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INTEGRATING A TRUST AS A SHAREHOLDER OF YOUR FAMILY BUSINESS

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As part of the implementation or reorganization of a business structure, the integration of a trust as a shareholder of an incorporated family business can prove to be an interesting tax and estate-planning tool. This holding vehicle is being used more and more in Quebec.

The creation of a trust results from a transfer, by a person called a "settlor", of property, which he appropriates to a particular purpose, to a separate patrimony that he sets up. One or more other persons called "trustees" undertake to hold and administer the property of the trust. In the case of a discretionary trust, the trustees may, in their sole discretion, distribute the income or capital of the trust to its beneficiaries in the proportions they (the trustees) determine.

POSSIBILITY OF SPLITTING INCOME WITH THE SPOUSE AND CHILDREN OF FULL AGE

Direct holding of shares of a corporation by one or more members of a family unit is governed by the rights stipulated in the articles, such as a preferential right to dividends granted to specific classes of shares. Moreover, considering that the holders of a same class of shares all have, in principle, identical rights to dividends, direct holding does not offer the flexibility offered by a trust.

Indeed, the trustee(s) of a discretionary trust which holds shares of an operating corporation may, in his(their) sole discretion, allocate part of a dividend received by the trust to any of the beneficiaries and thus split income among the members of the family of the owner of the business, including allocating the income to those subject to lower tax rates.

FLEXIBILITY FOR TRANSFERRING THE FAMILY BUSINESS OR POSSIBLY UNFREEZING THE ESTATE

In the context of transferring an incorporated family business, a trust may be used as part of an estate freeze established for the purpose of transferring the future increase in value of the business to the children and grandchildren of the creator of the freeze.

When the owner of the family business dies, he will generally be deemed to have disposed immediately before his death of the shares he holds in the business for an amount equal to their fair market value. To reduce the income tax to be paid by the estate upon his death, an estate freeze allows for "freezing" the accumulated value of the business at the time of the freeze into preferred shares: the common shares held by the creator of the estate freeze are exchanged for preferred shares called "freeze shares" which are equal in value to the then current value of the business. Thereafter, the increase in value of the business will accumulate in new participating common shares issued to the successors.

Although there are several methods for transferring a family business to successors (gift, direct sale of the shares or assets, etc.), implementing an estate freeze by integrating a trust to which the new participating shares are issued offers much more flexibility than certain other methods.

Proceeding in such a manner enables the creator of the freeze who is a trustee to retain some flexibility and control as to the eventual holders of the participating shares of the corporation because the children or grandchildren of the creator do not directly hold these participating shares prior to them being allocated by the trust. If the creator of the freeze cannot make his decision as to the person(s) who will take over the business, if he is not yet able to determine the proportion of the participating shares which will be distributed to each child or grandchild, or if they are still minors, using a trust enables him to postpone making these decisions while ensuring that the increase in value of the business no longer accumulates in the patrimony of the owner of the business. In short, the creator of the freeze may eventually allocate the participating shares to his beneficiary children and grandchildren taking into consideration criteria such as the fact that one is more involved in the business than the other or the degree of expertise of a child or grandchild.

Furthermore, if the creator of the freeze is also a beneficiary of the trust, it can be foreseen that the trust may allocate income to him should he need additional funds to maintain his standard of living following the transfer of the family business.

At the same time, the creator of the freeze who is also a beneficiary of the trust directly or through a management company which he controls may in certain circumstances benefit from an estate unfreeze: the trust allocates the participating shares it holds in the corporation to the creator of the freeze or his management company. The "estate unfreeze" is sometimes considered in situations where the creator of the freeze changes his mind as to the transfer of the family business or if he is not ready to carry out a final and irrevocable transfer of his entire business to specific persons.

MEETING THE CRITERIA TO BENEFIT FROM THE CGD

A trust with a beneficiary that is a holding company may be a useful planning tool to regularly "purify" the operating corporation, thus allowing it to avoid paying taxable dividends to individuals. This "purification" allows the operating corporation to meet the criteria for the issued and outstanding shares of its share capital to be considered qualified small business corporation shares eligible for the $750,000 capital gains deduction. This structure also makes it possible to avoid the application of certain attribution rules.

