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New Case Stresses Family-Business Corporate Governance

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Estate and succession planning structures generally involve the introduction of family members as shareholders. Without this planning, the founder of a business would likely be inclined to simply hold on to the shares of the family business. In fact, even with these structures in place, the founder's impulse will be to carry on as if nothing happened. And we practitioners are eager to assist in achieving this objective - by designing structures to put the founder in a position to continue to control the company with a minimum of interference from family members.

Trouble is, these positions of control may often carry duties to the family-member shareholders which may conflict with the inclinations of the founder. This is all well and good when the family is young and harmony prevails. But it's not so good when kids grow up and the founder wishes to favour some family members over others.

In these situations, what can/should be done to protect the interests of the founder – i.e., as estate and succession plans mature? A recent Ontario case, Tanenbaum v. Tanjo Investments[1] provides some insight into this issue.

For the purposes of discussion, we can think of the share structure of Tanjo as an estate freeze by the grandfather, the late (and very successful) Joe Tanenbaum. For many years, the growth shares of Tanjo had been held by three family trusts, one for each of Mr. Tanenbaum's children wherein Mr. Tanenbaum's grandchildren were beneficiaries. Prior to the distribution from the three trusts, Mr. Tanenbaum executed a "letter of wishes" to his trustees, which indicated that he wanted each of the grandchildren treated equally. While two of Mr. Tanenbaum's children each had three of their own kids, the third had only one, Katherine. Consequently, when the shares were distributed from that particular trust, Katherine's equity interest represented a third of the shares in question, whereas, if the grandchildren were to be treated equally, she would be entitled only to a one-seventh interest.

Even though the shares of Tanjo had been distributed from the family trust, the directors and executives of Tanjo wanted to continue to provide for the wishes of Mr. Tanenbaum (who passed away in 1992). Of course, payment of dividends would not have achieved this objective. So instead, the distributions were made to one of the grandchildren in the form of a bonus. The particular grandchild paid tax on the bonus and gifted the after-tax proceeds to the other six grandchildren so that they shared the proceeds equally.

An Oppression Application

Unfortunately, Katherine passed away in 2005. The trustee for Katherine's estate brought an action for oppression, based on the bonus regime[2]. As the court put it, the issue was whether the expectations of Katherine should be as a shareholder indirectly entitled to the benefits associated with the one-third shareholding in Tanjo, or "are those expectations to be limited to those of a young individual who was advised of her grandfather's wishes. . ."[3]

Although the court indicated that there was some evidence that Katherine was aware and concurred with the bonus regime, it observed that it "lacks the objectivity transparency and accountability that should accompany corporate acts."[4] The court concluded that the reasonable expectation was that Katherine was entitled to expect that Tanjo would be operated in a lawful and proper corporate form with meetings, resolutions and minutes that would reflect proper corporate acts.[5] It was not reasonable to change to the bonus scheme, the effect of which was to effectively reduce or eliminate the value of her shares "without informed advice or consent reflected in appropriate corporate resolutions".[6]

The court summarized a number of deficiencies in respect of the corporate records of Tanjo, including the fact that there were "no records of directors or shareholder meetings" nor formal record or other evidence to reflect the scheme for payments.**[7]**

Some Important Lessons

Tanjo teaches some important lessons for founders who have introduced family members as shareholders in succession and estate planning structures. The founder will typically be a director of the corporation in question (often the sole director) as well as a trustee of the family trust which typically holds growth or other shares of the corporation. As a director, the founder will have fiduciary duties to the corporation and its shareholders, as well as to the beneficiaries of the family trust as a trustee.

The case underscores the advisability of founders giving consideration to corporate and trust governance matters in estate and succession planning structures. Consideration should be given, for example, to having regular family shareholders' meetings, with minutes being prepared or at least notes of the discussion. Special consideration should be given to proper corporate governance and documentation where there are transactions that favour some shareholders over others**[8]**. Examples may include the payment of large bonuses**[9]** or dividends, especially if large enough to significantly erode the value of the corporation, as well as additional compensation given to children who are involved in the family business that cannot be justified by arm's length benchmarks**[10]**. Finally, as was the case with Mr. Tanenbaum, it is not uncommon for a founder to seek to treat his or her offspring equally or in some other manner which may not be consistent with the underlying share structure. Tanjo itself queries: "how easy would it have been to have the process proceed formally, including the appropriate resolutions . . ." **[11]**

In such situations, it is important both from a corporate and trust standpoint that there be records that seek to justify the particular course of action. For example, in the case of an asymmetrical distribution from a discretionary family trust, trustees' resolutions should document the considerations addressed by the trustees - and that these included relevant factors and excluded irrelevant factors, such as disapproval with a particular beneficiary's spouse or other personal circumstances.**[12]** Some other themes of Tanjo itself include the requirement for "informed knowledge sufficient to acquiesce" to the bonus regime**[13]** as well as lack of corporate documentation and corporate steps that would be required to support a conclusion that Katherine's reasonable expectations were only to receive what those in charge advanced her.**[14]**

The early years of an estate or succession plan will typically be uneventful, what with young kids, the protection of a family trust and so on. But kids grow up and get married, and family trusts run their course. Transactions could be impugned, often years after they are done, if there is a dispute among family members. Old corporate records, financial statements and tax returns could be reviewed by counsel representing a disgruntled family member. The Tanjo case illustrates that, from a corporate governance standpoint, the safe thing to do is to run the family business on the assumption that, one day, someone might be looking over your shoulder – and it is possible that the assumption may turn out to be correct.

– **David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. David's practice focuses on tax and estate planning for entrepreneurs and their corporations.** dlouis@mindengross.com**. Thanks to Hartley R. Nathan, Q.C., author of Nathan's Company Meetings, 8th edition (CCH Canadian Limited) also of Minden Gross.**

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[1] *Tanenbaum* v. *Tanjo Investments Limited*, 2009 CanLII 48526 (Ont. Sup.Ct.)

[2] When I first saw the judgment, one thing that jumped out at me was the top-drawer "legal firepower" that was brought to bear by both the Applicants and Respondents.

[3] Paragraph 52.

[4] Paragraph 55. The court also observed that two of Katherine's cousins were part of the decision makers who changed the distribution scheme from dividends to the bonus regime, assuming that they could be governed by the wishes of the late Mr. Tanenbaum – see paragraphs 53 and 54.

[5] Paragraph 64.

[6] Paragraph 65.

[7] Paragraph 60.

[8] This is particularly important where the transaction is somewhat unorthodox, as was the case with *Tanjo*.

[9] Including where the business has been following the practice of bonusing-down to the small business limit, which until recently at least, was commonplace

[10] Of course, it may be advisable to document these benchmarks.

[11] Paragraph 71. Query whether this would have been as "easy" as the court suggests.

[12] In fact, the importance of records of trustees' deliberations may have become more important because of the recent *Garron* case (2009 TCC 450).

[13] Paragraph 66.

[14] Paragraph 69. Also important in the case is the "appearance" of other transactions undertaken by the corporation. See, for example, paragraph 70.