

Addressing the Four “D’s” in Family Shareholder Agreements:

Decisions, Death, Disability and Disputes Part II



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The death of a shareholder in a family business creates two complementary concerns. On one hand, the family of the deceased shareholder may have a pressing need to continue receiving the income earned by the deceased shareholder, and their only alternative may be to sell the shares. On the other hand, if the deceased shareholder was actively involved in the business, the surviving shareholder(s) suffer from the loss of the deceased’s contribution to the corporation and may need to find a new shareholder. The surviving shareholder(s) may also want the ability to remove the family of the deceased shareholder.

There is the mutual desire to get the estate representatives (and perhaps the surviving spouse and children) out of the business, and can be dealt with by including a compulsory buy-out provision in the shareholder agreement. Such a provision requires the remaining shareholders or the corporation to purchase the deceased’s shares, and the representative of the estate to sell those shares. A compulsory buy-out provision necessitates consideration of two further issues that may require addressing in the agreement,

specifically valuation of the shares and the source of funds needed to complete the share purchase.

To avoid complications and disputes, it is wise to include in the shareholder agreement a method by which share value should be calculated in the event of a compulsory buy-out arising from the death of a shareholder. There are several valuation methods to choose from, including:

- a value confirmed in writing by all of the shareholders at regular intervals;
- the market value of the shares determined by an agreed upon formula; and
- the market value of the shares, determined by a third party.

The source of the funds required to purchase the deceased shareholder's shares is often an insurance policy. Insurance policies can be taken out by individual shareholders or the corporation may maintain a life insurance policy on each of the shareholders; the type of insurance taken out should be set out in the shareholder agreement. Income tax considerations must be considered in deciding whether to take part in individual or corporate-owned insurance policies. For example, if the individual shareholders take out the insurance policies and are the purchasers of the deceased's shares, the cost base of the shares will increase, allowing for a capital gains deduction on a subsequent sale. Before including an insurance provision in a family shareholder agreement, the shareholders should obtain tax advice to decide which type of policy, and which owner of the policy, would be most advantageous.

Disability

A family shareholder agreement should include provisions specifying what will happen in the event of the disability of a shareholder. It is prudent to include separate provisions for short- and long-term disabilities, as each raises its own unique issues and consequences.

With the short-term disability of a shareholder, two immediate concerns arise. For the disabled shareholder, the primary concern is income flow; for the remaining shareholders, the concern may be the temporary replacement of the disabled shareholder, unless, of course, that shareholder plays a very passive role in the business.

Generally, agreements will provide for employee shareholders to receive their full salary for a

specified number of months, giving that shareholder the financial security required to recover from the short-term disability. If the shareholder is a large contributor to the management and operation of the business, there should also be a provision governing temporary replacement in the case of disability. This provision should set out when and on what terms a temporary replacement should be hired.

The effect of these two provisions can be quite onerous on the corporation, which may not have the funds necessary to carry out these plans. The purchase of disability insurance by the corporation provides a solution to this problem. Generally, the disabled shareholder will start to receive payments from the insurance company shortly after the disabling event occurs. This alleviates the obligation of the business to continue paying the disabled shareholder's salary, freeing up those funds to pay for a temporary replacement.

The long-term or permanent disability of a shareholder raises issues similar to those raised in the death of a shareholder, with one further complication – there is no life insurance to provide funding. Although critical illness insurance now exists, which is similar to life insurance in that it pays out a lump sum to the disabled shareholder, it is rarely a viable option due to its extremely high cost, especially if coverage is required to keep pace with the value of the shareholder's interest in the corporation. As such, including a compulsory buy-out provision in the event of a long-term disability may prove to be far too onerous an obligation on the remaining shareholders. Furthermore, the remaining shareholders may also feel that such a provision is unnecessary where the disabled shareholder is simply a passive investor and not an employee of the business.

A middle ground may be to include a provision to balance the rights and remedies of both the disabled shareholder and the remaining shareholders. This is possible by providing the

remaining shareholders with an option to buy the disabled shareholder's shares, but also allowing the disabled shareholder the right to sell to a third party. The remaining shareholders can also have a "put" requiring the purchase of the disabled shareholder's shares, if the option to buy his/her shares is not exercised within a specified time.

In addition to providing for an optional buy-out, provisions pertaining to the long-term disability of a shareholder should also consider the future affairs of the business. For example, the inclusion of a provision governing the appointment of additional directors may prove useful. As well, it would be prudent to provide for a Power of Attorney to ensure that transfers of shares will be completed in the event that the disabled shareholder is unable to do so.

