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cutting through complexity

Family Business Story

Case Study 3
Planning ownership for future generations: shareholders' agreement

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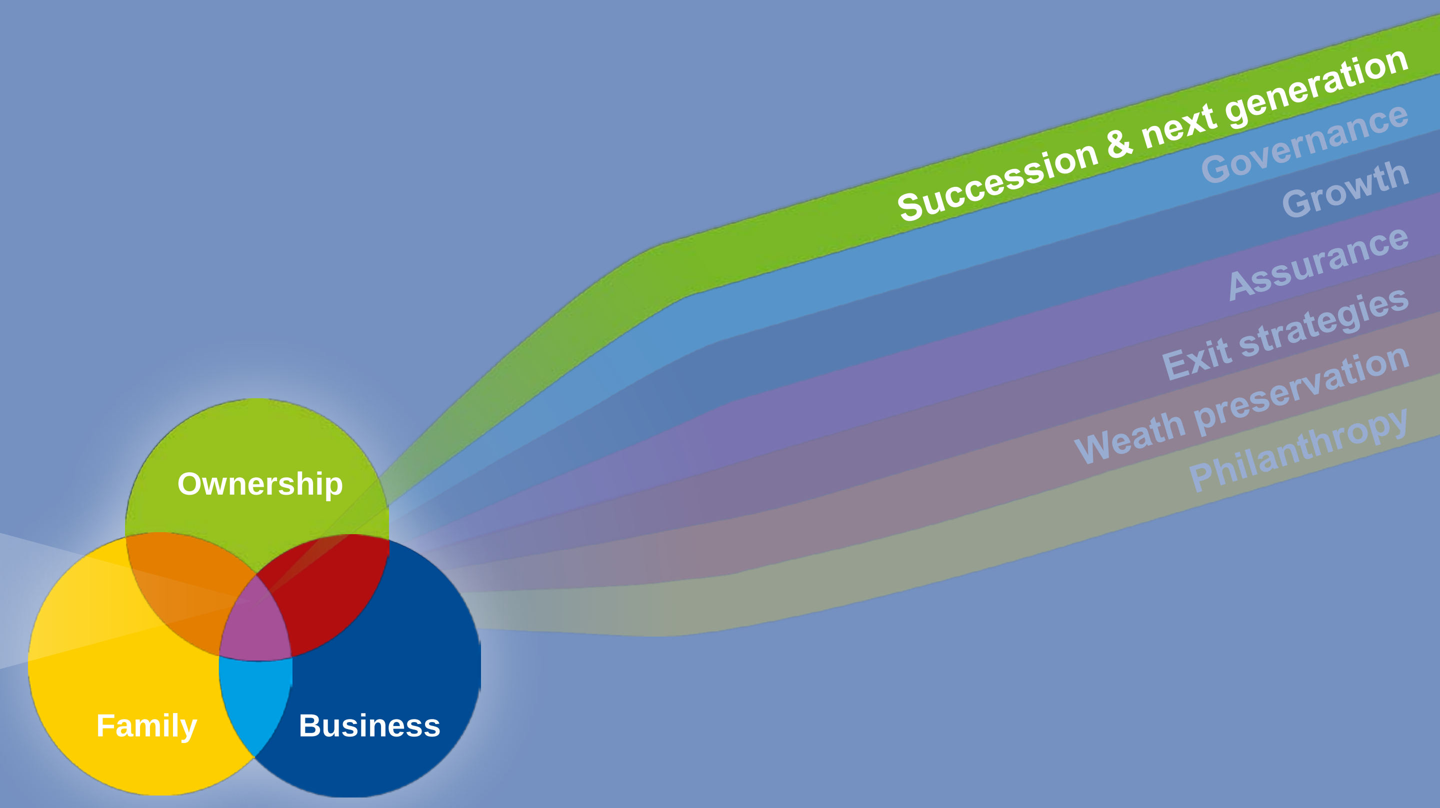
Family Business Story

Part 2:
Key learning points

Case Study 3



Part 2: Key learning points

Planning ownership for future generations: shareholders' agreements

1. Shareholders agreements regarding ownership and transfer of shares are crucial to ensure continuity of the family business.

