Additional notes, Legal Issues in Succession Planning

Joseph A. Gill

(http://www.mckercher.ca/lawyers/joseph-a-gill**)**

Direct Line: (306) 664-1276

j.gill@mckercher.ca

Slide 3

- Succession planning and business transition should be a continuing dialogue between the owner and his/her advisors
- Playing “hurry up offence” when a deal is on the table is not a good way to run strategic planning and will give rise to legal headaches down the road
- Being ready means not only for a potential third party sale but also (i) transition to next generation, and (ii) events such as disability which may force the owner “out” earlier
- Buyers will be able to sense “blood in the water” if the owner is not prepared to have transition discussions

Slide 4

- Is the intention for the owner to have continued involvement in the business? Alternatively, does the owner want a clean break so they can travel, golf, etc.?
- In most third party sales, we see the owner stick around for 1-2 years as a consultant to smooth the transition
- If a sale involves a deferred component to the purchase price (e.g. vendor financing), then the owner may be compelled to stick around to monitor their investment
- In a family/employee succession scenario, it may be a longer phase-in period with the owner slowly ceding away control
- Is the owner concerned about sticking around to ensure the business doesn’t tank (which, in many cases, might also tank their retirement nest egg)
- Need to be aware of ensuring a smooth hand-off of clients from owner to new owners

Slide 5

- Depends on the situation – particularly whether or not family is involved in the business itself (and has an interest in continuing that involvement)

- Third party 100% acquisition is often the most “clean break” since family/employee transition will probably be gradual over time
- Family or employee acquisitions can give rise to vendor financing issues where the owner is basically allowing the other family members or employee to buy into the business over time – creates a financing risk to the owner
- Family or employee acquisitions are also typically a much longer timeframe (slow introduction into ownership) whereas third party buyer will typically come in all at once (albeit we have seen majority-stake acquisitions followed by “picking up the rest” at a later date)
- Third parties also give rise to SK Immigrant Nominee Program requirements (e.g. $500K in net business and personal assets, minimum 3 years of relevant business/entrepreneur experience, and purchase price of (i) for Regina/Saskatoon, $300K, or (ii) for all others, $200K. BUT be aware it can take a long time (approx. 2 years) to unfold

Slide 6

- Ongoing process of determining whether business is “sale ready” and should be occurring, to varying degrees, annually.
- Examine whether historical liabilities can be cleaned up or debts re-negotiated with creditors on better terms
- Examine whether surplus assets should be removed from the corporation to another corporation owned by the owner
- Be aware of “human liabilities” – is it likely that the business may lose key employees? Is it likely that key employees will need to be compensated higher to retain them or potentially give them equity ownership to retain them?
- Latter question gets at whether a potential buyer is buying (i) for investment, or (ii) for livelihood. Some businesses are great for livelihood but terrible investments. Need to ensure the owner is aware of what type of business they own and what type of buyer that will attract.
- Keep in mind that what the owner really gets out of the business isn’t always on paper (benefits to family, standard or living, etc.)

Slide 7

- LCGE shields approx. $835K (2017 numbers) per individual from capital gains treatment on sale of “qualified small business corporation shares” – this amount gets ground down by (i) prior use of the LCGE, and (ii) certain tax accounts and losses that have to be claimed before claiming the LCGE
- Complicated definition for QSBC but watch out for (i) cash/securities/investments in amounts > 10% of total assets, (ii) activities of business outside Canada, and (iii) ownership of business by

non-residents of Canada – if surplus cash/securities/investments, may need to “purify” and move assets to another corporation (but be aware of tax trap in moving too much cash from CorpA to CorpB and inadvertently triggering capital gains instead of tax-free intercorporate dividends)

- New tax changes drastically limit ability to “sprinkle” income to family members who aren’t active in the business and who haven’t contributed any significant capital (or guarantees) to the business – rules very tight for those under the age of 24 but can apply to individuals of any age – thankfully government has dropped proposals about limiting access to the LCGE
- New tax changes limit ability to store funds in an “investment corporation” – the current system remains for investment income up to $50,000 but above that tax rates increase dramatically (to approx. 73%)

