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The Challenge of Exercising an Estate's Controlling Interest in a Private Corporation

By: David M. Smith[1]

1. Introduction

When a testator dies leaving his own business (hereinafter "Company") as an active going concern, the estate trustee named in his or her Will faces immense challenges. The estate trustee must determine the value of the Company and, depending on the wording of the Will, provide for its continuation, sale or liquidation.

The key issue, of course is knowledge. Not all estate trustees are aware of the estate assets prior to the death of the deceased. Prudent estate planning would suggest that a testator would, in the ordinary course, apprise his estate trustee of the assets of the estate and where to find the assets. Nonetheless, we are all familiar with the situation in which a bank account or a share certificate is inadvertently discovered late in the administration of the estate. From the estate litigator's perspective, the delay in locating estate assets ought to be avoided as it can create needless suspicion of the motives or competence of the estate trustee.

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[1] B.A. (Hons), LL. B., T.E.P., Partner, Hull & Hull LLP. This paper is not intended to serve as legal advice and readers are urged to seek and obtain legal counsel respecting any specific situation.

Certainly, the estate's ownership of a controlling interest in a Company is not an asset that one would expect the estate trustee to have difficulty locating. However, as a controlling interest is determined by share ownership, the estate trustee needs to first make him or herself aware of the exact nature of the share structure of the Company and the interest of the testator. This will require a review of the corporate records of the Company as detailed below. It is also worth noting that, on occasion, the owner of the shares will not necessarily be the directing mind of the Company or hold himself out to the public as the owner of the Company. Clearly, the estate trustee must never make assumptions as to the ownership of a Company nor rely on the advise of those in management as to who actually owns the chares of the Company.

This brief paper touches on a variety of topics that are far too complex to deal with in a fifteen minute presentation and which have been dealt with in a far more comprehensive fashion by others.[2] As such, the focus of this paper is restricted to the responsibility of the estate trustee in assuming control of a Company (as a going concern as opposed to an investment of holding company) with a view towards his or her fiduciary duty to the beneficiaries of the estate.

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[2] See, for example, "*Trusts and Estates that Control Corporations*" by M. Elena Hoffstein and Rosanne Rocchi, 10th Annual Estates and Trusts Summit, 2007 LSUC CLE, and "*Trust Principles and the Operation of a Trust-Controlled Corporation*" University of Toronto Law Journal, Volume XXX 1980 David Hughes.

2. Learning the Lay of the Land: Custody, Inventory and Valuation

An estate trustee must, as soon as possible after the death of the testator, acquaint him or herself with the nature and circumstances of the estate assets and scrutinize all relevant documents that may help ascertain the condition of the estate.[3]

Once the estate assets are ascertained, the estate trustee must take possession or secure the estate assets within a reasonable period of time.

The concern is not simply to realize the assets of the estate but to ensure their preservation and to optimize their value. The nature of this obligation will depend on the nature of the asset. The simpler the asset, the simpler the duty. For instance, there is very little difference between realizing a bank account and ensuring its preservation. For more complex assets, the duty becomes more onerous. For example, the estate trustee will need to ensure that adequate insurance is in place on real property. He or she will need to see to the making of any necessary repairs required to catch the highest sale price. A property manager may have to be engaged if there is an apartment complex (for example) that is required to generate income for a life tenant.

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[3] Underhill's Law relating to Trusts and Trustees, 14th ed. (1987) p.408. *Widdifield on Executors and Trustees*, 6th edition (2002), pp.15-1 to 15-19

A Company that was a going concern at the time of the testator's death presents special challenges which demand far more sophistication of the estate trustee. In all likelihood, the choice of estate trustee will have been dictated by his or her familiarity with the Company in question or his or her degree of business acumen. It is not uncommon to see a professional institutional trustee appointed either in such capacity or as co-estate trustee.

As noted above, the estate trustee would likely have been aware of an asset such as a controlling interest in a Company well in advance of the death of the testator. The estate trustee would then be well positioned to "hit the ground running" in terms of taking on his or her duties.

If the estate trustee is not aware of the assets of the estate, a thorough search of the estate residence will usually bring to light bank account statements, insurance statements and other documents to evidence the nature of the assets of the deceased.

As an aside, estate trustees will commonly point to the time spent cleaning out and searching the estate residence in their bid for enhanced compensation. Once again, from the litigator's perspective, another benefit of pre-death communications with the estate trustee is the reduced likelihood of a contested fight over executor's compensation if such a search is unnecessary.

