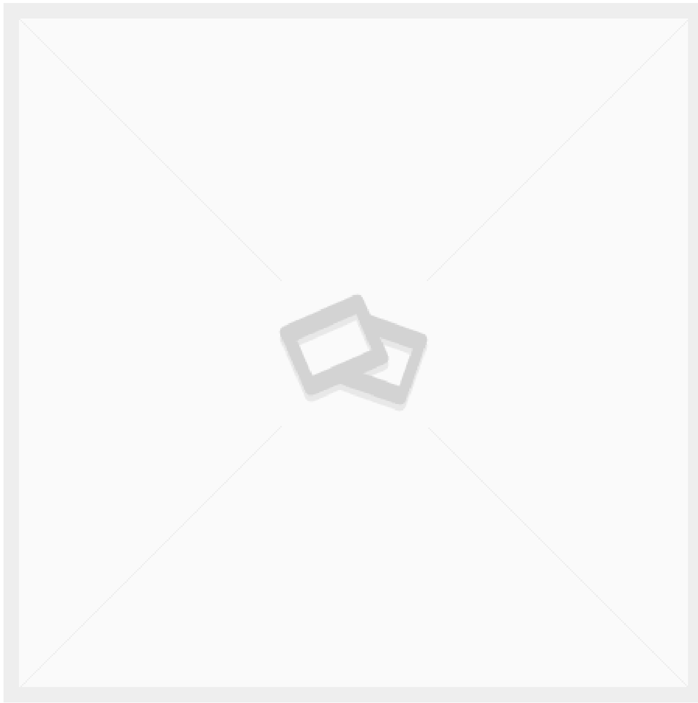

# BUSINESS SUCCESSION PLANNING (PART 1)

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**Category:** CNPupdates

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Despite the fact that many small-medium enterprises (SMEs) in Singapore are family-owned and it is common for family members to inherit shares in private companies, news articles in recent years indicated that a large number of Singapore companies do not have succession plans.

Like estate planning for individuals, business succession planning requires thorough consideration of the non-legal aspects, such as identifying and training (which will include mentoring) a successor. There are various stages in the planning, from preparation and selection to implementation. A proper legal framework should be put in place to support the plan.

This commentary introduces several legal mechanisms used by SMEs to prepare and plan for the retirement or passing of key individuals in the business.

## Choice of Successor

This will have to be determined at the preparation and planning stage. Business owners or founders may hold off identifying a successor for many reasons, and the choice may not be clear until the end. The successor may be a third party and may not be a family member. It is important that at some stage, or upon the happening of some trigger events, business owners/founders make a decision on the choice of successor or successors. This will affect the legal framework and mechanisms that are to be put in place.

## Succession in a sole proprietorship vs private limited company

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| Sole proprietorship | Private limited company |
|---|---|
| · Sole proprietorship is a structure unsuitable for succession since the business is tied to the sole proprietor, a natural person.<br>· When the sole proprietor passes away, assets owned by the sole proprietor would be inherited by his/her heirs (ie. through a will or by intestate succession) once the liabilities have been paid off. | · The company, a legal entity of its own right, owns the business assets and liabilities; the individual behind the business merely owns shares in the company.<br>· The constitution of the company (formerly known as the articles of association) would usually contain provisions addressing the death of a shareholder.<br>· According to the current Model Constitution[2], the shares would pass to the legal representative of the deceased shareholder (ie. executor, if there was a will, or the administrator of his estate, if there was no will), and the persons who inherit the shares can elect to be registered as members of the company, ie. transmission of shares. |

## The conflict between existing shareholders and incoming shareholders

The company's ability to survive following the death of its first-generation shareholders is regarded as one of the advantages of incorporation since the shares are assets that can be inherited by the owner's heirs. However, if there is more than one shareholder, this basic position has the potential to give rise to disputes, especially when the shareholdings are close to equal and neither side has a controlling interest.

Consider this relatively uncomplicated, yet vexing, example:
Mr Tan* and Mr Lim* were both 50% shareholders and directors of a company. When Mr Lim passed away, his shareholding passed under his will to his wife and sons. Mr Tan was initially keen on continuing the business alone and felt entitled to do so since the late Mr Lim had left all management decisions to him, but he decided he could not continue in a business partnership with Mr Lim's beneficiaries. (Among other things, one of Mr Lim's sons wanted to be appointed as managing director, a position held by Mr Tan since the incorporation of the company more than 20 years before.) The parties also could not agree on the price for a buy-out. Months later, and after both sides had consulted lawyers, it was finally agreed to liquidate the assets and strike off the company.
* Names have been changed.

In hindsight, if the shareholders had agreed that the shares held by Mr Lim will be passed to his sons and had begun the process of preparing the successors through a mentoring process involving both shareholders (Mr Lim and Mr Tan), and parties had agreed prior to the death of Mr Lim that Mr Tan will continue to maintain the position of managing director,

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the situation may have been different, and the business may have survived another generation.