On the other hand, the appreciation in value of the business accumulated in the participating shares of the corporation may be distributed to beneficiaries chosen at the discretion of the trustees when disposing of the shares. In this respect, the use of a trust may make it possible to multiply the capital gains exemption.

ASSET PROTECTION

Subject to certain specific provisions of the *Bankruptcy and Insolvency Act*, the *Civil Code of Québec* and the applicable tax statutes, the creditors of a beneficiary of a discretionary trust who becomes insolvent cannot get their hands on the assets of the discretionary trust, since its patrimony is autonomous and distinct. In fact, a distinction must be made between the beneficiary's patrimony and that of the trust, which comprises the shares of the operating corporation.

Subject to the possibility of the courts lifting the "trust veil" in certain circumstances, the property comprised in the distinct patrimony of the trust is generally not included in the beneficiary's patrimony for the purposes of the application of the family law rules in the event of a divorce.

However, all these options must be exercised in compliance with the tax laws and the provisions of the *Civil Code of Québec* pertaining to trusts, including those relating to the obligations of the trustees respecting the patrimony of the trust. Moreover, certain antiavoidance attribution rules, such as paragraphs 75(2) and 74.4(2) of the *Income Tax Act* and the related provincial provisions may apply in certain circumstances. It is therefore recommended that you consult a seasoned tax expert who has experience in creating and using trusts. This expert can ensure the best tax planning in light of your specific circumstances before implementing a structure of the kind discussed above.

NONCOMPETITION COVENANTS APPLICABLE TO SHAREHOLDERS

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The competition engaged in by businesses in Quebec leads to many entrepreneurs and managers seeking to protect their knowledge and achievements against their competitors. In order to do so, many of them resort to covenants aimed at restricting freedom of trade or employment. The courts are frequently called upon to resolve disputes relating to restrictive covenants, in particular noncompetition covenants, not only in the context of disagreements pitting employers against employees but also in situations involving sales of businesses or shares, and sometimes in the context of shareholders' agreements.

THE PRINCIPLE OF FREEDOM OF TRADE

In principle, freedom of trade can only be restrained exceptionally, by the parties agreeing to reasonable restrictive covenants in the contractual agreements between them. This principle, applied many times by the courts, was recently considered again by the Supreme Court of Canada in a case[1] cited in at least one Québec Superior Court judgment.[2]

We shall see below the meaning of the term "reasonable" in the context of the decisions in recent years concerning noncompetition covenants applicable to shareholders of private companies and we shall offer some suggestions as to how to draft this type of clause.

GENERAL PRINCIPLES FOR ESTABLISHING THE REASONABILITY OF THE COVENANT

In order to determine the reasonability of a covenant, one must first determine in what context it will be applied, that is to say in a commercial matter or an employment matter. Indeed, it is accepted that noncompetition covenants found in commercial agreements involving sales of shares or businesses are interpreted in a less restrictive way than those found in employment agreements, due to the balance of power existing between the parties at the time when the agreement was signed.

In matters of noncompetition covenants binding employees to their employers, the principles for establishing reasonability are found in part in the *Civil Code of Québec*, which provides that they must deal with the territory, time period and kind of activity that will be prohibited. The courts interpret each of these parameters restrictively and cannot rewrite the covenant if it does not fulfill the criteria of reasonability established by the law, including the case law.

1 *Shafron* v. *KRG Insurance Brokers (Western)*, 2009 1 S.C.R. 157.

2 *Gastier M.P.* v. *Sylvain Pelletier et al.*, EYB 2010-180191 (S.C.).

In matters of noncompetition covenants found in commercial agreements, in particular in agreements involving sales of businesses, the courts also deal with their reasonability in accordance with the parameters relating to territory, time period and kind of activity. However, the interpretation of these parameters is less restrictive than in employment matters and the courts will give their approval to a covenant that provides for a longer time period, a broader territory and a more extensive description of prohibited activities than they would in the case of an employment contract.

