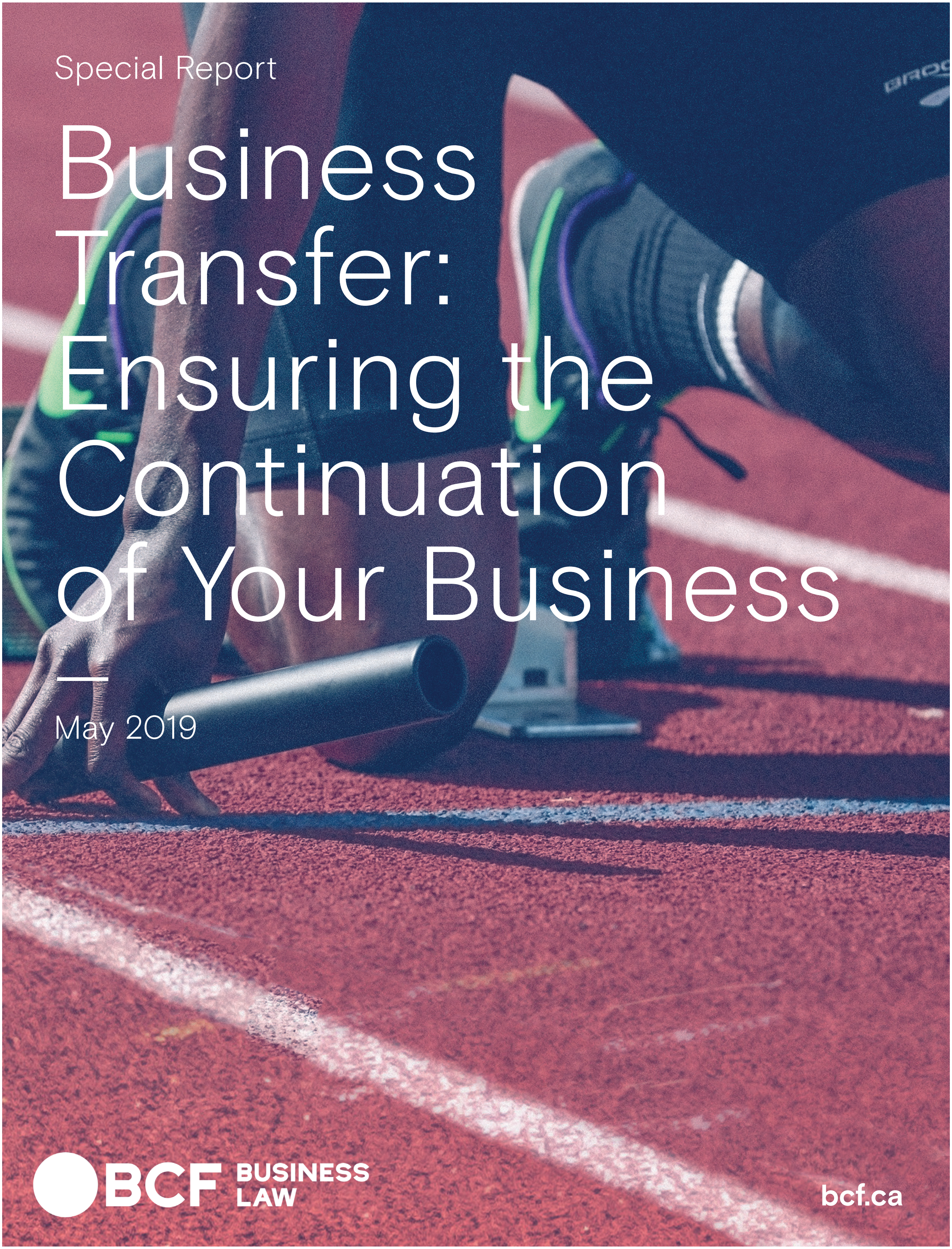

Special Report

# Business Transfer: Ensuring the Continuation of Your Business

May 2019

BCF BUSINESS LAW

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# Business Transfer: Ensuring the Continuation of Your Business

"Only 3 in 10 business owners are able to pass on the torch, and this transfer can take up to eight years."[1]

**No business owner is immortal. Sooner or later, every managing director of a company will need to face strategic choices in one form or another, to ensure the sound handover of a company they have built and grown over the years.**

Not only is planning for long-term continuation inevitable, its implementation is crucial. Among other things, transferring a business involves human, financial and, sometimes, family issues. Well-orchestrated planning will take into account each of these aspects to ensure the sustainability of the company when its founder is no longer there.

