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The Missing Link in Succession Planning

The Family Constitution

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In my last Tax Letter article I discussed the wind-up of a family trust and how to ensure that you avoid specific tax traps in doing so. What I did not discuss when distributing trust assets to the beneficiaries was the non-tax elephant in the room: Your kids now have significant assets, so how to control this? This question is all the more important if the assets being distributed are shares in a private company. While the trust owned the shares, the parents were able to control such shares. But now the shares are in the hands of the kids, which means that the company is now subject to a larger group of shareholder voices. What to do? Well, in some instances, it may not be an issue if the kids are no longer kids and they are fully involved in the business (or perhaps the parents are ready to fully retire and enjoy life); however, this is not always the case for all families.

Any successful estate plan whereby the next generation has been introduced into the corporate structure for private companies should contemplate a unanimous shareholders' agreement ("USA") as the final step. The USA sets out the rights and obligations of the shareholders as they relate to each other and the subject company. From an estate-planning perspective, the USA also serves as a "family constitution" for future generations once Mom and Dad are no longer in the picture. That way, having a "rule book" as to how the business should be run could potentially avoid any sibling in-fighting, which only serves to hurt the business in the long run.

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

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Keeping the Business in the Family

The USA can provide for any transfers of shares in the company are 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 parents, their children and grandchildren (including adopted children), the estate of any of the above, a corporation of which any of the above are shareholders or a partnership, joint venture or trust controlled, directly or indirectly, by any of the family members and are for the benefit of any of the family members.

Decision-Making

The USA would set out who gets to sit on the board of directors, which could include a nominee from each "family group" (i.e. each sibling group). Thought could also be given to providing for an "independent director" who would be a trusted advisor that does not represent a specific family group to provide an unbiased perspective.

Although most decisions could be made by the board of directors, the USA could provide that certain substantive decisions will require the unanimity of the voting shareholders (with an extra proviso that if a family group owns less than a certain percentage of equity, they do not have a vote – this would prevent minority shareholders from holding up the

process). These substantive decisions could include:

- ☛ 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
- ☛ Distributions of retained earnings for the current year in excess of a certain percentage

Dividend Policy

The USA could set out how dividends should be paid or when. An agreed upon policy on how money is distributed out of the company is the surest way to avoid arguments when some shareholders want distributions and others want to keep the money in the company.

Financial Statements

A clause could provide whether audited statements are required or not and who can insist on an audit (and who would bear the cost for such request).

Chief Executive Officer

The powers of the CEO could be set out in the USA, as well as who actually gets to fill that role (or who would be a successor CEO) so as to avoid future arguments as to who gets to run the business once the parents are no longer around. Compensation of the CEO can also be set out in the USA as well as how 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 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 becoming disabled (i.e. deemed resignation?). The USA would also set out the threshold of when a "legal disability" would be met.

Voting Rights

Voting rights 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.

Restrictions on Transfer & Default

The USA could contain restrictions on the transfer of the 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 in the USA where 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 the ability to purchase the defaulting shareholder's shares at a discount.

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 include such clauses as "drag-along" and "tag-along" rights in the event that a shareholder receives an offer to purchase. This could include the requirement that other shareholders have to sell their shares with the selling shareholder, or could provide that the other shareholders have the ability to require a potential purchaser to buy all of their shares in addition to selling shareholder's shares. 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 issue to be addressed in the USA would be what would happen on a death or disability of a shareholder. Would there be an automatic buyout of such shareholder's shares or would there be an ability to leave the shares to the next generation (or guardian/power of attorney).

Liquidity / Divorce Proceedings

The USA would also deal with the ability of (or restrictions on) a shareholder to liquidate his/her shares or redeem such shares. Alternatively, if all or some of the shareholders want to "divorce" themselves from the rest of the family or the company, provisions could be included to deal with how that would happen (if at all).

The above list is not meant to be exhaustive. Rather, it is meant to give a starting list of some of the key issues to be addressed in the USA in an estate-planning context. More importantly, it's one way to ensure that all of the estate planning that the parents put in place does not go up in flames in the event that the children now running the business can't agree on how to work together. ❑

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