In matters involving shareholders' agreements, it is difficult to establish a clear principle that can be used to interpret the reasonability of noncompetition covenants. In order to determine the degree of restriction appropriate to the covenant, the courts must determine in particular whether the person concerned is a real shareholder of the company or simply an employee who has received shares as an encouragement or an incentive, which would mean that the shareholder remains, above all, an employee of the business. Obviously, in the latter case, the courts will have a tendency to interpret the noncompetition covenant in accordance with the principles established in the context of employment, even if it was contained in a shareholders' agreement.[3]

In a recent matter in 2010, the Superior Court seemed to apply a principle that if the noncompetition covenant is contained in a shareholders' agreement and if that covenant applies to a minority shareholder, its reasonability will be determined based on the criteria applicable to an employment contract.[4] However, this decision was based on another matter in which the employee-shareholder had acknowledged in an affidavit filed in the court that he had remained a simple employee despite his status as a shareholder, having not taken part in meetings of the shareholders. Since each situation is different, a grey zone still exists, in particular in situations where the minority shareholder was the founder of the business, in which cases the interpretation could be less restrictive. This grey zone also remains in cases of sales of shares where the shareholder becomes a consultant or an employee following the sale of his shares.

A FEW SUGGESTIONS FOR DRAFTING NONCOMPETITION COVENANTS CONTAINED IN COMMERCIAL AGREEMENTS

1. The parameters of the noncompetition covenant (territory, time period and kind of activity covered) must protect the true interests of the business. When drafting such a covenant, it is essential that the party who wishes to impose the covenant question himself about the real reasons that motivate him in order to define parameters that can be justified before a court, if need be.

2. The various parameters:

   A. Territory:

   The territory must be clearly determined. In cases where it is possible to do so, a map may be appended to the covenant.

   In addition, when a firm carries on business over the Internet, it remains important to correctly define the firm's territory. In this regard, we are aware of a case in which an application for an interim injunction was refused (but subject to confirmation by the court at a subsequent stage of the proceedings) where the territory covered by the covenant was the whole world, given that it was the sales territory of the business, which made its sales over the Internet. This territory seemed to be too vast for the judge (as much on the aspect of labour relations as on the aspect of shareholders' agreement).[5]

   B. Activities:

   Only the present or current activities of the business should be covered in the covenant.

   C. Time period:

   In matters involving shareholders' agreements or sales of businesses, the time period during which the covenant applies may be longer than in employment matters. It emerges from recent decisions that a period of four or five years in matters involving shareholders' agreements is reasonable. It is possible to stipulate a longer period if the real needs of the business so require. In order to determine the necessary time period, the entrepreneur or the manager should ask himself how much time will be necessary to reposition his business in the market when the shareholder leaves, while keeping in mind that freedom of trade remains the principle.

3. Use clear terms. It is important to define who will be the beneficiary of the noncompetition covenant and, if a penalty clause is added to the noncompetition covenant, to ensure that the beneficiaries of the noncompetition covenant will be the beneficiaries of the penalty clause. For example, in the case of a sale of shares, the parties to the agreement of sale can only be the shareholders. However, it may be the parties' wish that the corporation of which they are shareholders benefit from the noncompetition covenant. In such a case, it must be stated that the corporation is the beneficiary of the noncompetition covenant, and also it must be referred to it in the penalty clause if need be.[6]

   In addition, in shareholders' agreements, it is suggested that the wording not refer to the shareholder's employment with the corporation and rather that it refers to his role as a shareholder. If the wording refers to the shareholder's employment, the court may wish to interpret the covenant in accordance with the rules applicable in employment matters.[7]

We invite you to communicate with our team if you wish to have more detailed information concerning the principles discussed above.

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[3] *2865-8169 Québec inc.* v. *2757-5331 Québec inc.*, JE-99-1859, (S.C.).

[4] *Lebel* v. *Stal Diffusion*, JE 2010-2194 (S.C.).

[5] *Fier Croissance* v. *Christian Fillion*, EYB 2010-169790, (C.S.).