Hence the importance of continuation planning on a long-term basis, as well as studying the options for successfully completing the transfer.

Aside from selling to one or more third parties, there are a number of scenarios in which a business owner or manager may wish to hand over their business. This series of articles is intended to summarise some of the key elements regarding transfers and business continuation.

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By Natasha Girouard,
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# Achieving a Successful Business Succession: An approach that is as technical as it is personal

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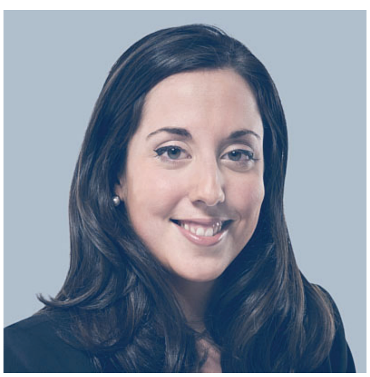

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**"Shareholders agreement," "succession planning," and "governance" are terms that all business owners will encounter as their business evolves and grows. In the context of a business succession, each of those terms is also relevant.**

In addition to technical skills, the human personalised approach of the professionals advising an entrepreneur for the succession planning of his business are of utmost importance.

Planning the succession of a business extends far beyond the boundaries of the business itself: it involves understanding the entrepreneur's values, wishes and objectives as a whole, while also considering his retirement plan and vision of the future.

Typically, clients have the following objectives: "I want my company to remain prosperous. I want my succession plan to be successful, and I want to take care of my family."

Each succession plan is unique. The 360° approach we recommend consists in assisting entrepreneurs in their reflection on their values and objectives from the start of the succession process, in view of ultimately implementing a customized plan taking into account their specific situation, both on a personal and economic level, as well as the human considerations that can arise from their retirement.

## The Entrepreneur's Family Dynamic: Not to Be Neglected

Concretely, professionals must understand an entrepreneur's family dynamic to help him reach his objectives. Will all family members be involved in the family business after the entrepreneur's retirement? Have certain candidates already been identified, trained, and/or prepared for the next steps? Does the entrepreneur want the ownership of his business to remain exclusively in the family, or is the owner open to involving third parties (including, for example, their children's spouses)? Will that apply to the business' management in the future? What is the entrepreneur's vision for his family, after his retirement? Should he contemplate a gradual transition? Should a family council be constituted? Should the decisions be made by a formal board of directors with or without third parties? Who should be protected in the event of a deadlock or unforeseen circumstance? Will his spouse be able to maintain a similar standard of living in the case of such unforeseen circumstances? If certain children are not involved in the business, will the succession plan disrupt the family dynamic or cause an economic imbalance between his children (and future generations)? Has the entrepreneur subscribed to a life insurance policy that is sufficient to cover taxes payable upon his death, and if not, who will bear such tax burden?

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## Reflecting the Entrepreneur's Reality in the Transfer of his Business

To answer these questions and plan the succession accordingly, the business owner should work with a team of advisors (i.e., notaries, lawyers, accountants, financial advisors, insurers and/or bankers) who will work together to implement a logical structure and prepare documents that are coherent with the entrepreneur's reality, family dynamic, and his business on a legal, tax, practical and human level. While the coherence between the various corporate and family documents is important, the understanding of such documents by all individuals involved is crucial, all in accordance with determined values and objectives. In planning a business succession, nothing must be left to chance.

In addition to corporate agreements and resolutions, these family-related considerations must be reflected in various important documents such as the shareholders' agreement. The shareholders' agreement will notably govern the ownership and transfer of the shares in view of maintaining ownership within the family after the entrepreneur's retirement. It will provide a clear decision-making process for the future. A voting agreement can also be prepared to ensure compliance with pre-established guiding principles. Finally, the entrepreneur's last Will and Protection Mandate will ensure that his spouse, children, and loved ones will be protected, resulting in a harmonious transition, while respecting the owner's objectives for the enduring success of his business.

To learn more about the human and technical aspects associated with business transfers and successions, please contact Natasha Girouard, Pascale Villani, Geneviève Vigneault, or Vincent Chaurette.

