



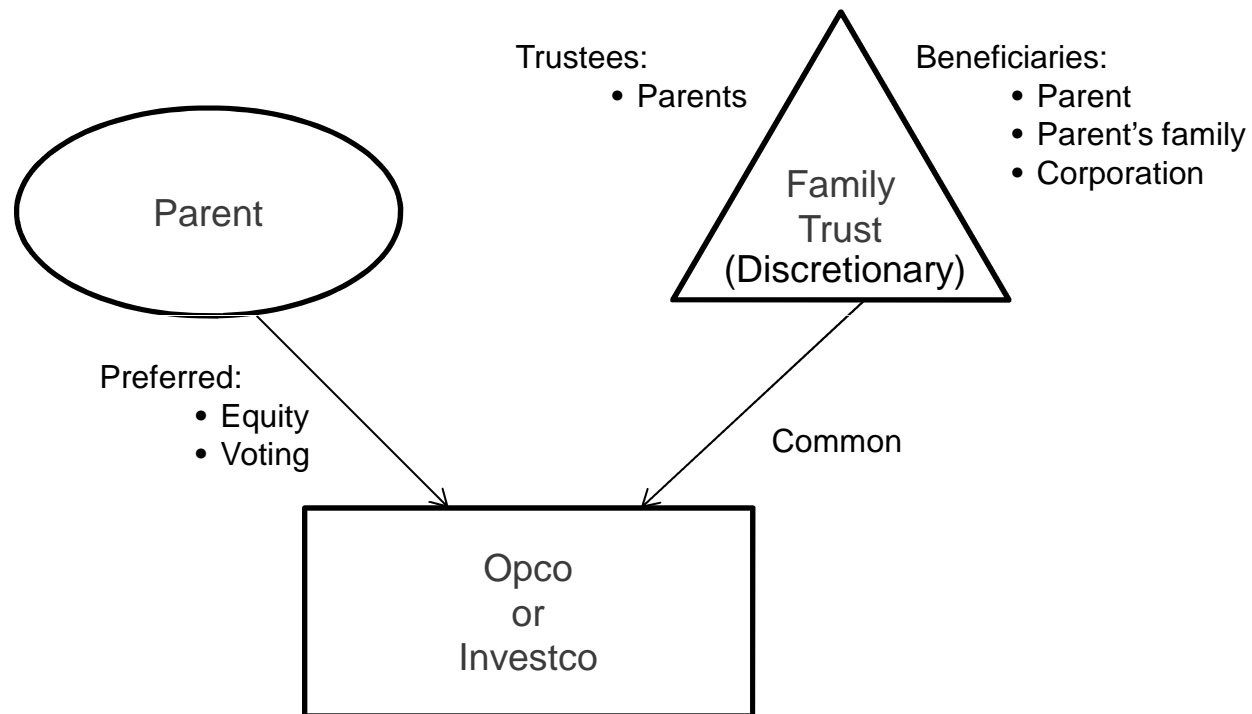
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# **SHAREHOLDER RIGHTS IN THE CONTEXT OF FREEZES, TRUST DISTRIBUTIONS AND 21 YEAR PLANNING**

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# Typical estate freeze



Planning Focuses on Parent's Mortality

- Wasting freeze
- Common shares in Trust really an extension of the Parent

# Typical estate freeze

## SHARES GIVES YOU A RIGHT TO:

- Vote
- Receive a dividend
- Participate in return of capital

## TRUST ALLOWS:

- Parent to have control over all three rights in an Estate freeze
- Acts like term insurance
  - No exposure to deemed disposition on someone's life
  - Additional defense against creditors

# 21 Year Issue

## NEED TO RECONSIDER STRUCTURE

### PARENTS:

- Still relatively young
- Will they have enough assets?
- Prefer not to give any rights away
  - Do not understand what giving up
  - Certainty of future capital
- Will parental influence work?