[6] Supra note 4, af. *Bouffard* v. *Supra Formules d'affaires inc.*

[7] *Cyberflexx inc.* v. *Rouleau*, 2009 QCCS 4543.

A SHAREHOLDER AGREEMENT: THE ESSENTIAL TOOL OF THE PRIVATE CORPORATION SHAREHOLDER

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An entrepreneur who sets up a corporation with other shareholders should never do so before having first established certain rules and parameters in an agreement entered into between himself and the other would-be shareholders. In fact, contrary to a corporation whose securities are listed on a stock exchange and whose shareholders seldom have any contact between themselves, the closeness that exists between fellow shareholders in most private corporations results in their relationships often being governed by a necessity to cooperate: either they manage to agree on the direction and measures to take or the corporation will fail!

However, good relationships do not happen by chance but rather they often result from the fact that all involved know the rules of the game in advance. That is where a shareholder agreement becomes important since it allows all of the shareholders to set out in advance certain fundamental rules for managing the corporation they jointly hold. In addition, in the event that a disagreement arises that cannot be resolved, it can determine in advance the terms under which a shareholder may leave the common project, that is to say the corporation, without causing its demise.

A shareholder agreement may prevent conflicts, in particular by forcing the shareholders to commit themselves in advance as to how they will exercise their voting rights. It may, for instance, determine who will be the officers of the corporation or the number of representatives each shareholder will be entitled to have on the board of directors. It may also restrict certain powers of the directors by subjecting certain of their decisions to approval by a vote of the shareholders (whether by a simple or a special majority) and thus protect the minority shareholders against decisions of the directors appointed by the majority shareholders.

In the event that the agreement fails to prevent conflicts between the shareholders and one arises, it can provide escape hatches. For example, if two shareholders each hold 50% of the voting stock of the corporation, they fail to agree on decisions to be made, a stalemate ensues, and neither of them is interested in selling his shares, a shotgun clause in their shareholder agreement will allow them to resolve the impasse without resorting to the courts, by instead forcing one of them to sell his shares to the other using a neutral process established in advance in the agreement.

A shareholder agreement is essential not only because it can offer solutions to conflicts, but also because it can achieve other objectives, as illustrated below.

A shareholder agreement may allow the shareholders to preserve the private nature of the corporation by imposing restrictions on the issuance of additional shares of the share capital of the corporation or transfers of shares by existing shareholders. This may be attractive for the founding shareholder who wishes to retain the control of the corporation. Conversely, it may be somewhat less interesting for his fellow shareholders of the corporation, to the extent that such provisions enable the founding shareholder to retain control of the corporation and prevents them from increasing their interest therein.

However, if the corporation is held by several persons who have equal shareholdings, it may be desirable for them to maintain this balance of power by avoiding one of them holding more voting rights than the others. A shareholder agreement can provide for the continuation of the holding of the shares, and thus the voting rights, in this proportion, by subjecting any additional issuances of shares, or transfers of shares by existing shareholders, to pre-emptive rights or rights of first refusal.

Another significant objective that is usually achieved by a shareholder agreement is to protect the interests of minority shareholders by subjecting certain decisions of the directors to approval by a special majority of shareholders. To the extent that a minority shareholder holds a sufficient number of shares, he will be able to ensure that certain transactions cannot be carried out without his agreement.

The most detailed shareholder agreements sometimes also have the objective of determining or confirming the expected participation of each shareholder in various aspects of the corporation, such as management, operations and financing.

These are only a few examples of the various applications of shareholder agreements that may prove to save the day during the existence of a corporation.

In fact, the objectives and effects of a shareholder agreement will vary according to the type of agreement implemented. So, it is the specific needs and circumstances of the corporation and its shareholders that will dictate the type of agreement chosen. Therefore, we cannot insist enough on the dangers of using standard forms of contracts because they require the exercise of considerable judgment combined with competence and experience. These dangers are all the more significant when drafting shareholder agreements because the circumstances in which this type of agreement is negotiated and entered into may vary significantly from one situation to another. The drafting of an effective and useful shareholder agreement should be done by a lawyer who will take into account the characteristics of the business concerned and the specific circumstances of the shareholders.

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