# Business Succession: An Incentive Plan to Retain Your Employees

By Marianne Desrochers, Lawyer,
Julie Lavigne, Partner and Lawyer,
and Geneviève Vigneault,
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# Business Succession: An Incentive Plan to Retain Your Employees

**In today's business world, skilled labour is becoming scarce and it is common for an employee to change jobs several times over the course of his career. As a result, it can be difficult for business owners to build a team that is committed to the business for the long term and to retain potential successors within the business.**

In this context, the implementation of an incentive plan for key employees of a business is a cornerstone in retaining these highly skilled employees. Indeed, such a plan may help in achieving following objectives:

- retain specific employees;
- promote the recruitment of skilled workers in a competitive environment;
- increase the employees' sense of belonging to the business in order to achieve a common objective; and
- align the employee's financial interests with the business' performance.

To that end, there are many incentive plans available to business owners. This article briefly examines the characteristics of frequently used incentive plans[1], which plans are divided in two main categories:

1. Bonus-type incentive plans, and
2. Quasi-equity or equity incentive plans

Each incentive plan has its pros and cons, depending on the objectives pursued by the business owner. One important aspect to consider in the implementation of an incentive plan is the tax impact this plan will have on both the corporation and the employees covered by the plan. In fact, an incentive plan favourable tax-wise for the employees may constitute an additional incentive for the retention of such employees. We have thus outlined, for each plan summarized below, the tax benefits (or negative impact) of such plan for the employee and the corporation.

## Bonus-type Incentive Plans

A bonus-type incentive plan (for example, a bonus payable annually based on certain individual or common objectives to be met or a phantom stock plan[2]) does not involve any change in the shareholding of the corporation and does not grant the employees any additional rights with respect to the corporation.

On the tax side, the employee will be taxed on this bonus as employment income, i.e. at a marginal tax rate of 53.31% (2019), and the corporation will be able to deduct the bonus from its income. However, the use of a bonus-type plan where the payment of the bonus (and the resulting tax) is deferred at a later date (for example, if we wish to allow the employee to receive the bonus only once he needs it financially or if for retention purposes, the bonus is payable following the achievement of some goals over a period of time) has its limits. In such a case, the taxation of such a bonus earned cannot be deferred for a period longer than 3 years. However, if specific conditions are met, this time limit will not apply to a phantom stock plan.

## Quasi-equity or Equity Incentive Plans

A quasi-equity incentive plan (for example, a stock option plan) or an equity incentive plan (for example, a restricted stock plan) is a solution halfway between a bonus and a direct and unconditional holding of equity by employees in the corporation.

### Stock Option Plan

The grant of stock options in favour of an employee allows him to have shares of the corporation issued in his favour at a preset price and at a predetermined time. The employee may exercise these options at a price equal to the fair market value of the underlying shares at the time the option is granted or at a discount. The option may be exercisable only upon the occurrence of a liquidity event (for example, the sale of the corporation's shares or assets) or upon the achievement of certain specific quantitative objectives (for example, the passing of a period of time or the corporation reaching a specific profit amount). This plan does not involve any change in the shareholding of the corporation and does not grant the employees any additional rights with respect to the corporation at the time of the grant of the options in their favour.

On the tax side, the grant of options has no tax impact for the employee or the corporation. The exercise of the option by the employee will trigger a taxable benefit for him equal to the difference between the exercise price paid by the employee and the fair market value of the shares at the time of the option is exercised but the inclusion of such benefit in his revenue will be deferred until the employee sells the shares. This benefit will be taxable for the employee as employment income, i.e. at a marginal tax rate of 53.31% (2019). However, if certain conditions are met, the employee will be able to benefit from a deduction which could lower the taxation of the taxable benefit to the same level as the taxation of a capital gain (i.e. 26.65%)[3]. In certain specific circumstances, the employer will be able to deduct the cost of such a plan from its income but in this event, the employee will not have access to his own deduction. Indeed, the employer will have to renounce to its own deduction in order to allow the employee to benefit from his.

Following the exercise of an option by an employee, the increase in value of the shares thus held by the employee between the exercise of his option and the sale of such shares will be taxable to the employee as a capital gain, i.e. at an effective marginal tax rate of 26.65% (2019).

## Restricted Stock Plan

In the case of a restricted stock plan, the corporation's shares are issued to the employee upon implementation of the incentive plan but are subject to restrictions on the increase in value of the shares, voting rights and dividend rights. As in the case of options, the restrictions may be lifted upon the achievement of certain specific quantitative objectives (for example, the passing of a period of time or the realisation by the corporation of a certain level of profit). The employee may acquire these shares at their fair market value or at a discount. It is also possible for the employee to pay for these shares by renouncing to portion of his salary. This plan involves a change in the shareholding of the corporation since the shares of the corporation are issued to the employee from the outset. Employees will therefore have the right, for example, to review the corporation's financial statements but in this context, it will also be possible for the corporation to tighten the non-competition and non solicitation obligations of such employee shareholders.

