How to Fire a Shareholder

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We like to remind families that the ownership of a family business shouldn't be regarded as a birthright, even in those countries, like Brazil, where inheritance laws make it likely that children and a surviving spouse will receive some stake in the business previously held by a parent. In fact ownership of a family company is a job, and family members should meet certain minimal requirements to be accepted as owners of the family company just like people need to meet certain qualifications to be employees in the company.

This is because the motivations and unity of the owners of a company—any company—make a huge difference in the long-term performance of the company. If the owners are united in their support of aggressive, quality, long-term oriented management of the company, and only take sustainable benefits from the company, the company will have a much better chance of succeeding. If, on the other hand, the owners are in conflict about the mission or management of the company, or if they drain the company of needed resources, the company will be on shaky ground. Unsupportive behavior by owners is at least a drain on the time, attention, and motivation of management and can slow, halt, and even reverse, the company's momentum. In worst-case scenarios, shareholder unrest takes companies down. That's when we read about it in the news. Trust us, it's never good news. For this reason we repeat *ad nauseam*: Ownership is a job, not a birthright.

GOOD OWNERS

The job of ownership is relatively straightforward and is quite different than that of a board member or manager in the family company. Owners elect board members (generally annually) and can but infrequently change the bylaws of a company. Owners also need to endorse or reject proposed big changes to the company (say a big acquisition) or a significant change to the financial structure of the company (say a big increase in debt, outside of the company's normal practice). That's the formal job description.

Being a good owner of a family business—doing the above activities—is in easy reach of most family members. Good family owners should be interested in the company, willing to learn about it and understand what makes it successful. They need to read useful background materials about the business, attend and participate constructively in important meetings. They need to understand what qualities and skills they need on their board and then elect good board members. And they need to be good ambassadors for their business. Capable owners accept responsible dividend levels and don't ask for jobs or other benefits from the company that they don't deserve or that the company can't well afford. Good owners respect the rules and policies that have been created for the owners (or follow good process in changing them). Owners also must be able to get along reasonably well with other owners and relate respectfully with the business leader. In order to do her job well, a business leader needs to know that the owners have long-term loyalty to the company, that they don't expect unrealistic benefits from the company, and that they will support board and executive leadership which manages in an aggressive, long-term, and high quality way. The business leader, like the family, wants and needs a capable and united group of owners to provide a stable base for the family business. It also helps for the ownership group to determine and articulate its core values, as well as its mission and vision as owners.

These qualifications for ownership aren't very stringent, but not everybody meets these standards. If someone in the next generation clearly doesn't meet these reasonable requirements, or just isn't interested in being an owner of the family company, don't pass ownership to him or her, if you have the choice. And if a current owner neither meets these requirements nor is willing to achieve them, consider whether he or she should be bought out.

But before you get to the point of "firing an owner," ask yourself if you have adequately explained to your owners the job and the qualifications of ownership. Most family companies haven't. (Can you imagine not explaining to an employee the job you expect him to do, and assessing whether he has the qualifications to do the job?) We know of many situations where owners aren't effective because (1) they haven't been informed of the rights and responsibilities of owners, (2) they haven't been educated and trained to become more capable owners, or (3) they haven't been given adequate information or included in discussions owners should have. Develop a sensible approach to your owners: treat them like they have an important job in your family company. You may be able to help a lot of your owners become very good at their job.

BAD OWNERS

But some owners simply aren't interested in the business (except perhaps the benefits from it), aren't willing to make the effort to attend meetings or read information sent to them, or don't relate well with other owners. Even when you offer them education and training, and are inclusive and forthcoming with timely information so they can be knowledgeable owners, they don't respond. When you are convinced someone will not be a good owner, what do you do?

First, ask yourself how serious the problem really is.

Firing a shareholder requires a careful calculus of costs and benefits. What are the benefits and costs of taking this owner out of ownership or perhaps reducing his or her ownership to a lower level of influence? (In some cases all that is necessary is to reduce an owner's power; in other situations, the owner needs to get out completely.) Make sure you understand the political network you're operating within. You need to understand the legal, social, and economic power of the owner you'd like to remove. What if the owner retaliates, mobilizing support among his or her allies? Take the example of a disruptive shareholder who owns 7% of the stock, but has strong allies, who collectively own 30% of the business. Consider what would or could happen if these close allies rebel in solidarity when you remove the minority shareholder. Some or all of them might also demand to be bought out. Now you are potentially buying out a third of the shareholders, not just the 7% owner. Can your company afford it?

In any ownership group, some owners don't contribute much, but they don't detract much either. In those situations, be careful about firing them as an owner, because it could be too disruptive compared with the likely gains. In other situations, where the disruption and distractions caused by poor performing owners are great enough, find a way to get them out of the ownership group that meets three important requirements: First, make sure that firing the shareholder doesn't severely drain the company financially. Second, make sure your actions don't incite other owners to misbehave when they see benefits in exiting at the same time. Third, ensure that you don't cause hard feelings on the part of those who see a fellow owner removed in a way that looks demeaning, humiliating or unfair. While keeping the negotiation with the owner as private as possible to avoid humiliating him or her and increasing the intensity of the disagreement, you also need to demonstrate to potential allies of the person that you are trying to treat him or her fairly.

Some owners solve this problem for us by asking to be bought out or suing the company to be bought out. We hope you can avoid the latter situation. It is nasty, exposes the company and family to all kinds of bad publicity, is ridiculously time consuming and costly, and often creates harmful precedents for share price. Sometimes it encourages other owners to also want out and in some cases, it causes a stampede that can ruin a company. Keeping the buyout process out of court and away from aggressive lawyers is of paramount importance.