## The conflict between the beneficiaries

A second danger is where the second generation shareholders disagree on how the business should be run and no one party has sufficient shareholding to make decisions. On a basic level, the shareholding percentages determine the level of control a shareholder has:

- Typically a majority vote is required in order to pass an ordinary resolution to decide shareholder matters, i.e. over 50%. A 50-50 split may be seen as the most equitable division but it opens the company to the dangers of a deadlock when the shareholders are unable to agree on a course of action.
- A shareholder who holds 75% of the shares generally has extensive control in the company. In the absence of other provisions in the company's constitution, a shareholder or shareholders holding 75% of the shares are able to take major actions such as applying to wind up a company.

For a business owner, the temptation may be to exercise “fairness” and divide ownership of the company equally amongst the business owner's heirs - however, this could lead the company into a deadlocked position. To reduce the potential for feuding, it may be better for the control of a company to rest with one party. It may also be possible to structure the business into different segments or business units, allowing more than one heir to run and manage the respective business units. For example, decisions on strategy may be decided by one heir under a management company, which will provide corporate advice to the other business units, and another heir may helm the various business units and make decisions on the day to day operations. Nevertheless, such structures will have to be well thought out and the appropriate legal and tax advice sought.

## Shareholders Agreements

Where there are two or more shareholders, the parties would usually put in place certain contractual rules by way of a shareholders agreement covering how the company will be run by the shareholders.

The terms of shareholder agreements vary widely depending on the relationship the individuals have and there is much flexibility in the kind of provisions that the shareholders can agree on, but some common provisions are as follows:

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## Compulsory share buy-out

Rather than the shares passing to the deceased shareholder's heirs under a will or intestate succession laws, shareholders may agree in advance that there shall be a compulsory transfer of the deceased shareholder's shares to the surviving shareholders upon death. The agreed terms shall continue to bind the deceased shareholder's estate, so this prevents persons who have had no prior involvement in the business from interfering with the functioning of the company. The price mechanism for the buy-out can also be included. Nevertheless, this will have to be properly structured so as to prevent the heirs or beneficiaries from staking a claim on the deceased shareholder's shares.

Buy-out options are not limited to options being triggered by death. Owners can consider how to minimise disruptions stemming from changes in personal circumstances and breakdowns in relationships of the key personalities in the business, such as a divorce, bankruptcy or disability.

## Sale of shares

Shareholders may also provide for a sale option to be exercised by the deceased shareholder's heirs upon the death of the deceased shareholder, using a price-determining mechanism. An agreement may be made between the parties to allow the successors to retain the deceased shareholder's equity in the company as passive shareholders, leaving the running of the business to the surviving founders or existing shareholders. The successors may continue to reap the benefit that comes with being shareholders or exercise the option to sell their shares at a later date using a predetermined price mechanism.

## Shareholder reserved rights

The general position is that directors have the power to make all management decisions relating to the business unless such decisions are expressly reserved to the shareholders. Consequently, if there is a shareholders agreement, shareholders can reserve the right to vote on and make decisions on material issues, leaving the management team to manage the day to day operations with minimal intervention.

## Information and observer rights

Shareholders do not have a right to demand access to the company's financial documentation, save for the right to receive the financial statements in an annual meeting. They also do not have the right to attend board meetings. However, rights, commonly known as information and observer rights, can be conferred on them in a shareholders' agreement. For minority shareholders who are not interested in executive control over the

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business, but nevertheless do not wish to be kept in the dark, this could be a useful right.

### Special right to appoint directors for the minority

A minority shareholder, for example holding 10% of the shares, can be given the right to appoint a director to the board of the company. The director would have access to the financial records of the company and also the right to participate in board meetings. Unless otherwise agreed in the shareholders' agreement, such right may not be conferred on the minority shareholder.
This shareholders agreement would typically be signed between all the then-existing shareholders and future shareholders would be required to sign deeds of accession, stating that they agree to be bound by the terms of the shareholders' agreement.

## Insurance

Business owners could also consider the use of insurance in order to supplement their plans where liquidity could be an issue.

### Supporting the buyout options

Parties may have agreed on the appropriate buy out prices in a shareholders agreement, ie. that Shareholder A will have the option to buy out Shareholder B's shares if B passes away, but when the time comes A may not have set aside sufficient funds to do so. B's beneficiaries may also find it difficult to sell the shares to a third party given that there is no open market for the sale of private company shares

However, if A takes out a life insurance policy insuring B's life, the proceeds received from the insurer can then be used to fund the purchase of the deceased shareholder's shares at the agreed price; B's beneficiaries can also be assured that B's estate will have sufficient assets for distribution. This is more common in a close family setting, where the spouse or children are the beneficiaries under an insurance policy.

### Tiding the business over

According to a 2014 news release by UOB, small businesses take approximately 9 months to replace key persons, and in such a case key man insurance, which insures a business against the sudden passing of its key personnel, may be worth considering.

## Conclusion

Given the eventuality of passing away, business owners are encouraged to discuss

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succession plans, while they are in good health and on good terms with their business partners, taking tax, financial and legal advice if needed. The next step would be to ensure that the legal documentation supports a smooth transition.

To be contrasted are the situations where no suitable successor can be found or the longevity of the business is not a priority. In these cases, the owners can consider liquidating by selling all the company's shares and/or assets to key employees of the company (ie. management buy-out) or third party purchasers. This would be the topic of Part 2 of this article.

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