On the tax side, the issuance of the shares in favour of the employee has no tax impact for the employee, the taxation (if any) being deferred to the time of the sale of the shares by the employee. If the shares were issued to the employee for a price equal to their fair market value, the increase in value of the shares between the time of issuance of the shares and the time of their sale will be taxable to the employee as a capital gain, i.e. at an effective marginal tax rate of 26.65% (2019). However, if the shares were issued to the employee at a discount, the difference between the fair market value of the shares at the time of their issuance and the discounted value actually paid by the employee will be taxable to the employee as employment income, i.e. at a marginal tax rate of 53.31% (2019) while the increase in value of the shares will be taxable to the employee as a capital gain. As in the case of options, the employee will be able to benefit from a deduction which can lower the taxation of this taxable benefit to the same level as the capital gain (i.e. 26.65%) if certain conditions are met.

Finally, in the context of a stock option plan and of a restrictive stock plan, it is advisable to have an agreement signed between the corporation and the employee to govern, among other things, the share holding (once the shares are issued) as well as the rules relating to the transfer of the shares.

The incentive plans presented above are examples frequently used by Quebec businesses, but there are a multitude of them that can be adjusted according to the specific needs and objectives of a given business and the field in which it operates.

For further information on employee incentive plans, contact Marianne Desrochers, Julie Lavigne or Geneviève Vigneault.

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# Governance, a Key Element in Successful Business Succession Planning

By André Ryan,
Partner and Lawyer

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# Governance, a Key Element in Successful Business Succession Planning

**One word in particular has been the subject of much attention in recent years: "governance". Governance is linked to several adjectives including "healthy", "good", "bad", "modern", and "inadequate". Expressions that contain the word governance are often overused, misused, and misappropriated.**

As a result, when a company faces any sort of challenge, it is quickly attributed to a governance problem. This is not always the case, but it is true that entrepreneurs can often avoid major challenges by planning and taking appropriate measures in a timely manner. Below are a few important points that will help to demystify governance and make entrepreneurs aware of the increasing importance of governance in business management.

## What Do We Mean by Governance?

Several definitions of governance are available in scientific publications, company law, and business-management faculty publications. Many organisations, faculties, and management schools have, in recent years, begun to specialize in the study of governance and the promotion of measures aimed at raising awareness of and improving governance. IGOPP[1] defines governance as follows:

"Governance, in its fiduciary form, consists in implementing all the means for an organisation to achieve the ends for which it has been created in a manner that is transparent, effective and meets the expectations of its stakeholders. Governance is thus made of accountability rules and operating principles implemented by the Board of Directors to define the strategic orientations of the organisation, ensure supervision by management, assess its economic and social performance and promote the emergence of values of integrity and excellence within the organisation."[2]

We can see that governance is comprised of a series of rules and regulations that have been implemented to ensure the overall success of the company. Even though corporate governance rules are often embodied by the company's Board of Directors, it is not always the board that applies these rules. In order to fully understand the importance of governance nowadays, we must think of it as encompassing all the measures taken by a company to ensure that work is coordinated, goals are defined, control mechanisms are in place to monitor activities, and the interests of its stakeholders are taken into account.

For several years, it was believed that governance was only applicable to publicly-trade companies or government enterprises. However, it is now generally recognized that it serves a purpose in companies of all sizes and business sectors.

## Who Are the Stakeholders?

The stakeholders of a company are, naturally, shareholders, and also employees and partners, clients, suppliers, community members where it is active, public authorities to which the company is subject, and, generally speaking, all persons and entities with whom the company deals when conducting business. Canadian law differs slightly from US law when it comes to the role of business leaders and directors versus company stakeholders, for example. South of the border, it is generally recognized that directors only have to take the company and its shareholders into account when carrying out their duties. In Canada, it is recognized that the interests of every company shareholder must be taken into account during the decision-making process[3].

This entails that an entrepreneur, for example, before paying a dividend or repaying a debt, must consider whether the decision takes into account the interests of certain providers and clients and the company banker.

Most of the time, this is a reflex on the part of entrepreneurs, but given the increased importance of governance and its introduction, over the past 15 years, into everyday business language, governance must be carefully considered and taken into account when making both large and small decisions that influence the operations of every company, regardless of its size.