### CHILD:

- Have an asset
  - Tax exposure on death
  - Subject to matrimonial/creditor challenge
- Issues if non-resident
- May want something if they actually own it

# Basic Distribution Strategy

## ASSUME DESIRE TO CONTINUE FREEZE

Trust allocates common shares to children/grandchildren:

- 107(2) Rollover in most cases

Parents retain:

- Voting control
- Rights to direct dividend

Children or grandchildren receive:

- Common shares (capital)
- Tax/creditor exposure (term insurance) has expired

Is this good enough?

Will the parties understand their rights?

# Ownership Rights Related to Common Shares

- Three issues:
  - Common shares held by discretionary family trust
  - Common shares held directly
  - Effect of shareholders agreement (more later)

# Common Shares Held by Discretionary Family Trust

- A beneficiary of a properly drafted discretionary family trust that truly gives full discretion as to the allocation of income and capital among a class of beneficiaries to the trustees, dispenses with the even hand rule and has appropriate non-vesting provisions and the like should mean that a beneficiary of that trust has no interest in the trust property until an allocation of it is made to him or her by the exercise of trustee discretion or a power of appointment or default distribution on a pre-determined distribution event

# Common Shares Held by Discretionary Family Trust

- That principle has been stated as follows:
  - *The trust is discretionary if the trust leaves a determination of how to distribute the income or capital of the trust in the discretion of the trustee ... The beneficiary has no ability to compel the trustee to make payments to the beneficiary, such that the trust funds are beyond the reach of the beneficiary ... In other words, there is no positive obligation on the trustee to disburse the trust funds for the maintenance of the beneficiaries (Elliott (Litigation Guardian of) v. Elliott Estate, 2008 CarswellOnt 7448, 45 E.T.R. (3<sup>rd</sup>) 84 considering a “Henson” style trust)*



# Common Shares Held by Discretionary Family Trust

- However, notwithstanding the principles, a beneficial interest in a fully discretionary family trust might be considered a matrimonial asset in some jurisdictions
- For example:
  - In British Columbia, a contingent interest in a trust can be a family asset for the purpose of division under the *Family Relations Act* (see *Horne v. Horne*, 2010 ABQB 32, 2010 CarswellAlta 69 at para. 72-5)
  - In Ontario, any interest, be it present, future, vested, or contingent, can be divided under the *Family Law Act* (*Horne* at para. 76-9 and *DaCosta v. DaCosta*, 1992 CarswellOnt 257, 89 D.L.R. (4<sup>th</sup>) 268)
  - In Alberta, a contingent interest in a trust is within the scope of the *Matrimonial Property Act*, but all of the increase in value of the contingent interest in the trust during marriage can be allocated to the spouse who was the beneficiary of the trust if the other spouse did not contribute to the growth of that value and the spouse beneficiary had no control over access to the funds in the trust (*Horne* at para. 98-104)

# Common Shares Held by Discretionary Family Trust

- This is not the case in Nova Scotia where the beneficial interest in a trust, whether contingent or vested, which has not been used to benefit the family, is not a matrimonial asset, and distributions from the trust to the beneficiary after the date of separation is an after-acquired asset not subject to division (see *Coady v. Coady*, 1995 CarswellNS 486,144 N.S.R. (2<sup>nd</sup>) (106) and *Kennedy-Dowell v. Dowell*, 2002 CarswellNS 111, 203 N.S.R. (2<sup>nd</sup>) (130))
- The interesting question is how jurisdictions which treat such interests as matrimonial property value that interest

# Common Shares Held by Discretionary Family Trust

- Options include:
  - An “if and when” approach similar to the pension valuation in *George v. George*, [1983] 5 W.W.R. 606 (Man C.A.)
  - A notional or deemed distribution method among the capital beneficiaries as at the valuation date (see *Sagl v. Sagl* (1997), 31 R.F.L. (4<sup>th</sup>) 405)
  - By determination of the purposes of the trust and whether contingent beneficiaries would actually ever receive a distribution and, if so, how much (see *Kachur v. Kachur*, [2000] ABQB 709 (Alta. QB))

## Common Shares Held Directly

- What rights do the holders of common shares have following an estate freeze where voting control (typically through a separate class of special voting shares) and the majority of the economic value (through redeemable, retractable dividend-carrying fixed value preferred shares) is held by the freezer?
- Does the fact that common shares are acquired for no or nominal consideration (but with nominal value at the time) in the context of a family estate freeze alter the rights that would normally attach to those common shares?