Slide 8

- Most businesses will have an accountant, a lawyer, and a financial advisor. This can also include bankers, insurers, investment advisors, and management consultants
- Owner should “date” multiple advisors before settling on a “relationship” with one – owner needs to find the right “fit” for his or her business – largest dimension of advisor-client relationship is trust; if the owner doesn’t trust his or her advisor, they should change advisors
- As time goes on and the business grows, the owner may need to change his advisors or bring in new advisors. It is very common, for example, for a specialized tax advisor from a larger center to help a more general advisor in a smaller center. The goal is ensuring the owner feels comfortable and that this isn’t seen as the specialized advisor “poaching” the general advisor’s client.
- Force your advisors to be clear on fee structures – professional fees can often “run amuck” but owners should do what they can to keep things under control

Slide 9

- Too often, a business sale opportunity comes to an owner but their minute book is in complete disarray
- At minimum, need annual director and shareholder resolutions for each year of operation (i) electing directors, (ii) dispensing with auditor requirement, (iii) approving financials, and (iv) approving any distributions (e.g. dividends) from the company
- As part of a purchase and sale, lawyers can often fix this up (so-called “whitewashing”) but it is far better to have this in order
- This can dovetail into ensuring the company is current with its filings with corporate registry – a failure to make these filings and paying annual fees can result in the business being kicked off the registry and potentially dissolved

- A lack of legal documentation respecting particular business transactions can lead to legal liabilities and questions around the effectiveness of past transactions

Slide 10

- The business owner may already have another “relationship document” executed (such as a shareholders’ agreement) but will want to ensure his or her Will is consistent with that document
- If the owner hasn’t already brought family members or others into the business, they may want to make provision for this transition in their Wills (e.g. how to divide up a family farming corporation)
- Wills can get complicated and resemble more of a shareholders agreement than a Will – goal, however, is certainty in the face of death
- Properly drafted Will mitigates (but doesn’t entirely preclude) estate litigation after the owner has passed away
- In addition to Will, owner should have a “If I die” plan which covers all the specifics of winding-down a business if the owner passes away (e.g. who to sell to, advisor contact information, passwords for accounts, etc.)

Slide 11

- Shareholders’ Agreements or “USAs” are often called “corporate Wills” owing to the transition/succession planning dimension of them
- USA is equally applicable whether (i) bringing in next generation of family members as owners, or (ii) bringing employees into ownership
- Need to establish clear ground rules around a wide range of corporate matter, such as (i) corporate decision-making and fundamental changes (e.g. sale of the business, dissolution of the business, admittance of new owners, etc.), (ii) how are shares dealt with when a new or old owner dies, becomes disabled, becomes bankrupt, becomes subject to divorce, or ceases employment with the business, (iii) confidentiality of business information, (iv) non-competition with business after exit and non-solicitation of clients and customers in same scenario, and (v) dispute resolution, i.e., whether to settle disputes in the courts or by private arbitration
- USA exists to avoid “airing dirty laundry” in the courts – arbitration is kept private
- Thoughtful USA can serve as a roadmap for bringing in new ownership (e.g. acquire more equity over time, how payment is made for that equity, etc.) and is particularly useful when one party is acquiring equity over time or buying in through “sweat equity”

Slide 12

- The right time to begin this conversation is NOW – it likely won't be public but should start with advisors and family members
- For those being groomed for succession, the new owners need to "be on board" and understand what the succession plan is – more fundamentally, they need to understand the current owner's goals in transitioning the business
- All the "fancy" legal documents in the world won't create a smooth transition where open communication either didn't occur or was severely lacking
- Lawyers, fundamentally, give form to the desires of a business owner as far as their transition; those desires can only be articulated after lengthy communication on the subject of transition

Slide 14

- Parting Thought: Make sure you have a "If I die" binder detailing thoughts about succession planning/transition and how the business might be unwound, sold, etc.
- The binder is useful not only for personal estate planning but focusing thoughts on how the business might transition to its next phase