## Does Governance Have to Be Analysed When Planning Business Succession?

For several years, it was believed that governance was only applicable to publicly-trade companies or government enterprises. However, it is now generally recognized that it serves a purpose in companies of all sizes and business sectors. We must avoid thinking that the introduction of governance into such business environments can fossilize operations or make the company less versatile. On the contrary, sound governance rules that are tailored to the company serve to maintain flexibility while offering additional protection against improvisation and unnecessary or avoidable risk.

We believe that this becomes particularly evident when the time comes to plan business succession. Whether succession is being planned in the event of a handover to the next generation, an MBO[4], or a merger with another company, the governance structure must be carefully considered so as to ensure a successful transition. For example, when a family business is transferred to the founder's children, the structure of the company's Board of Directors must be reviewed. What will the role of the primary company founder be? If the founder is a father or uncle, will he remain President of the Board of Directors? Will the company accountant be asked to serve on the Board or to lead an audit committee if the founder wishes to track the results? If the managers and founder acquire the company, how will they divide up the management responsibilities? Who will act as President and who will serve on which advisory committee?

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All of these questions must be considered when finalizing the transaction and also in advance. Parents, for instance, may be hesitant to transfer their company to their children because the parents are unsure whether their children will be capable of adequately fulfilling certain business functions. The implementation of a sound governance structure could alleviate any such concerns. Another solution could involve hiring an Executive Director or a competent Finance Manager if the parents worry about how well their children can manage company finances.

Our team of professionals know exactly what governance entails and they can adapt the structure to the needs of your company.

# How Will Selling Your Company to Your Managers Influence the Transaction?

By Nathalie Gagnon,
Partner and Lawyer, and
Genevieve Martin, Lawyer

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# How Will Selling Your Company to Your Managers Influence the Transaction?

**Many business owners who, in the short or medium term, intend to sell their company, will consider doing so to the company's management team; one of the reasons being their extensive knowledge of the business.**

The management buy-out, or MBO, is a transaction with its own set of challenges. An MBO differs from a sale to a third party in a number of ways; this may relate to how the transaction will be financed, the dynamics of employer-employee negotiations, the schedule, or the representations and warranties given by the seller.

Therefore, to maintain an overall view of the sale of their company, a business owner must bear in mind certain elements, including the following:

- The financial aspects
- The employer-employee relationship
- The timeline
- Risk cut-off

## The Financial Aspects

Financing plays a key role in an MBO. Employees who purchase a business often have limited financial capacity and must rely on financing from financial institutions, partners or the selling owner.

An MBO transaction therefore often includes a balance of sale payable to the selling owner over a period of time. The vendor is then essentially paid with the profits generated by the company following the sale: as a result, the balance of the sale price is at risk if the company's profitability decreases. In these circumstances, the selling owner may wish to remain actively involved in the company following the sale, not only to ensure a successful transition for the managers, but also to protect their own financial interests.

As in all cases where there is a balance of sale, the vendor must be provided with a guarantee for the balance of the sale price, namely in the form of a security on the assets or shares. However, due to the financing in place, the vendor must bear in mind that any guarantee on the balance of sale will be subordinated to any guarantees given to financial institutions. This means that the seller will not receive their balance of sale if the company defaults on its obligations to financial institutions, regardless of previous agreements between the buyer and the seller.

An MBO essentially consists of three transactions in one: the financing, the sale, and the agreement that manages the post-closing partnership, with both the seller and with the other members of the management team.

## The Employer-Employee Relationship

The dynamics of the negotiation are always a determining factor in a successful transaction, but even more so in the context of an MBO. If the buyer wishes to rely on the seller for a smooth post-closing transaction, then maintaining transparent and courteous communications between the seller and the buyer becomes essential. This is especially relevant if, for whatever reason, the transaction were to fail, as the selling owner could be at risk of losing their management team if the parties fail to maintain a good relationship throughout the negotiations. In fact, the more advanced the transition between selling owner and manager, the more important it is to sustain a good relationship, as the blow will be even greater if the manager decides to leave following the failure of the transaction.

Moreover, if the vendor must be involved in the company's business following the transaction, whether to ensure the transition of responsibility or to protect their own financial interests, it is important to properly manage their role and responsibilities to avoid potential misunderstandings and conflicts.

## The Timeline

An MBO essentially consists of three transactions in one: the financing, the sale, and the agreement that manages the post-closing partnership, with both the seller and with the other members of the management team. These three transactions must be coordinated to ensure they are carried out simultaneously. In doing so, this can have a significant impact on the timing of the transaction.