## Common Shares Held Directly

- Issues arise under oppression remedy provisions in relevant corporate statutes or on an application for a winding-up order
- Case law sets test as whether the “reasonable expectations” of the minority shareholder have been violated, unfairly disregarded or prejudiced by the voting control shareholder
- Expectations must form part of the “compact” among the shareholders

## Common Shares Held Directly

- Can arise because of the nature of an agreement or from a course of conduct
- Can a freeze create a contract among the shareholders?
- Likely not as no consideration (see *Reeson v. Reeson*, 2004 SAQB 399, 3 B.L.R. (4<sup>th</sup>) 183 at para. 14)
- Further, irreconcilable differences among the shareholders as to the management of the company may not be a sufficient basis for exercising the court's discretion under the oppression or wind-up tests unless such differences demonstrated a failure of the reasonable expectations of the parties amounting to a repudiation or termination of arrangements among the shareholders (see *Animal House Investments Inc. v. Lisgar Development Ltd.*, 2007 CarswellOnt 6509, 87 O.R. (3<sup>rd</sup>) 529 at para. 55)

# Common Shares Held Directly

- What are “reasonable expectations”?
  - The “legal and equitable interests of the shareholders based on reasonable corporate expectations” (see *Such v. RW – LB Holdings Ltd.*, 1993 CarswellAlta 223, 11 B.L.R. (2<sup>nd</sup>) 122 (“Such”) at para. 71)
  - More than personal squabbling or personal disputes
  - Examine conduct by the oppressor

## Common Shares Held Directly

- Factors can include:
  - History of the corporation
  - Types of interests affected
  - General commercial practice
  - Nature of the relationship between complainant and alleged oppressor
  - Extent to which the acts or conduct were foreseeable
  - Expectations of the complainant
  - Size, structure and nature of the corporation
  - Extent of the detriment to the interests of the complainant (see *Such* at para. 72)



## Common Shares Held Directly

- The personal considerations of the shareholders are relevant if they are part of the compact among the shareholders, including how the shareholder came to own shares (i.e. purchase v. gift or devise) and this compact can change over time (see *Cohen v. Jonco Holdings Ltd.*, 2005 MBCA 48, [2005] 7 W.W.R. 212 at para. 36-37)

# A Cautionary Tale

- *Such* case is an extreme example
- Father froze assets worth approximately \$2 million in 1978
- Corporation's assets included 29 duplexes, an apartment building and a game farm together worth between \$5-6 million by 1993
- Father held voting preferred shares and spouse, son and daughter held common shares of corporation
- Father ran the business as if it was a sole proprietorship, ignored accounting standards, flaunted income tax compliance (resulting in substantial penalties and interest) and compliance with provincial game farm laws and laws governing cross-border transportation of wildlife

# A Cautionary Tale

- Common shareholders successfully applied to remove father as a director, to amend the articles of incorporation to convert non-voting shares into voting shares and vice versa and to value and redeem the father's preferred shares
- Court held at para. 83 as follows:
  - *There is no doubt that the reasonable expectations of the Plaintiffs have been denied by Wolfgang Such's unfair disregard of their interests. His mismanagement and brinkmanship are unfairly prejudicial to their equitable interests. It has put their substantially greater share value at risk. Most importantly, there is no compromise in Wolfgang Such's position in this lawsuit. He asserts he must have control. He has resisted all efforts to resolve these difficulties in co-operation with and the assistance and advice of the Plaintiffs. He has fought each step in these legal proceedings. The businesses have been preserved from drastic reversals by the appointment of the receiver/manager who, with the assistance of the Plaintiff Robert Such, has been able to bring stability, organization and sound financial planning to rescue the companies from probable disaster.*