It is the duty of an executor to realize all the testator's estate. Executors must take possession of the deceased's property or secure it within a reasonable period of time. Executors have a duty to give full explanation of all of their dealings and the causes why outstanding property of the deceased was not collected or has disappeared. A trustee who can not satisfactorily account for any estate property shall be chargeable for same. [4]

When an estate trustee has reason to believe that a testator may have had a controlling interest in a Company at the time of his death, he or she must take appropriate action to learn the facts of the situation. The executor must decide whether to: (i) sell the company, (ii) liquidate the company, or (iii) manage the company as a going concern, as the executor is accountable to the benficiaries for the profits of the Company and may be personally liable for any losses.[5]

In such a situation, it has been suggested that the appropriate steps for an executor to take are as follows:

(a) Review the will;

(b) Review the Company's financial statements in order to "understand the financial implications and be able to demonstrate his knowledge

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[4] *Widdifield on Executors and Trustees*, 6th edition (2002), pp.15-1 to 15-19

[5] *"Private" Companies owned by Estates"*, D. Michael Arnold and Christopher J. Stringer, (1976-77), Vol. 3 E. & T.Q. 58

of them to the beneficiaries, employees, lawyer, accountant, banker and others involved with the Company or estate";

(c) Review Corporate records including the Company charter and by-laws;

(d) Contact individuals with knowledge of the Company's affairs including: beneficiaries and family, directors and shareholders, employees, solicitors, accountants and bankers.[6]

a) The Will

As it relates to the Company, the exact terms of the Will may provide for the following:

- What powers are given to sell the Company?
- Are there powers to sell or convert shares?
- Are there powers to retain or postpone conversion?
- Are there powers to renew or extend guarantees?
- Are there powers to sell to or employ specific people?

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[6] *"Private" Companies owned by Estates"*, D. Michael Arnold and Christopher J. Stringer, (1976-77), Vol. 3 E. & T.Q. 58

b) Financial Statements

The Estate Trustee must understand or engage the assistance of someone who will understand the Company's financial statements for the simple reason that business acumen is inseparable from the exercise of the estate trustee's fiduciary duty to the beneficiaries. In all likelihood, regardless of the level of sophistication of the estate trustee, the accountant and legal counsel engaged on behalf of the Company during the testator's lifetime (or certainly in the period of time immediately before his or her death) will be key players in helping the estate trustee understand the situation of the business that he or she has been entrusted with.[7]

The purpose of understanding the Financial Statements is to best inform the beneficiaries of the health of the Company and to permit a meaningful assessment of which of the options (continuation; liquidation or sale) to pursue.

c) Corporate Records

The corporate records reveal the history of the management of the Company and, as such provide valuable assistance respecting the making of decisions.

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[7] Of course, oftentimes such key players are themselves appointed as Estate Trustees.

d) Communication with Beneficiaries

Although the term “private coorporation” has been used in the title of this paper, the term is virtually synonymous with “family company” in that, more often than not, a spouse of child of the testator will play a major role in the management of the Company. In all likelihood, such spouse or child is also likely a beneficiary of the estate.

The estate trustee, in assuming his or her role, will need to confer with senior management of the Company. As noted, beneficiaries of the estate may be in such positions. This reality puts the estate trustee in an awkward position which must be confronted. If the estate trustee’s role is to respect his or her fiduciary duty to the beneficiaries, then this duty may run into conflict with a person in a position of management in the Company who is also a beneficiary.

Put bluntly, the estate trustee must make a business decision in contrast to the (possibly) emotional assessment of family members (particularly those in a position of management with the Company).

3. Exercise of Ownership

Once it is established that the estate has a controlling interest in a Company, how is this control in fact exercised? The discussion to this point has been

concerned with what action should be taken by the estate trustee to understand the nature of the corporate asset of the estate. Of course, it is entirely possible that after making the various enquiries, the estate trustee would choose to renounce his or her position.

But let us now assume that the appointed estate trustee fully intends to act in accordance with his or her appointment. How should the estate trustee now **exercise** his or her controlling interest in a private corporation?

Unless there is a contrary provision in the Will, common sense and business acumen suggests that an executor who is also a shareholder should be a director of an estate-controlled Company. In such capacity, the executor is best able to oversee the management of the business and ensure that this asset of the estate is safeguarded.[8]

In an oft-quoted decision, *Lucking's Will Trusts (Re)*, the Court states:

> "Now what steps, if any, does a reasonably prudent man who finds himself a majority shareholder in a private company take with regard to the management of the company's affairs? He does not, I think, content himself with such information as to the management of the company's

[8] *"Estate Ownership of Shares of a Private Company"*, P.A. Robinson and A.W. Rowe, (1993), 12 E & T.J. 25.

affairs as he is entitled to as a shareholder, but ensures that he is represented on the board."[9]

The rationale is simple: Directors are privy to the best information respecting the management of a corporation. As the directing minds of the corporation it will only follow that the estate trustee with a controlling interest (and all that entails) would need to sit on the Board. Surely, if asked, the beneficiaries would want the estate trustee to be actively involved in the management of the Company.

All that being said, it appears that there is there is no duty for the estate trustee to sit on the Board of Directors. In *Bartlett v. Barclay's Bank Trust Co. Ltd.*[10] the Court clarified the obligation of a trustee to exercise his or her controlling interest as a "reasonably prudent businessman" although emphasized that it was not necessary to sit on the Board of Directors.

