

## Business Law

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### Creating Chaos in Corporate Reorganizations

Reorganizing private companies should be a simple task for corporate lawyers. Tax professionals design tax plans setting out the steps that have to be followed, and corporate lawyers follow the “step plan” and document the transaction. What could be simpler?

And, therein lays the problem. Corporate lawyers sometimes forget that nothing is really that simple and that following the road map laid out by the tax professionals without applying some critical thought to it can lead to commercial difficulties.

Let’s discuss this in the context of a simple estate freeze in a family owned business intended to pave the way for the next generation of the family or employees to become shareholders. In a typical estate freeze, the holder of the common shares (often a founder) exchanges his or her common shares for fixed value shares, and a new person (often a family member or an employee) then subscribes for common shares.

I often tell my clients that since my knowledge of tax is conversational and relying upon anything that I say about tax is dangerous, they must obtain advice from a qualified and well-insured tax professional. However, as a corporate lawyer, I do have to be able to recognize the danger signs that indicate that the client’s tax advisor may not be up to the job, or that although the tax advisor may be knowledgeable, he or she may not be looking beyond the tax issues.

Here are some examples of what I have seen in my practice:

#### Valuations

Estate freezes often rely upon section 85 of the *Income Tax Act* to effect a tax-free rollover. The tax professional will usually require that the Articles of the corporation and/or an exchange agreement contain a “price-adjustment clause” which will be used to adjust the purchase price and the value of the consideration received in the event that CRA alleges that the purchase price does not represent the fair market value of the shares which are being frozen.

However, CRA will only allow the parties to rely upon a price adjustment clause if they have taken reasonable steps to value the shares which are being sold. There is room to disagree about the extent of the valuation exercise which must be conducted in order to be able to rely upon a price adjustment clause, but there is little doubt that some reasonable steps must be taken. I recently became aware of a transaction which was completed without any valuation being undertaken by the client’s accountant. The accountant reported that the shares in question were valued “at what the client said they were worth”. The corporate lawyer who implemented the tax plan should at least have raised the absence of a valuation as a danger sign.

#### Retractable Shares

In the typical estate freeze, common shares will be converted into fixed value shares. One of the features that make shares “fixed value shares” is that they are usually redeemable and retractable at a fixed value. All of this is fine and good from a tax perspective, but tax professionals sometimes do not address the commercial issue arising from holding retractable shares, which simply put is that the shareholder may demand his or her money at an inopportune time for the corporation, and that subject to the statutory solvency tests, the corporation will be obligated to pay.

One issue that should be addressed is how the Corporation’s bankers are going to react to the common shares being converted into retractable shares, which may be to require that each shareholder sign a subordination agreement. Signing subordination agreements for the current bank and committing to sign subordination agreements for future banks should be addressed with the shareholders before they are allowed to hold retractable shares.

Another issue that should be addressed is whether, and the extent to which, limits can be put on the right of a shareholder to retract the shares at all so that a shareholder cannot put financial pressure on the corporation by demanding that his or her shares be redeemed.

I have seen retraction rights exercised by a disgruntled sibling in order to put pressure on management and by an aged father who “changed his mind” about what his cash-flow requirements were and who he was going to leave his shares to in his will. I have also seen retractable shares come under the control of a disgruntled sibling exercising influence over a parent with Alzheimer’s disease. The corporate lawyer has to look in the crystal ball and think about where these shares may end up and whether there is a way to limit the retraction rights while still satisfying CRA’s requirements.

## Voting Freeze Shares and Thin Voting Shares

Sometimes the tax professionals or corporate lawyers will suggest that frozen shares should be voting to allow a founder to be able to control the corporation until all of his or her frozen shares have been redeemed. However, as these shares are redeemed, the voting rights may fall below the 66 2/3 threshold required to pass a special resolution or the 51% threshold required to elect the board of directors. In order to address these issues, a class of non-participating shares without dividend rights but carrying sufficient votes to control the corporation and known as “thin voting shares” are sometimes used to preserve control with the founder.

As with retractable shares, the corporate lawyer has to consider who may one day be exercising the voting rights and how to bring them to an end when the frozen shares have been redeemed.

## Shareholders Agreements

It doesn’t even take a crystal ball to identify some other issues that could become a problem but which are often missed.

For example, since corporate reorganizations often result in a change in the shareholdings of the corporation, when the

reorganization dust settles individuals who used to hold their shares directly often hold their shares through holding companies and family trusts may have subscribed for new common shares. The shareholders agreement which was drafted prior to these events may no longer fit the situation, and if it is not amended or replaced, there may be real legal issues as to whether the shareholders agreement continues in effect.

## Price Adjustment Clauses

Here is another example of an issue which should be obvious, but is often missed. As mentioned above, price adjustment clauses are a feature of estate freezes. These provisions make perfect sense from the perspective of complying with CRA’s requirements, and in a family situation may also be consistent with the objectives of the parties. However, it is not difficult to imagine situations where stakeholders may be troubled to find out that the corporation in which they have invested actually “owes” the holder of the frozen shares much more than the stakeholder thought. Some thought should be given as to what will happen if the price adjustment clause is invoked and how that situation will be managed.

## Consents

A corporate reorganization may result in a change of ownership or a change in control within the meaning of a loan agreement, lease, license agreement, franchise agreement or other commercial agreement. Consents may be required from the other parties to such agreements.

## Conclusion

The discussion above has all been about simple estate freezes. There are, of course, many other types of corporate reorganizations, and all of them raise commercial issues. Asset transfers will often require the financing to be looked at; transfers of real estate will raise land transfer tax issues; amalgamations may expose a strong company to the creditors of a weak company or even result in the “merger” of two parcels of real estate that had previously been severed.

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My point, and I do have one, is that after the tax professionals do their job, the lawyers implementing the reorganization transaction must be more than just scribes. They have to bring the same general commercial knowledge, experience and analytical skills to the transaction that they would bring to any other commercial transaction. And yet, sometimes they don't, as if the labels "tax plan" or "corporate reorganization" somehow result in an exemption from all of the usual rules.

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