# A Cautionary Tale

- Could this apply to common shares held by a discretionary family trust where the trustees wish to (or should) assert a claim as the holder of those shares?
- Does this apply when the holder of the common shares of Opco is Holdco, the common shares of which are held by individuals or another trust?
- Does substance prevail over form?
- Are family businesses different from other corporations?
  - Court in *Animal House* said No

# A Cautionary Tale

– Court concluded:

- Lack of case law authority for that proposition
  - No principled reason to treat family businesses differently than any other corporation
  - No principled basis not to apply the principles typically used to determine the expectations of parties in arm's length matters
  - However, when a shareholder of a family business acquires shares by gift, the reasonable expectations of the donor are relevant – specifically when the donor is still alive and retains voting control “the donor’s intention and therefore the reasonable expectations of the parties, would exclude winding up”
  - See para. 72-76 of *Animal House*
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- Does this last point include situations where the shares have been distributed as a capital distribution from a discretionary family trust to that shareholder as part of 21 year planning?

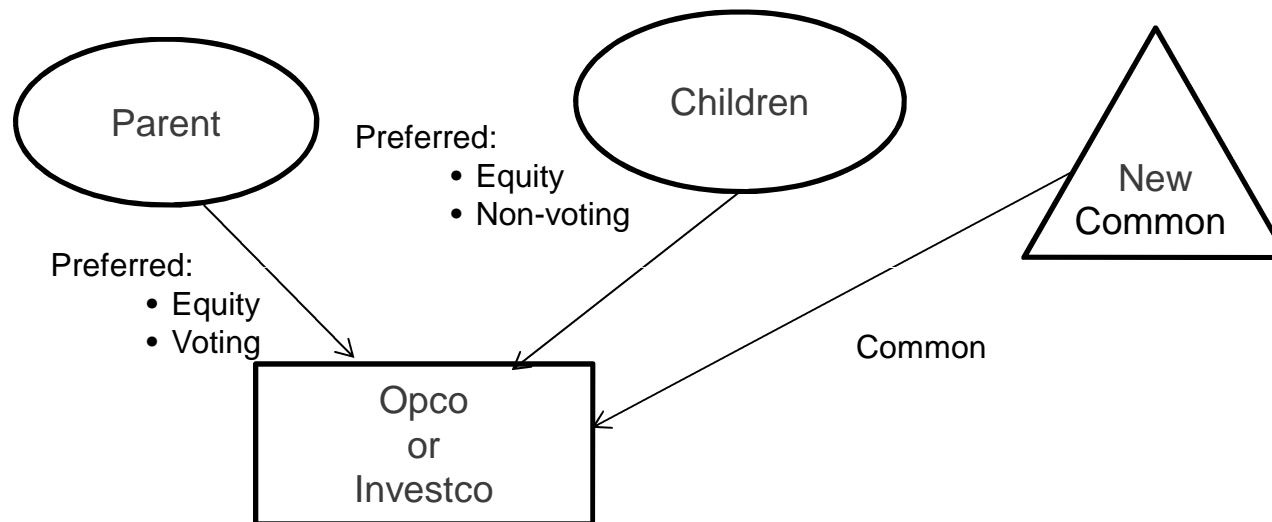
# Other Strategies

## Allocate to grandchildren:

- Freeze – they should live longer
- Perhaps control given to minors
  - Once adults may be more difficult
- All issues remain

# Other Strategies

## FREEZE TO NEW TRUST – THEN DISTRIBUTE



### Fixed value to children

- Support value – retractable or cumulative dividend?
  - price adjustment clause
- Perhaps waste after parent's equity gone
- Use dividend-reducing preferred shares

