AFTER A CAREER HELPING TO BUILD CALGARY'S FUTURE, MCLEOD LAW IS HERE TO HELP YOU PROTECT YOURS

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The importance of succession planning

Fundamentally, succession planning involves determining what will happen when a business owner exits their business, and specifically planning for issues that could arise in the future. When planning for a major change in one's business involvement, there are a multitude of aspects to consider, including financial, family, legal, tax, and the emotional ramifications of this change. It also requires the business owner to choose their trusted advisors, those who will work well together and specifically who will take the lead. It is a challenging exercise that requires commitment and perseverance to be successful. The exercise involves shareholder agreements, valuations, tax planning, marriage agreements, living trusts, wills and incapacity planning.

Succession planning is key to both maintaining and preserving your family's wealth, including, the assets and operations of your family business, and maintaining the equity built up in the family company for the future generations (this can be shared with your family through the creation of a family trust). The establishment of a family trust or estate freeze will require you to consider a multitude of documents including marriage contracts to protect the assets being transferred to adult children from a spouse or former spouse. From a family law perspective, the importance of succession planning is ensuring the assets created during your lifetime are passed on to your family and not a spouse by marriage into your family.

What is involved in succession planning from the perspective of family law

In a divorce, a spouse can make a claim towards the shares and equity of a family business.

The key consideration when establishing a succession plan is to develop a strategy to alleviate any future claims against the business or the trust by a non-family member, such as the former spouse of the shareholder or the spouse of a beneficiary of the family trust.

To prevent the family business from being attacked due a separation or divorce, we recommend that your succession planning includes drafting cohabitation agreements, and prenuptial and postnuptial agreements to protect the family business from being devalued and interfered with by a non-family member following a separation.

You can protect a family trust and the family business from a divorce by entering into marriage contracts, such as a prenuptial agreement, to keep the shares and wealth within your family in the event of a divorce.

Sometimes things go wrong, go into the process with your eyes open

Problems often arise when an adult child separates from his or her spouse and then claims an interest in the family business or the family trust. However, the business and the trust were never created to benefit the future husband or wife of your children.

Disagreements due to a divorce are stressful and costly, and often will result in litigation against the family member. A family trust or family company can be named in the litigation and unwillingly dragged into the divorce of a family member. It is prudent to resolve in a marriage contract all such financial matters as part of your proper succession planning, and avoid any unforeseen consequences due to a future separation of a shareholder or beneficiary of the family trust.

A marriage contract provides insurance to address the unpleasant consequences of a separation in advance and avoid being part of any litigation in the future. We do not know what life will bring, but we can address many of the uncertainties of a divorce and its impact upon a family trust and the family business in a prenuptial agreement. We will prepare waiver and releases as part of the creation of a family trust to waive any claims by a spouse to the trust funds that you wish to preserve for your children and grandchildren. Accordingly, a family lawyer is an important part of your team to review and develop your succession planning, and protect your family's wealth.

How to get it wrong: A legal case study

(Names and identifying facts have been changed to protect the innocent)

Johnny was a journeyman electrician. He was good at his job and had lots of work. He did not like paying for lawyers and he did not like paying for accountants. He did, however, hire a bookkeeper because he didn't like that part of running his business.

His bookkeeper recommended that he incorporate a company for his electrical business, and that he should issue non-voting common shares to his common-law partner for income splitting. Things were going well and he was making good money. He never paid any dividends to his partner because she had a good job and didn't need the money. Johnny started an RRSP and named his partner as the beneficiary using the bank forms. He expensed whatever receipts he could to his business and purchased his vehicles through the business. The good times were never going to end.

Johnny's relationship with his partner deteriorated to the point where it needed to end. They owned a home together, and they agreed that Johnny would buy her out of the house. The mortgage lender told him they needed a lawyer to handle the transaction and referred them to a real estate lawyer who transferred title to Johnny's name as sole owner, Johnny took out a new mortgage to take out the old mortgage, and put some cash into the lawyer's trust account so that his partner walked away with half of the lender's appraised value in cash. Johnny then picked up the phone and called his bookkeeper and told him "she isn't a shareholder anymore". Johnny did nothing further.

Three years later Johnny was diagnosed with a terminal illness and died before he could execute a will (in fact, Johnny never spoke to a lawyer at all). His estate is going to be administered on intestacy because he died without a will. Johnny's brother, Jimmy, steps into the breach to act as personal representative of the estate. Johnny died without a partner, no children, and no parents, so Johnny's surviving siblings (Jimmy, Jerry, and Jenny) are equal beneficiaries. In short order, Jimmy finds out that:

- Johnny died with his ex-partner as the designated beneficiary of his RRSP, the ex-partner received the RRSP proceeds and Johnny's estate received the tax liability.
- Johnny died with his ex-partner still holding 50 per cent of the common shares of his business. The ex was going to receive half of the value of the business on dissolution.
- Johnny used company money to buy his ex-partner out of the house - Jimmy's accountant determined that this was a loan to shareholders

> and amended tax returns to be filed. Johnny's estate eventually had to pay additional funds to the ex and his income tax under an amended return was re-assessed with $80,000 payable.

