



BASIC GUIDE: Trusts for IPOs: pre-IPO planning for founders and employees.

Lawyers with experience of trusts should now be an integral part of any IPO transaction: whether acting for the founder of a business to be listed (“Listco”), for pre-IPO investors looking for a profitable exit via a listing, or for Listco itself.

The current climate relating to regulation and good practice only serves to emphasise the advantages of a trust structure whether for the founder(s), the employees or both.

Why use a trust¹?

A typical IPO in Hong Kong, will, in basic terms, involve a small group of individuals (founders) holding, directly or indirectly, the majority of the shares in an offshore company. The other main shareholders will typically be seed investors that have provided a certain amount of capital to grow Listco and make it attractive to be listed. The sale of a portion of Listco to the public will result in profits both for the founders and for the seed investors. So how does the addition of trusts add to the structure?

The first point to note is that the founders, being human beings, are not well-suited to owning assets because of what may happen to one or more of them. For example, they may die, lose capacity, be affected by human relationships (particularly divorce) and emotions or be the victim of blackmail or kidnapping. Where an individual holds most of the shares in Listco, the consequences of any of these events can be severe, ranging from chaos and uncertainty to complete paralysis of Listco. [It being noted

¹ <https://www.linkedin.com/pulse/succession-issues-individual-shareholders-richard-grasby-tep>

of course that the death or incapacity of a major founder may put paid to a listing notwithstanding a trust.]

Such possibilities are often overlooked, and, as the timeline for an IPO can be many years from conception to final listing (and then often with post-listing restrictions), there is a significant period during which the IPO is at risk. For example, despite popular misconception, on the death of a founder, the founder's shares in Listco will not pass automatically to the deceased's surviving spouse or to the founder's eldest son or to whomever's name is inserted into the blank signed stock transfer form left in a drawer to be dated the day before death. Only those with the authority of the appropriate court can instruct the directors of Listco in respect of the shares – such as where to transfer them or how to exercise votes attaching to them. Until such a time, the shares are paralysed. Administration can easily take many months (longer if contentious).

In addition, following such a court process, it is likely that, as part of the administration of the founder's assets, the shareholding will be broken up and placed in the hands of more than one person – none of whom will have control. If these persons are family members, there may be family infighting, which can only damage Listco further.

Incapacity of one of the founders may result in even greater uncertainty, as there may be heated debate about whether the founder has lost capacity and when. Or, in certain cases, the loss of capacity may only be temporary and the founder will recover. What happens during this time? Again, until the court has stepped in, there will be uncertainty and paralysis relating to the shares in Listco.

These problems can be reduced considerably if, as part of the pre-IPO structuring, the relevant block of shares is transferred into the ownership of a corporate trustee. This trustee will be, or will own, the shareholder of record of Listco and cannot die, lose capacity, get divorced or fall out with its family members. With proper management of the trust assets in place, this will remove the possibility of the controlling shareholding in Listco becoming paralysed or being broken up. This is the top priority for the seed investors and is, in all probability, likely to result in greater wealth being generated for the founder's family. A derailed transaction is also most likely to be bad news for the professional advisors (auditors, sponsors, lawyers, etc) looking to recover their fees.

Having all or part of the controlling shareholding in Listco owned by a regulated, corporate trustee also provides an additional layer of security to the transaction. As a trustee is personally liable, the corporate trustee will ensure the IPO is done properly without any corners being cut. The trustee will typically be a subsidiary of a large financial institution and will instruct its own lawyers to carry out its own due diligence. The trustee will need to comply with any necessary reporting requirements arising from holding listed shares.

The trustee-shareholder will only give representations and warranties about matters that it knows are true or which it knows it can perform. This can only provide additional comfort to the seed investor, the relevant regulator, the investing public and other advisors. In addition, it is very common in Asia for shares in Listco to be pledged as security for loans and having the shares held in a trust structure can be more attractive to lenders.

But how does this deal with the control of Listco? Day-to-day control will be in the hands of its board of directors but controlling shareholders may have a significant role to play. The trustee will not wish to have ultimate control (and therefore responsibility). Likewise neither the founders nor the seed investors will want the trustee to have control and a large corporate trustee being in control is unlikely to be attractive to the investing public.

Those who have got the business suitable to be listed need to remain front and centre. The solution lies in the ability of a trust structure to separate legal ownership of the trust property (Listco shares) from control of the trust property and from economic enjoyment by the beneficiaries of the trust.

The premier trust structure for a trust of this type is one where investment and management of the trust assets (i.e. the controlling block of Listco shares) is reserved to a management committee. The trustee will have no choice but to follow the direction of the committee relating to the Listco shares – in particular how and when to exercise any votes attaching to them. The committee will invariably include the founder, but the provisions relating to the committee must be structured to ensure that there are always members of the committee able to act, even in the event of the death, incapacity or retirement of the founder. Such committee members should be familiar with the business of Listco and could include adult children of the founder, trusted advisors or senior management of Listco. Ownership by the trustee ensures that the shareholder of record does not change; the committee ensures that the business is run by those most suited to run it.

Employee Benefit Trusts

Employee Benefit Trusts (“EBT”s) are used to attract, retain, reward and incentivise employees of a company or group. The expectation is that this will also increase profitability of the company. It also enables the company to more easily fund bonus payments in the future as provision can be made in advance of payments becoming due.

EBTs can be set up at any time but are frequently established before a listing or funding event².

Most EBTs are what can be described as “discretionary trusts” in the sense that no beneficiary has any absolute entitlement at the outset. The potential beneficiaries are typically employees (current, future and previous) of a company / group but in certain cases be wider (e.g. including family members) or narrower (senior management). If specific to a company, the EBT should contemplate future events which may happen to a company such as a takeover, a merger or a change of domicile.

The Trustee of the EBT will typically be a professional trust company or, with appropriate care, a trustee set up for the purpose of acting as the trustee (aka a private trust company).

The EBT would be established with cash or shares from the company itself or from the founder(s). Where share options are part of the EBT arrangements the company will need to ensure that it has

² That said an EBT can be beneficial to any company and would also make sense in the event of a take private or management buyout scenario. An EBT could also be adapted for a developed family business as a way to create a market for shares for family members whilst retaining the closely held nature of the business.

sufficient unissued shares at the time when any options are exercised. From an employee's perspective it is preferable that the trust is ring-fenced from the company's creditors – particularly if the EBT contains cash. However, this is not always the case!

Typically, the company – or its remuneration committee- will determine which employees become entitled to what and in what circumstances. In most cases, awards are subject to certain conditions – usually some form of time period during which the specific employee must remain with the group, together with specified performance targets. It needs to be set out who can control the votes in respect of any shares held by the trustee and for whose benefit any dividends are held.

Once awards are vested, the relevant beneficiaries could become entitled to receive shares in the company, could be granted share options capable of being exercised (and therefore receive shares) or could receive cash. Each beneficiary's tax and reporting obligations need to be considered. It is also important to note that vested awards do form part of the employee's assets in the event of death, divorce or bankruptcy – even if still held by the trustee. No two structures are the same so appropriate advice should be taken.

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