Particularly in the context of an MBO, it is in the seller's interest to actively follow-up on the buyer's financing status, as this is often what will cause additional delays in the transaction or prevent the transaction from taking place. Occasionally, it even occurs that the selling owner is more involved in researching and securing financing.

The scope of the due diligence performed by a purchasing manager can have a positive impact on the timeline. If the transition of operations in favour of the buying manager has been initiated before the transaction, this can sometimes mean that the manager has a better knowledge of the company than the selling owner and that their due diligence is therefore very limited. However, if the manager is receiving financial support from an institution or financial partner, they may wish to expand their due diligence, much like a third party would do in the same circumstances. The trust between employer and employee also influences the scope of the due diligence conducted by the manager. For example, if the employee knows that their employer is a shrewd negotiator, their tax and financial audit of the company will undoubtedly be more thorough.

Another important element to consider is the degree of involvement of the vendor when selling their business. This factor is amplified in an MBO transaction, because not only must the vendor be actively involved in the sale process, so must the buying management team, while still ensuring the continuity of the company's daily business.

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## Risk Cut-Off

Lastly, the impact of the vendor's representations and warranties of the company is pivotal when negotiating an MBO transaction. The representations and warranties are essentially an image of the business and relate to several topics, including the environment, buildings, employees, finance and taxation. If any of the representations and warranties were found to be false or inaccurate, the buyer would have the option of claiming compensation from the seller for damages .

The selling owner may often wish to limit the extent of the representations and warranties they give regarding the business, as the buying manager often knows the business very well (if not better). On the other hand, the buyer will consider that since it was the vendor who benefited from the company's profits during the period prior to the sale, the vendor must therefore bear the risks related to the company's past. This argument is all the more valid if the buying employee pays for the company at its full value: in addition to paying the full price, they will not want to bear the risks relating to past transactions. One possible solution would be to simply stipulate that the seller will bear responsibility for the past, and the buyer for the future.

The financial aspects, the employer-employee relationship, the schedule and risk cut-off are some of the elements that every business owner must keep in mind for a clear overview of their transaction. These considerations will provide guidelines for transferring their business to their managers.

To learn more about the ins and outs of an MBO, contact Nathalie Gagnon and Geneviève Martin.

# About BCF

With more than 500 employees and 275 professionals, BCF Business Law is the go-to firm for business leaders, growing companies, and well-established global enterprises that have chosen Quebec and Canada as a stepping stone to growth and success. Our entrepreneurship not only distinguishes us from the competition but has earned us the recognition of one of *Canada's Best Managed Companies* for the 12th year in a row.

BCF understands its clients' business which makes us the ideal partner for ambitious startups, well-established private and public companies, investment bankers, venture capital and private equity firms. BCF's pragmatic and forward-thinking solutions turn clients' dreams into viable and innovative businesses. Our relentless pursuit of excellence has earned BCF the trust of companies in all sectors of activity throughout Quebec, Canada and the world.


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# Notes

**Business Transfer: Ensuring the Continuation of Your Business**

[1] Sources: Chamber of Commerce of Metropolitan Montréal and Centre de Transfert d'Entreprise du Québec (Centre for Company Transfer in Quebec)

**Business Succession: An Incentive Plan to Retain Your Employees**

[1] In the context of a Canadian-controlled private corporation.

[2] A phantom stock plan is a plan that allows an employee to receive a bonus based on the variation in value of the corporation's shares, although he is not a shareholder.

[3] It should be noted that in the March 19, 2019 federal budget, the Minister of Finance announced that amendments would be made to the taxation of stock plans to limit the deduction that can be claimed by an employee benefitting from such a plan. The details of these amendments are expected before summer 2019.

**Governance, a Key Element in Successful Business Succession Planning**

[1] Institute for governance of private and public organizations, a Quebec company that is renowned as a leader in governance in both the private and public sectors.

[2] The IGOPP article entitled "Governance in short" can be found here: https://igopp.org/en/igopp/governance-in-short/ (our translation).

[3] The importance of taking the interests of stakeholders into account came to the fore during a case in the 2000s, following the Supreme Court landmark ruling regarding Peoples Department Stores Inc. (Trustee of) v. Wise, [2004] 3 S.C.R. 461.

[4] MBO (Management Buy-Out) involves the purchase of a company by its managers. Please consult Nathalie Gagnon and Geneviève Martin's article entitled "How Will Selling Your Company to Your Managers Influence the Transaction?" on the BCF website.

**How Will Selling Your Company to Your Managers Influence the Transaction?**

[1] Subject to certain restrictions in the sales agreement.

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