A very sad story, but one that clearly had problems of the "low hanging fruit" variety that would not have required teams of professionals and tens of thousands in fees to resolve before Johnny died. The beneficiaries are receiving significantly less than they should have. In the end, the estate wound up with significant yet avoidable payables, as well as substantial legal and accounting fees.

Business Succession

What happens to your business after you are gone? Do your children want get into the business? Do you want your children in the business? These are all things that you should consider, but also act upon by talking with your family and your advisors.

Your relationship with the other shareholders of your company is a lot like a marriage - there are ups and downs, and sometimes, the relationship needs to come to an end. In the same way that a nuptial agreement can address many things like what happens if the relationship ends, a shareholder agreement speaks to how you and your business partners are going to deal with each other. These are not "fill in the blank" agreements - they must be customized to meet the specific needs and plans of yourself, your partners, your business, and your future. From a succession perspective, things that should be addressed in a shareholder agreement include (a) how an existing shareholder gets out of the business, (b) how a new shareholder gets into the business, (c) what happens on the death or incapacity of a shareholder, and (d) what happens if a shareholder winds up in a dispute with their spouse or partner.

Every shareholder in your business should also have a will and an enduring power of attorney. How do these personal documents affect your business?

The Will

If you die, the executor appointed in your will has the duty and authority to take control of all of your assets, including your shares in your business. They may need to take steps to appoint themselves or someone else to act as a director and officer of your business. They may need to hire other professionals to run your business. The will should dovetail with the shareholder agreement so that the right people are appointed with all the powers and authorities they need to ensure that the business can either survive as a going concern or the value of the business is maximized as quickly and efficiently for the benefit of the beneficiaries under your will and your fellow shareholders. You should think long and hard about who is the right person to be your executor, particularly if this person is going to need to run your business and get along with the other shareholders, directors or officers of your business.

The Enduring Power of Attorney

If you lose capacity, the attorney appointed in your enduring power of attorney has the duty and authority to take control of all of your assets, including your shares in your business. A thorough enduring power of attorney will give the attorney the power to appoint themselves or hire others to run your business or wind it down. You should be thinking about appointing someone who has all the skills necessary to step into your shoes, or at the very least ensure that you have provided your attorney with everything they need to engage the right people to administer your living estate. As above, your attorney may need to run your business and get along with the other shareholders, directors or officers of your business. It is important to ensure that shareholder agreements and the will are reviewed when preparing an enduring power of attorney for the sake of consistency.

Trusts

Trusts are an ancient English institution used for planning for nearly a thousand years. They are created during one's lifetime by deed or by will and are also known as testamentary trusts. Generally, they allow the business-wealth owner to appoint a trustee who will determine how funds will be distributed and to whom. In other words, it allows a measure of control even after incapacity or death and in some cases sound tax planning. They have protective characteristics as well in case of marriage breakdown, spendthrift heirs and related circumstances.

Proper Planning

No one wants to talk about when they will die or if they become incapacitated. No one wants to talk about what happens if a relationship turns sour. A surprising number of people avoid these conversations simply because of superstition. These can admittedly be difficult conversations, but they need to be had. You need to engage the right qualified professionals for the assistance you need.

In our experience, a comprehensive and effective plan for a businessperson will require lawyers (corporate, wills/trusts/estate, and family), an accountant, financial advisor, banker, and insurance agent. One of these professionals will need to be designated as the "project manager" who will coordinate the work to ensure it all fits together. If you anticipate strong resistance or if you already know differences of opinion exist, consider engaging a professional mediator to help facilitate the discussions. You want your plan to achieve what is in everyone's best interests, not just yours, and most importantly, you want your plan to work.

"They'll need to figure it all out themselves when I'm gone" is a plan that does nothing but jeopardize the business, destroy relationships, and enrich the professionals who have to help everyone else pick up the pieces.

This may sound terribly expensive but do you remember that old Fram oil filter commercial? The mechanic recommends a Fram oil filter, and the suggestion is that choosing a cheaper filter could lead to engine seizure. The voiceover is the mechanic saying "you can pay me now or you can pay me later". Keep in mind that, when planning, you can take input from all of the stakeholders and advice from all of the professionals, and craft a plan that is intended to work as efficiently and effectively as possible. Without planning, those left behind may have nothing more than the tools available by statute or common law. This leads to serious unintended consequences that cost a lot more to deal with than a good plan ever could. ■