ownership distribution patterns of a monarchy or partnership and a democratic corporation and within this difference lies a great number of unstable organization structures. A stable ownership distribution will encourage leadership to thrive, while an unstable distribution will promote instability and conflict. When planning ownership transfer, consideration must be given to leaving in place a stable ownership structure that promotes the execise of leadership. This month's article will review two examples of how ownership transfer can result in a stable or an unstable ownership distribution and the impact this has on a firm's leadership.

TWO EXAMPLES

After working with over fifty firms in the area of internal ownership transfer, the pattern is clear. Firms with stable ownership distribution structures seem to be able to overcome great personal differences and learn to work together as a team. In firms with unstable ownership distribution structures, even minor differences can be exaggerated and blossom into heated struggles for power and leadership. Two of the firms I have worked with exemplify this principle. One firm began as an equal partnership between two mid-career civil engineers. They had formed their partnership some five years earlier and grew steadily from a two-man firm to a thirty person company. Their partnership was good and their friendship was genuine.

Pressures began building to share ownership with other key managers who were contributing significantly to the firm and had been with the firm for several years. Based principally on one partner's vision that broader ownership distribution would benefit that firm, they sold ownership to four of the firm's key employees. The figure below shows the ownership distribution before and after this transfer.

See Exhibit I.

After taking on four new shareholders, the firm held an election to identify the chief executive officer. For the first time in the firm's history the designation of a president took on a "special meaning."For years they had passed the title of president and chairman between them selves. Now the perception was that the president should lead the firm while the other partner would follow. The chosen partner, as president, quickly began to develop plans for the firm's future growth and prosperity. His ambition was to double the firm's size in five years by placing a heavy emphasis on marketing. However, for every bold idea he had it seemed his partner had a more conservative approach. Whatever one wanted, the other didn't. The firm's five year history of high profitability was quickly replaced by break-even perfor mance. The tension between the two was clearly distracting the organization from its objectives. A showdown came in the form of a resignation by the chief executive officer citing "personal differences." However, he let it be known that if he were asked to stay, he would, but his partner would have to leave. An election resulted in a tie between the two, and the CEO with drew gracefully. It is surprising how this healthy partnership of six years unraveled so quickly. I believe the unstable ownership structure contributed greatly to the environment for this struggle to take place. Another situation seemed just the opposite. A civil sanitary firm of approxi-mately 50 people was jolted when its chief executive officer died suddenly. A collection of minor shareholders suddenly found themselves the inheritors of the firm with sufficient insurance proceeds to redeem the deceased executive officer's shares and move forward on a firm financial footing. The problem was that the firm's two strongest managers were intense rivals with years of strife and conflict in their relationship. One man ager felt that his rival was in "the backwaters" of engineering because he was not involved in the firm's mainline sanitary services. He felt that he worked harder and that his efforts contributed more to the firm's overall success.

His rival, an older roadway engineer felt that his younger rival created his own "brush fires" and was constantly demanding the firm's manpower resources unexpectedly. He felt that he did a superior job of managing his workload to not place demands upon other departments and to provide a more consistent delivery of engineering services to his clients.

The younger rival, during my first meeting with him, indicated that "under no conditions will I work for him!." The hostility was open and outright. Resolution seemed impossible. Although the older rival had the largest block of stock. he did not own a majority of the firm's shares. It was decided that an election should be held to identify the firm's chief executive officer. Several key managers that were not shareholders were identified as key desicion makers and were allowed to participate in the election. The firm's eight top managers selected the older roadway engineer. They felt that the younger rival was stubborn and didactic in his engineering approach. His intensity was not always well received by his peers. The older rival was perceived as more statesman-like and the consensus was that he would do a better job of looking out for the entire firm.

For the two rivals, the time to bury the hatchet had arrived. Within months these two had developed a good working relationship that was mutually supportive in their management roles. It was in their

best interests to put their differences behind them. The younger rival had a substantial stake in the firm's ownership and was the natural successor to the older rival. The chief executive officer had everything to gain by keeping the team together. The organization sorely needed his rival's talents. As probably the strongest member of his management team, it would be his rival's contributions that would ultimatly determine if his owner-ship could be puchased by the company upon his retirement.

SUMMARY

These examples of how one organization moved quickly from peace into conflict while another moved from conflict to peace. are situations which were nurtured by their ownership distribution structures. Once an unstable structure is created, a firm can remain unstable for years with long-drawn out struggles. One side tries to gain power by discrediting the existing management and the existing management tries to avoid conflicts. Through out the struggle, the firm's leadership suffers. Most of the time even poor leadership in a stable ownership structure is better than the lack of leadership characteristics of an unstable ownership structure.

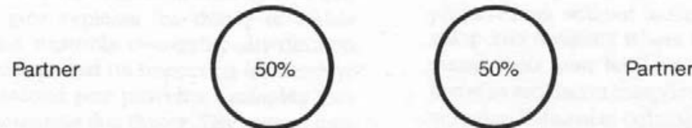
For a firm to continue to grow, ownership must be broadened. Howerver. careful planning and insight is required to successfully implement an ownership transfer plan that leaves in place a stable ownership structure. About the Author: Michael Hall is President of Hall and Company, a management consulting firm to architects and engineers. He has been a speaker and seminar leader for Consulting Engineers Councils, The Professional Services Management Association, The American Institute of Architects and the Financial Managers' Group. Mike has an MBA from Harvard Business School and a Civil Engineering degree (summa cum laude} from the University of Washington.

EXHIBIT

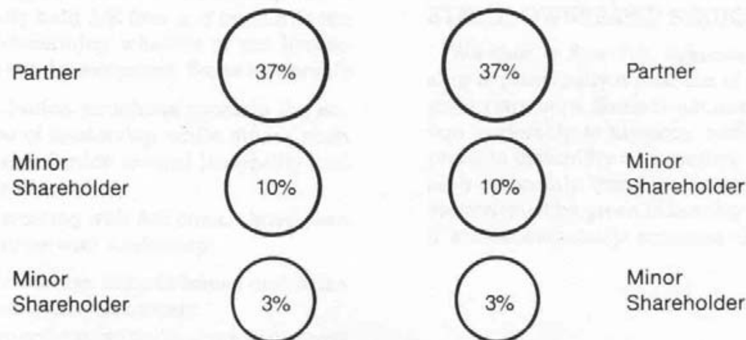
Figure One

Company Ownership Distribution

BEFORE



AFTER



100%