Disputes

Disputes includes both disagreements and dispute resolution. Including such provisions will save time and money if and when a dispute arises, as the terms of how the shareholders will buy each other out will already be set out. The specific needs and circumstances of the corporation at hand should be carefully considered in order to determine which mechanism will be most appropriate. These include:

Rights of First Refusal

When one shareholder receives an offer from an arms-length party to purchase his or her shares, a right of first refusal will provide the remaining shareholder(s) with the right to purchase those shares on the same terms and conditions as the offer. Theoretically, this mechanism affords the non-selling shareholder the right to choose whether to include a new shareholder in the business, while at the same time allowing the selling shareholder to exit the corporation if he or she so desires. In practice, the right of first refusal mechanism is rarely exercised, and may not be desirable for two main reasons. First, if the

non-selling shareholder doesn't have the capital to buy the selling shareholder's shares, it will force the non-selling shareholder into business with a stranger who could change the corporation completely, particularly if the new shareholder is a majority shareholder. Second, it discourages third-party buyers from wanting to spend the time and money required to make an offer, as most shareholders of a family business will not want to risk allowing such a fundamental change to the make-up of the business.

Tag Along and Drag Along Rights

Often called a "piggyback" clause, a tag along provision gives a non-selling shareholder the right to sell his/her shares along with the selling shareholder's shares to the third-party buyer on the same terms and conditions. A drag along provision entitles the selling shareholder to force the non-selling shareholder to sell his/her shares on the same terms and conditions, thereby selling the whole of the business to the third-party buyer. Both of these rights are often coupled with a right of first refusal, such that the non-selling shareholder has the opportunity to buy the selling shareholder's shares prior to being allowed or forced to take part in the third party purchase. Tag and drag along provisions are less common in family shareholder agreements than in shareholder agreements of larger or public corporations.

Shotgun/Buy-Sell

In a shotgun/buy-sell situation, one shareholder sets the price and may set the terms under which he or she is prepared to either buy the other shareholder's shares, or sell his or her own. Alternatively, the agreement may provide



for fixed terms of payment, so that only the price is established by the initiator. The other shareholder then has the choice to either sell or buy according to the set price and terms. In a perfect world, where both parties have equal bargaining power and financial capacity, a shotgun/buy-sell will result in a fair set price and an equal opportunity for both shareholders to resolve their differences expeditiously. Where there is equal bargaining power, even the threat of a shotgun/buy-sell clause can force civility and keep things on an even keel. However, where there is unequal bargaining power, the shareholder with lesser means will often suffer as a result because of the inability to raise the necessary funds in order to make a purchase.

When exercising a buy-sell, it is important to set terms and conditions that are reasonably

capable of being met and/or have a legitimate business purpose. In *Gray v. Gray*, two brothers were parties to a shareholder agreement

containing a buy-sell/shotgun provision. One of the brothers exercised the shotgun, and in the offer to purchase included a condition that the transfer of shares must be approved by a third party, who happened to be the franchisor of the business. The offering shareholder included this condition because he knew that the franchisor would approve a transfer that left him as the sole shareholder, but would not approve a transfer that left his brother as the sole shareholder of the business. The two shareholders took opposing positions on whether a shotgun offer

can contain a condition requiring the consent of a third party, and so the matter came before the court.

It was determined that any term or condition included in a shotgun offer must be reasonably capable of being met through the shareholder's efforts. Further, it may only require the consent of a third party if the need for that consent has a reasonable business purpose or is necessarily related to the performance of the shareholder agreement itself. In this case, the court was unable to find a logical business reason to include such a condition. By including an improper clause, the offering shareholder had taken the offer outside of the realm of a shotgun clause, thus turning it into a normal buy-sell offer. The offer was still capable of acceptance or rejection, but lacked the force of a shotgun offer.

Right to Sell Entire Business

An alternative or an additional right to the shotgun/buy-sell clause is a right to sell the entire business, being all of the shares or the assets of the business. This is often coupled with a right of first refusal for the non-selling shareholder. However, as stated above, making an offer to purchase a business takes time and money; a third-party purchaser is unlikely to take the risk where a right of first refusal exists.

Windup and/or Division

A second alternative or an additional right to the shotgun/buy-sell clause may be a windup or division clause. A traditional windup clause will provide for the sale of the assets of the corporation. Once sold, the shareholders will receive their proportion of the proceeds and subsequently part ways. There are however, two disadvantages with a traditional windup provision; first, there is a risk that the corporation will obtain lower prices for the assets when the



corporation is sold in this manner, and second, neither shareholder retains an interest in the business. A windup clause is most effective where the corporation's assets consist of passive investments, such as rental real estate which can be sold at full market value. Where appropriate, a division clause that contemplates a "butterfly" transaction can circumvent the disadvantages of a traditional windup. A butterfly is a tax transaction that distributes some or all of the assets of a corporation to the shareholders on a tax-deferred basis. In a family owned business where the assets or properties owned by the corporation are easily divided into roughly equal parts and can be operated independently of one another, a butterfly transaction can leave each shareholder with a fair division of the business on a tax-deferred basis. The shareholders can then go their separate ways while still retaining interests in the corporation.

