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PERSPECTIVE

Private Companies: The Next Generation

Transferring a family business to the next generation is often more complex than owners expect. Family dynamics, such as your children's interest in the business, as well as their qualifications and capabilities, play a role. So does their capital preparedness. At the same time, you need to consider the legal structure that will support a successful transition.

Some of the questions you need to answer include:

- What will happen if one child wants to take over the business and another doesn't?
- Will you make provisions to buy back a child's shares if they aren't the right leadership fit?
- How will you compensate any children brought into the business? Will they receive a salary or dividends (or both)?
- If a child gets married or has a common-law relationship, to what extent will his or her spouse have a stake in the business?

There are ways to resolve these legal issues before they become full-blown challenges. Yet this requires foresight, preparation, and sometimes some difficult conversations. Before legally transferring ownership to the next generation, it's consequently important to leave enough time to draft a robust shareholder agreement, employment agreements, marriage contracts, and wills and estate plans.

Shareholder agreements

Shareholder agreements typically take a long time to implement. Nevertheless, they're critical to a smooth succession and, therefore, well worth the effort.

In its most basic form, a shareholder or partnership agreement outlines the rules for running a family business. For instance, a shareholder agreement can

- Create an agreed-upon framework that clearly outlines how business decisions are made;
- Provide the original founder with veto rights on key decisions, even if operational rights have been passed onto the next generation;
- Create restrictions on how shares are transferred (and prevent them from being transferred outside of the family);
- Place restrictions on encumbering shares, so shareholders can't borrow against shares or pledge them to acquire financing;
- Ensure confidentiality, by prohibiting the disclosure of sensitive information; and
- Put stipulations on children's shares (for instance, requiring minority shareholders to vote in line with their parents or identifying situations where the original founder owner has the right to buy back an adult child's shares).

A shareholder agreement is an important document that can give you a say in the structure and future of the company, even after you're no longer the primary owner.

Employment agreements

Whether family members already work in the business, or will in the future, an employment agreement can help set expectations.

Often, business owners use the business as a piggybank, bringing home both a salary and dividends, and potentially taking additional funds on as-needed basis. This can be problematic when the number of family owners grows, particularly because remuneration may not correlate with work performance.

An employment agreement can help remedy this issue for the next generation. For instance, it can outline the performance expected of all family owners, and pay salaries (and bonuses) to those that live up to these responsibilities. This, in turn, can dramatically impact morale—especially if employees see that owner-employees adhere to the same standards as their non-family colleagues. This can also help manage expectations of family members who may be shareholders but do not work in the business. Such non-participating family members may receive dividends (together with other shareholders) but justifiably will not receive salary or bonuses.

Marriage contracts

Family members should know whether a spouse or common law partner could potentially become a shareholder in, or otherwise derive benefits from, the family business. To avoid a family rift, this needs to be decided well in advance.

To avoid thwarted expectations, communication is key. Shareholder agreements should clearly outline what happens in the event of a marriage or common law relationship. If the family decides to exclude spouses from becoming owners, or limit spousal share transfers, family members will have to stipulate this in all marriage contracts.

Wills and estate planning

Your shareholder agreement should also spell out how the family business shares can be distributed on death. If there is a clause that requires shares to pass only to family, this could make spouses ineligible to inherit (or control) shares upon an owner's death. In this scenario, owners must plan ahead to ensure spouses are financially protected when the family business is transferred to the next generation.

If a spouse is not to be involved in the business, they likely shouldn't be named as the sole executor of an owner's will. They also shouldn't be granted sole power of attorney over the family business assets in the event of an owner's incapacity, as this will give them control over business decision-making that is not aligned with the family's wishes.

Needless to say, this raises a number of complex issues. It also makes it difficult to balance your obligations to support and benefit your spouse and other dependents, your philanthropic interests, and your commitments to ensure the success and continuation of the family business as it passes to future generations. To overcome these challenges, it's important to have a clear understanding of the family structure and make sure every child entering the business is on-side. A professional can help family members navigate this terrain and make sure everyone is prepared to honour their commitments.

Start early

Succession planning is an ideal time to create rules of engagement around the operation of the business, clearly outline the responsibilities of all successors, and preserve the original business vision even after the departure of the original owners. It also offers an opportunity to consider your legacy and communicate your wishes to your successors.

For all this to happen, however, you need to be willing to get the difficult conversations out of the way now, so you can avoid surprises and family upheaval down the road. To learn how BLG can help you tackle your most pressing succession issues, contact us.

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