Without such rules, individual shareholders have the ability to sell their shares to any outsider, which can put family ownership in jeopardy. The objective is to ensure that ownership stays within the family while providing a degree of freedom to shareholders.

2. Forward planning is key to addressing most family business issues

Trying to source cash in an emergency to buy-out a disgruntled shareholder - while negotiating the price of his stake - can damage both the family and the business. Planning ahead requires the establishing of processes to value and transfer shares, being aware of the owners' ambition for the business and monitoring the personal needs of the individual shareholders.

3. A number of legal tools exist to develop ownership agreements, and each country has its own unique practices.

Shareholders pacts, articles of association of private holding companies, trust structures (in certain jurisdictions)… are just some of the ways to secure family ownership. This is an area where experts should be involved and options considered. Families should clarify their long-term goals before considering legal and fiscal advantages and constraints. As an example, the use of trust structures can bring an inheritance tax saving and may promote collegiality, but their misuse can lock the next generation into "golden handcuffs". The same may hold true for other forms of ownership agreements.

4. The ability to sell shares may reinforce rather than reduce shareholder loyalty.

Feeling locked in can trigger the search for an exit. To paraphrase a family member: "the door must be open, but with enough incentives to stay inside". The incentives are dividends but not only: information on the business, company visits, family meetings and other activities foster the "emotional" attachment of family members to the family business.

5. A number of topics must be considered when designing shareholder agreements.

They include:

- **Definition of the potential ownership group:** a "hot" topic is whether spouses can be owners, and if not, how to ensure that ownership is protected through prenuptial agreements, wills, forced buy-back of shares, etc…

Planning ownership for future generations: shareholders' agreements

• **Mechanisms to sell shares**: the options available may include, informing the board of directors or owners' council, offering shares to certain members of the family first (e.g. the seller's "branch"), share buy-back by the company, right of first refusal, occasional "liquidity" event, annual liquidity event, on-going internal market (when many shareholders), etc.

• **Valuation**: if not properly addressed, valuation can trigger major conflicts. Several options exist including regular valuation of shares by outside experts, arbitrage mechanisms, etc.

• **Cash reserves:** ensuring cash is available to buy-back shares and maintain steady dividends. Reserves can be built with retained earnings, but also the sale of some assets (e.g. real estate, business unit), etc.

• **Pre-agreed buy-out option:** some specific clauses can force a potential buyer to make an offer to all shareholders

• **The involvement of a governance body to monitor ownership:** as mentioned above, this can be a role for the board of directors of the family holding company, for the owners' council or family council, for a specific committee.

6. Working on ownership agreements is an opportunity for the family to share its vision of the family business

Some families regularly ask themselves whether they wish to remain owners of the business – or even if they are the right owners for the business. Fundamental questions such as those below are best addressed during settled periods:

• What does it mean to be an owner? What are the owners' expectations towards the business? (dividends, level of risk, return, role in society, etc.)

• Does the family wish to handover the family business to the next generation?

• Is it acceptable for an owner to sell his/her shares to other members of the family? If so, will this person still be considered a member of the family?

• Is the family ready to accept the entry of non-family investors?

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The agreement drafted by the second generation

The Sages family selected this approach from the different options considering it to be the best for them. Each family will find its own path.

The four siblings decided that they would meet at least once a year to talk about ownership matters. The topics that they would address would include their marital financial agreements, plans for donations to their children, and, last but not least, whether or not they wished to keep their shares.

They also decided to hire an expert to value the business annually, at the time of the close of the annual accounts. The method used would be the same year on year. In order to encourage family ownership, they agreed that shares would be traded among themselves at a discount on the valuation. After much discussion they agreed upon a 15% discount.

The shares will first be offered to the other siblings:

- When demand for shares exceeds the offers, shares will be allocated proportionally to the buyers based on ownership percentages;
- When offers of shares exceeds demand, the company will buy-out the remaining shares

A cash reserve would be built at the company level to ensure sufficient liquidity.

The four siblings also decided to look into the possibility of setting up a holding company to pool the family shares. The holding company would retain dividends to create the liquidity fund, and transfers of shares would take place in a restricted environment.