Naturally, you have to be prepared for a buyout to avoid these consequences. You should have a legally binding ownership agreement that ownership disputes will first be mediated and then arbitrated and cannot be taken to court. And you should have a method for valuing shares and for buying and selling shares that is reviewed and endorsed by the owners every three years. Most family companies of moderate to large size and in the second or later generation will face buyout situations but very few prepare for them. If you need to buyout an owner and you don't have these policies, you will have to create them to accomplish the buyout, meaning it will take twice as long and be three times as difficult. Your choice.

A family I respect very much recently went through a painful buyout. The family company was sued by small group of small owners who had grown apart from the family and company. For years they had resisted efforts to be part of the large cousin family and more active owners. The rebellious owners were encouraged to sue by lawyers who hoped to gain from this action (the lawyers received a percent of the settlement) and the owners asked for an outrageously high price. When they couldn't negotiate a buyout, they went to court and tried to harm the family and company's strong reputation. The majority owners decided that the issue was so disruptive, so potentially harmful to the family's reputation, and so costly in legal fees that it needed to be resolved. They agreed on a price that I consider unfair to the company. The family soon rallied and agreed to a very strict shareholders agreement that should prevent this problem in the future. But this was a costly lesson.

Shareholder agreements can provide specific grounds for "firing a shareholder", meaning, the right of the company or other shareholders to purchase the shares held by a shareholder who violates specific provisions of the shareholder agreement. For example, a shareholder agreement might give the company a call option (the right to force a share redemption) if a shareholder violated an explicit non-competition provision, or committed a fraud upon the company, betrayed a valuable business confidentiality, or otherwise violated provisions of an agreed upon code of conduct for shareholders.

In the absence of a legal right to "fire a shareholder", the remaining owners are left with two options to remove a shareholder: a) create circumstances which encourage the disruptive shareholder to "voluntarily" depart and sell his or her shares; or b) negotiate with the disruptive shareholder to persuade a departure. An example of creating circumstances that encourage departure occurred within a family business system where the enterprise was owned by three branches. Two branches were distrustful of each other based upon a long history of actions taken by key executives from one branch. These two branches were unable to resolve their differences and the company was at risk of being fatally disrupted. To solve this problem, the few remaining members of the third branch agreed to sell their shares to members of the first branch, thereby giving effective control to the first branch. In the face of this shift in decision-making authority, members of the second branch ultimately agreed to sell their shares as well and depart

Let's say you have agreements in place and an owner you want to buy out. Who decides that an owner needs to be bought out? Usually a few significant owners get together because they are upset by the behavior of an owner they consider disruptive. They talk about the problem, form a coalition if they are in agreement, and start thinking about what they are going to do to address it. If a family has an effective family council, concern about an owner's behavior should be discussed here, because one of the important roles of a family council is to preserve family harmony when conflict arises. Shareholder unrest always affects family unity, and the family council should address this issue. It may not have the authority to structure a buyout—that may need to be done by the owners or the board—but the family council is usually the right place to discuss what has led to the situation and consider what practices or policies to change and what to do in this particular situation.

One family council in a cousin consortium helped to organize the owners of the company so all the owners could discuss their interests and concerns. Now the two groups meet regularly so the council can monitor and evaluate how well the core owners are getting along and functioning as a group. This council is not shy about giving feedback when it believes the controlling owners are not working well together or fulfilling their individual responsibilities. The family council gets early warning signs of shareholder issues and the family and business benefit from a more stable ownership base.

Then someone has to talk with the disruptive owner.

If you want to fire an owner, you need to use a fair process so that family members feel that it was needed, done in a respectful way, and didn't cost the company and the other shareholders unreasonable losses. You also must show that you offered the disruptive owner the training and other opportunities they needed to be an effective owner.

First, counsel the owner about where they're falling down in the job of being a good owner, and why you need them to improve their performance. This counseling needs to be done reasonably privately, but in full view of the owner's close allies in the system, while his or her enemies are shielded from this. The worst thing you can do in this situation is to humiliate this disruptive owner. If he or she is publicly humiliated, their behavior will get worse. So you need to be publicly respectful to them at all costs, especially in the presence, of their allies.

If that doesn't work, above all, remember that ownership is a job. Firing a shareholder must happen in the same way as firing an employee. First, demonstrate that you tried to make the person functional. You offered them training. They were invited to meetings. You treated them in a responsible fair way to allow them to perform well as an owner. You counseled the person effectively. Make sure that your efforts are recognized by the owners and that most owners think the company acted fairly to that owner.

There are always financial implications of buying anybody out. The purchase price will set a precedent. And that precedent will be binding until conditions change. So make sure you can live with the precedent you set. Think carefully about the price of the shares and the terms under which they are being bought out if others follow suit. And prepare for that, because they might.

If you have not already brought this issue to your board, now is when the board needs to understand that this process is under way. The board needs to do its own risk/reward analysis to understand the implications of this buyout on the company and on the owners who will remain.

If the company is a party to a shareholder agreement, then the board of directors will likely have a role in approving or executing share redemption under the terms of the agreement. Share redemption will usually require board of director approval. The board of directors is a bridge between the shareholders and the company (and its key executives). In a family owned business, the board may often have a critical role in helping to resolve conflict among family member shareholders. By assisting in the resolution of conflict and adopting an effective process for addressing share redemption, the board will have a better chance at preventing inappropriate public exposure of the underlying conflict.

"Firing" a shareholder is sometimes a necessary action to remove a source of disruption to the business and to keep remaining shareholders aligned.

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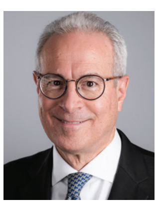

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