So what then is the obligation? According to Rosanne Rocchi and Elena Hoffstein, "[Estate Trustees] must "place themselves in a position to make informed decisions regarding what actions are appropriate to be taken for the protection of the assets of the trust."[11]

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[9] [1967] 3 All E.R. 726 (H.C.).

[10] [1980] 1 All E.R. 726 (Ch. D.).

[11] "*Trusts and Estates that Control Corporations*" by M. Elena Hoffstein and Rosanne Rocchi, 10th Annual Estates and Trusts Summit, 2007 LSUC CLE, p.3-6.

If an estate holds a substantial or controlling interest in a corporation, and the trust provides for the continuation of the business of the corporation, the trustee in all likelihood has an obligation to become a director of the corporation to oversee the management of the estate's investment.[12]

It is universally accepted that a trustee holds his powers as shareholder for the benefit of his trust beneficiaries and must exercise those powers in accordance with the principles of trust law. The most crucial power which a trustee holds *qua* shareholder is the power to vote trust shares.[13]

A trustee's considerable powers *qua* shareholder are trust property in the full sense. A trustee must exercise those powers for the benefit of his trust. He must conform to trust principles such as the even-hand rule and must exercise that degree of care, prudence and skill which a reasonable man would exercise in the management of his own affairs.[14]

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[12] *"Trustee, Director, Officer, Beneficiary... One Hat Too Many?"*, A. Sean Graham, (2003), 1 E.T.R. (3d) 158.

[13] *"Trust Principles and the Operation of a Trust-Controlled Corporation"* University of Toronto Law Journal, Volume XXX 1980 David Hughes at p.154.

[14] *"Trust Principles and the Operation of a Trust-Controlled Corporation"* University of Toronto Law Journal, Volume XXX 1980 David Hughes at p. 196.

4. Dividends

When a company makes a distribution to a deceased shareholder's estate, the executor must allocate the distribution to the estate's income or capital account depending upon how the Directors have chosen to distribute the profits.[15]

Where trustees have to decide whether to: (i) distribute the surplus of a business as an income dividend to the life tenant or (ii) use such proceeds to redeem the preference shares which would benefit the remaindermen, the proceeds should be used to redeem the preference shares.[16]

In making investment decisions, a trustee must consider the interests of successive beneficiaries and structure a portfolio of investments that has regard to the interests of both a beneficiary with a life interest in the income of the trust and the remainderman who will ultimately inherit the corpus of the trust on the death of the life tenant.[17]

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[15] *Estate Ownership of Shares of a Private Company"*, P.A. Robinson and A.W. Rowe, (1993), 12 E & T.J. 25.

[16] *"Trusts that Control Corporations"*, W. D. Goodman, Vol. 3 Estates & Trusts Quarterly, 115.

[17] *"Trusts and Estates that Control Corporations*, Maria Elena Hoffstein, Rosanne Rocchi 10th Annual Estates and Trusts Summit, November, 2007, p. 3-16.

The duty of a trustee to act impartially between the life tenant and the remainderman also requires that receipts coming into the trust be allocated fairly between income and capital beneficiaries.[18]

If a private corporation has a surplus at the date of death of the testator, it can be seen as inequitable for executors, as directors of such corporation, to declare a cash dividend that would reduce the value of the shares below the date of death value, thereby depleting the capital which would ultimately pass to the remaindermen.[19]

Therefore, any surplus ought to be distributed by way of a stock dividend payable in shares, so as to increase the assets of the Estate for the benefit of the remaindermen.

5. The Standard of Care

The standard of care and diligence required of a trustee in administering a trust is that of a man of ordinary prudence in managing his own affairs.[20]

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[18] *"Trusts and Estates that Control Corporations*, Maria Elena Hoffstein, Rosanne Rocchi 10th Annual Estates and Trusts Summit, November, 2007, p. 3-16.

[19] *"Trusts that Control Corporations"*, W. D. Goodman, Vol. 3 Estates & Trusts Quarterly, 117.

[20] *Fales v. Canada Permanent Trust Co., 1976 CanLII 14 (S.C.C.).*

A trustee must be alert to changes in the fortunes of any company represented in the portfolio of the trust estate.[21]

When there are two trustees who do not agree on a decision respecting the investment of a trust asset, an application ought to be made for the advice and direction of the Court.

6. Summary

Estate Trustees who are left the responsibility to run, liquidate or sell a Company must, as has been noted by many commentators, consider legal principles relating to trusts and corporations which are not always in accordance with one another.

The bottom line is that the shares of a private corporation are an investment of the estate. If the estate has a controlling interest in a private corporation, the estate trustee surely has a more complicated and challenging role but the mandate remains the same: to maximize the estate for the benefit of the beneficiaries.

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[21] *Fales v. Canada Permanent Trust Co., 1976 CanLII 14 (S.C.C.).*