Arbitration

Arbitration clauses are often included in the hopes that any disputes can be resolved with minimal damage to the relationship between the shareholders. Arbitration and dispute resolution clauses tend to be most useful for interpretation and enforcement of other proceedings provided for in the shareholder agreement, and often can serve as the medium to achieving a voluntary settlement, through mediation procedures.

Conclusion

There are numerous precedents and variations of family shareholder agreements available that may serve as a solid starting point in

developing an agreement. However, the key to a good family shareholder agreement is to not prepare a smorgasbord of provisions, many of which may not be applicable or useful in each specific family context. The content of a shareholder agreement should consider many factors, including the parties' relationships with one another, their expectations for the business, their respective expertise, the current and anticipated needs of the business, and the desire to keep the business within the family, to name but a few. A well-drafted agreement will address not only the current requirements of the business, but will also provide for future events in a thorough and thoughtful way that addresses the broad scope of the parties' interests and concerns.

*Part 1 of
"Addressing the Four "D's" in
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Decisions, Death, Disability and Disputes,"
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Written with Lisa Roscoe, Student-at-Law

Aaron S. Grubner
Tel: 416.369.4318
agrubner@mindengross.com





BARRISTERS & SOLICITORS
145 KING STREET WEST, SUITE 2200
TORONTO, ON, CANADA M5H 4G2
TEL 416.362.3711 FAX 416.864.9223
www.mindengross.com



Professional Notes

Howard Black spoke on “Minimizing the Potential for Future Disputes in Estates” on the Business News Network’s *MoneyTalk* with Patricia Lovett-Reid on January 28.

The April 2008 *Shopping Centre Newsletter* published “An Unappealing Appeal: *JSM Corporation Ltd. v. The Brick Furniture Warehouse*” written by **Mordecai Bobrowsky** and **Alicia McKeag**.

Kenneth Kallish was featured in *Law Times* in the February 25 article “Canada’s not the Wild West of bankruptcy proceedings.”

David Louis with Meritas Canada Tax Group members William Cooper of Boughton Law Corp. and Guy Dubé of BCF were featured in the article “Alliance extends reach of regional firms” on April 9 in the *Legal Post* section of the *Financial Post*.

Stephen Messinger participated in the Georgetown Advanced Commercial Leasing Institute in Washington, DC on March 26-28 where he is a member of the advisory board. Stephen also took part in the ICSC School for Professional Development on April 15-16 in Arizona and was a moderator at the ICSC Next Generation Reception in Toronto on April 17.

Hartley Nathan, Q.C., wrote several articles for *The Directors Manual* on current issues involving directors.

Steven Pearlstein spoke on “Documenting Mortgage Loans to Partnerships, Limited Partnerships and Trusts” at the Law Society of Upper Canada conference “Commercial Mortgage Transactions: Complex Issues in Documentation and Due Diligence” held on February 25. He presented “Three Months Interest on Mortgage Default – Understanding the Principles” and was part of a panel on title insured deals at the “Fifth Annual Real Estate Law Summit” hosted by the Law Society of Upper Canada on April 16-17. **Reuben Rosenblatt** presented

“More Cases that Scare Me.” Steven’s article “U.S. credit crunch reduces capital available for Canadian transactions” appeared in the April 18 *Lawyers Weekly*.

On February 13, **Stephen Posen** spoke on issues relating to tenant operating cost audits at the “Six-Minute Commercial Leasing Lawyer” hosted by the Law Society of Upper Canada.

Samantha Prasad will continue her involvement with the Meritas Leadership Institute as a mentor for 2008-2009 after serving as a member in 2007-2008, during which time the Institute studied how pro-environment/sustainability initiatives are creating new industries and changing the way existing industries do business.

Minden Gross LLP’s Leasing Group sponsored the 2008 ICSC Law Conference on March 6-7 in Toronto. **Michael Horowitz** and **Christina Kobi** were on the planning committee. Christina also co-chaired the Breakfast Roundtable Sessions, **Stephen Posen** spoke on distress and **Ian Cantor** was a roundtable leader on lease remedies. The Group also hosted “Debunking 5 Commercial Leasing Myths” on March 26, where **Stephen Posen, Stephen Messinger, Christina Kobi** and **Mordecai Bobrowsky** were panelists. Cheryl Gray of Bentall Real Estate Services was a guest panelist for the event.

Firm News

Minden Gross LLP acted on the sale of shares of Billy Bee Honey Products Limited to La Cie McCormick Canada Co. Billy Bee was represented by **Hartley Nathan, Q.C.**, **Jack Tannerya** and **Yosef Adler** (Corporate); **Joan Jung** (Tax); **Martin Maierovits** and **Melodie Eng** (Real Estate); **Glen Lewis** (Insolvency); **Tracy Kay** (Employment & Labour); and **Adam Perzow** (Leasing).