### Future growth

- Sheltered (term insurance)
- Parent control

### Trustee decision issues?

# Other Strategies

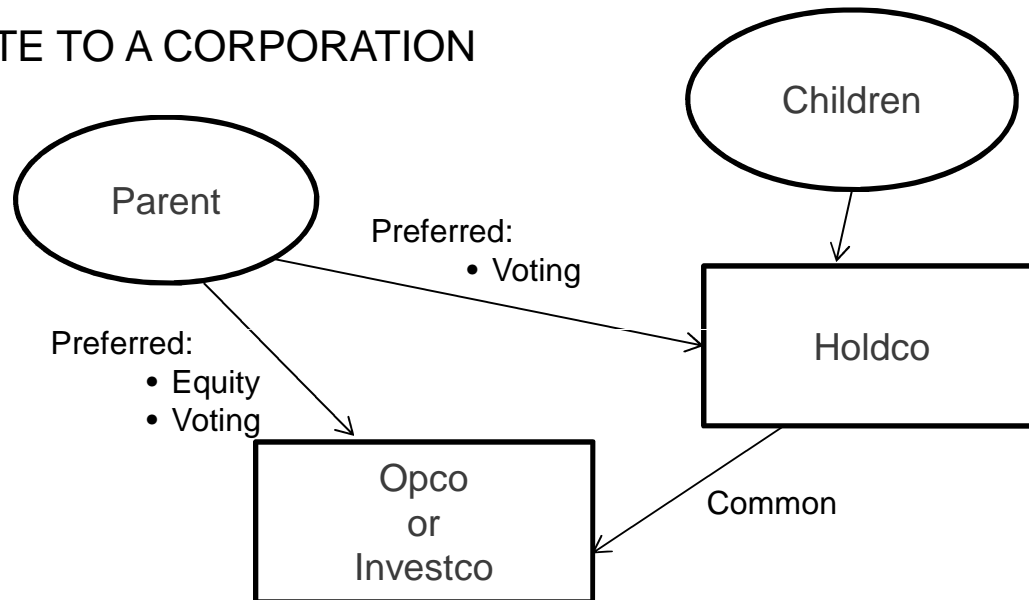
## Refreeze periodically:

- Consider freezing capital increment in Trust every 10 years so
- Preferred shares retractable while in Trust
- Prior to distribution convert from retractable to cumulative
- Perhaps waste if opportunities arise
- Trustee decision issues?



# Other Strategies

## ALLOCATE TO A CORPORATION



Holdco own common shares

- Any real difference to child's rights?
- Perhaps relevant to non-resident child planning?

