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A USA can be useful tool in succession planning

The missing link

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In my last *TaxLetter* article, I wrote about winding up a family trust and how to ensure you avoid specific tax traps.

What I did not discuss was the non-tax elephant in the room when distributing trust assets to beneficiaries: Your kids now have significant assets. So what happens next? This question is especially important if the assets being distributed are shares in a private company.

When the trust owned the shares, the parents were in control. But now the shares are in the hands of the kids, meaning that the company is subject to a larger group of shareholder voices. What to do?

Well, any successful estate plan where the next generation has been introduced into the corporate structure for private companies should include a unanimous shareholders' agreement ("USA").

The "USA" sets out the rights and obligations of the shareholders as they relate to each other and the company.

From an estate planning perspective, the USA also serves as a "family constitution" for future generations once the founders are no longer part of the company.

It sets out the framework that future generations should work within as they carry on running the family business.

This "constitution" would not only attempt to pre-empt any family infighting down the road, but also ensure the continued success and operation of the business over the years.

The following is a brief summary of some of the issues that could be dealt with in a USA, in a family business/estate planning context:

Keeping the Business in the Family: The USA can provide that any transfers of shares in the company are to be made only to those persons that qualify as a "Family Member" in order to ensure that the company remains within the family structure (this could also attempt to limit a child's spouse from being involved in the family business).

A "Family Member" could be defined as the founder or any issue of the founder, including adopted children, the estate of any of the above, a corporation of which any of the above are shareholders or a partnership, or a joint venture or trust (controlled directly or indirectly) that benefits any of the above persons.

Decision-Making: The USA would set out who gets to sit on the board of directors, which could include a nominee from each sibling group.

Thought could also be given to establishing an "independent director," i.e., a trusted advisor who does not represent a specific family group. This provides an unbiased perspective.

Although most decisions could be made by the board of directors, the USA could provide that certain "substantive decisions" would require unanimity of the voting shareholders (or at least two-thirds of the voting shareholders), with an extra provision that family groups owning less than a certain percentage of equity do not have a vote.

This would prevent minority shareholders (i.e. those holding

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under 10 per cent of the equity) from holding up the process.

Those substantive decisions could include: non-arm's-length dealings; sale of all (or substantially all) of the assets of the company or of the assets of a subsidiary of the company; dissolution or wind-up of the company; distributions of retained earnings from prior years; and distributions of retained earnings for the current year in excess of a certain percentage.

Dividend Policy: The USA could set out how (and when) dividends should be paid.

Financial Statements: The Agreement could also provide whether audited statements are required or not (in most cases, an audit may be overkill). It could also clarify who can insist on an audit – and who would pay for it.

Chief Executive Officer: The powers of the CEO could be delineated in the USA, as well as issues such as who would fill that role, or who would be the successor. This would avoid future arguments about future appointments once the founders are no longer around. Compensation of the CEO can also be set out in the USA, along with conditions under which a CEO could be removed and replaced.

Other Family Members: The participation of other family members in the running of the business could be set out in the USA and in what capacity (e.g., whether spouses should be included or not).

Disability of the Chief Executive Officer and/or Director: The USA is an appropriate place to deal with the consequences of the CEO and/or director/officer being disabled (i.e. deemed resignation).

The USA would also set out the threshold of when a "legal disability" would be met as this question alone could cause all sorts of in-fighting.

Voting Rights: These can be dealt with in the USA, subject to the governing corporate statute for the company and whether certain shareholders (i.e., minority shareholders) should agree to vote their shares with a controlling shareholder or not.

This sort of clause can be popular while the parents are still running the business and the kids are just passive shareholders.

Restrictions on Transfer & Default: The USA could contain restrictions on the transfer of shares (unless the transfer is to a Family Member), as well as restrictions on the ability to pledge the shares of the company as collateral.

Events of default could also be set out wherein a shareholder acts contrary to the USA. A consequence of an event of default could include the defaulting shareholder being deemed to waive all dividend and voting rights, as well as giving the other shareholders (or the corporation itself) the ability to purchase the defaulting shareholder's stake at a significant discount.

This type of a clause serves to act as a deterrent to any family member who may want to consider "ignoring" their obligations under the USA.

Sale of the Business, Drag-Along Rights, and Right of First Refusal: The USA would set out the process of selling the business, as well as including such clauses as "drag-along" and "tag-along" rights in the event that a shareholder receives an offer to purchase.

The USA could require that all shareholders must sell as a group, or that they require a potential purchaser to buy all of their shares before selling.

Alternatively, a shareholder who receives an offer to purchase may be required to first offer their shares to the other shareholders pro rata before they can sell to a third party purchaser.

Death / Disability of a Shareholder: One key issue that should be addressed in the USA: what would happen on the death or disability of a shareholder? Would there be an automatic buy-out of such shareholder's shares, or would there be an ability to leave the shares to the next generation (or guardian/power of attorney). Again thought would be given to whether the remaining family shareholders would want a deceased's shares to go to his or her spouse.

Liquidity / Divorce Proceedings: The USA could also deal with the ability of (or restrictions on) a shareholder to liquidate his/her shares or redeem such shares. Or, provisions could be included for when/if all or some of the shareholders want to "divorce" themselves from the rest of the family or the company.

A simple divorce clause could provide that if a shareholder truly wanted to cash out of the company, he or she would only be able to sell with the purchase price being paid over time, and perhaps at a discount.

Note that the above list is not meant to be exhaustive. Rather, I hope it provides a starting point for addressing some of the key, estate-planning issues of a USA.

So consider instituting a unanimous shareholders' agreement – it's one way to ensure that all of the estate planning you've put in place does not go up in flames if the children who end up running the business can't agree on how to act together. ❑

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