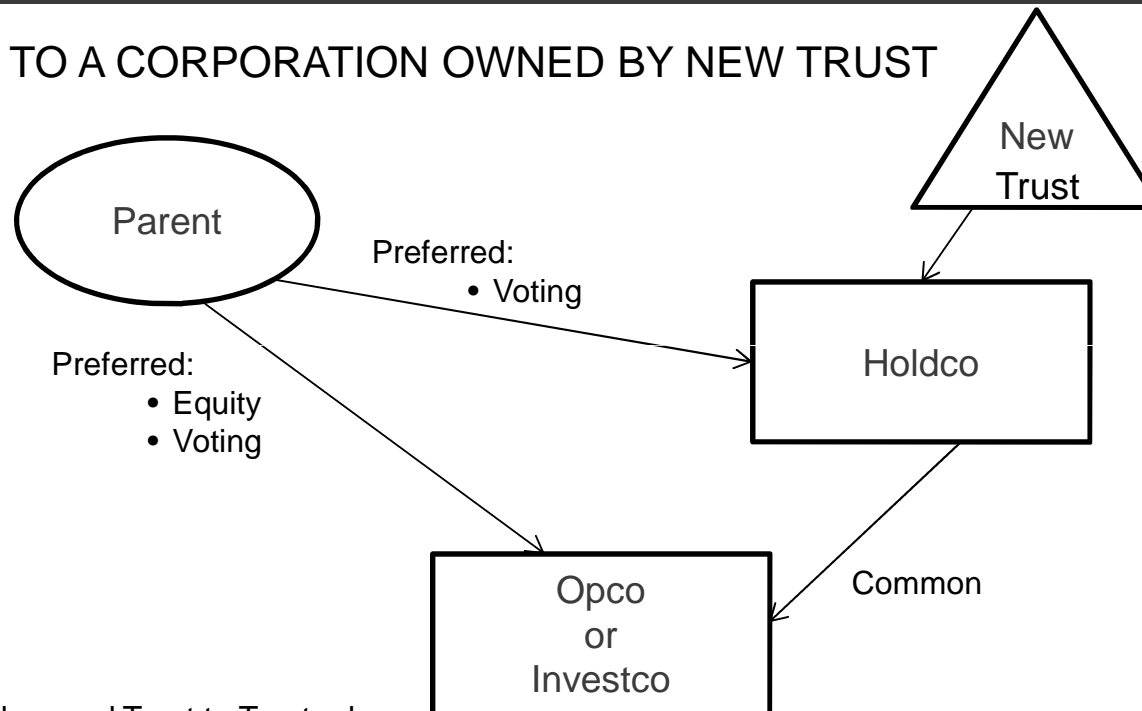
Holdco owns preferred shares

- Allow for use of retractable preferred shares
- Does this limit child's rights?

Do trust terms allow?

# Other Strategies

ALLOCATE TO A CORPORATION OWNED BY NEW TRUST



## GAAR

- Structured around Trust to Trust rules
- Are you prepared to take downside risk?
- CRA – unlikely they would rule positively

Different if allocate to existing company and Trust?

- Non-tax purpose?

Do trust terms allow?

# Other Strategies

Limit child's rights through Shareholders Agreement:

- Limit sale rights
- Valuation concerns

# Effect of Shareholders Agreement

- Shareholders agreements (particularly those that qualify as unanimous shareholders agreements under the CBCA or similar statutes) are strong evidence of the parties' reasonable expectations (see *BCE Inc. v. 1976 Debentureholders*, [2008] 3 S.C.R. 560)
- In *Lyall v. 147250 Canada Ltd.*, (1993), 106 D.L.R. (4<sup>th</sup>) 304 (B.C.C.A.) (quoted favorably by the SCC in BCE) two of three equal shareholders who were also two of the three directors breached the terms of a shareholders agreement requiring the sale of a television studio to CanWest and the third shareholder/director successfully challenged their actions as unfairly prejudicial to him

# Effects of Shareholders Agreement

- However, a shareholders agreement will not absolve the party or parties given control pursuant to that shareholders agreement from breach of the duties to act honestly and in good faith with a view to the best interests of the corporation, to exercise reasonable care, diligence and skill and to comply with the corporate statute (see, for example, subsections 122(3) and 146(5) of the CBCA)
- Consider also arguments that might be used to set aside a shareholders agreement entered into among a voting control shareholder and minority common shareholders (i.e. duress, unconscionability, etc.)

# Pay Tax on 21<sup>st</sup> Anniversary

## OPTION OFTEN OVERLOOKED AS PRACTICAL ALTERNATIVE

### Mitigate Tax:

- Opco
  - Capital gains deduction
  - Have to distribute half of the gain
  - Create note with ACB to manage distribution tax going forward
  
- Investco
  - Trigger corporate gains to avoid double tax
  
- Income splitting to low rate beneficiaries
- Use RDTOH/CDA to mitigate tax
- Provincial residency
  - Change residence in light of Garron
  
- Structure to achieve capital gains on dividend
  - Relative attractiveness depends on Province
  
- Plan to avoid double tax



Questions?

