Strategies for Protecting the Business After an Owner's Death

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After a business owner dies, there is often confusion about who has the right to manage the business and access business records. Family members may assume that they have ownership and management rights when in fact they do not. When these family members overreach into business affairs, litigation may be required to straighten out the dispute. Litigation is costly and could delay the beneficiaries from receiving their full inheritance.

Unfortunately, many small business owners in closely-held companies are not prepared for such a situation. This article discusses a few case studies and provides strategic guidance for protecting a business after a business owner's death.

CASE STUDIES

In one of our firm's cases, the decedent, whom we will call Adam Evers, was survived by his estranged wife, Barbara, his son, Carl, and Adam's long-time boyfriend, Denny. Though Adam had prepared an estate plan in which he provided for Barbara and Carl in his trust, he left other personal belongings and his company, Adam Gadgets Inc., to Denny, who had helped him run it for decades. A few days after Adam's death, Barbara directed Carl to go to Adam's office and take documents, personal belongings, and anything else he could find relating to Adam Gadgets' financial and tax affairs.

In another of our cases, the decedent, whom we will call John Rogers, owned 50 percent of a company called Jolly Rogers Corp. His business partner, Bobby, owned the other 50 percent. John was divorced and had two adult children, Dean and Sam. In his will, John named his lawyer, Mary, as personal representative. But before the court appointed Mary as personal representative, Dean and Sam went to their dad's office to look for certain personal items and to find out what was in Jolly Rogers' profit sharing plan. They ultimately took both personal and business effects, including business records, from the office without Bobby's permission.

The actions of Carl, in the first case, and Dean and Sam, in the second case, were improper for similar reasons. First, Carl's father, Adam, was the sole owner of Adam Gadgets, and Dean and Sam's father, John, was a 50 percent owner of Jolly Rogers—but neither Carl, nor Dean and Sam, were owners of the respective businesses when they entered the company premises and absconded with company records. Second, even if they were owners, they likely exceeded the rights and privileges granted to an owner (who is not a director or officer) under the business laws of most states.

ADAM, DEAN, AND SAM WERE NOT OWNERS

Adam died with an estate plan in place, and he had transferred his business interest into his revocable living trust prior to passing. He had designated an administrative trustee whose appointment became effective immediately upon his death. The administrative trustee, therefore, was the sole owner of Adam Gadgets until it was appropriate to distribute the shares to Denny. Carl was never to have any interest in the company.

John, on the other hand, died with a will in place in which he left all his assets—including his 50 percent interest in Jolly Rogers—to Dean and Sam. However, he had designated Mary to act as his personal representative. When Dean and Sam took property from the company offices, Mary had yet to be appointed. Between John's death and Mary's appointment, there

was nobody with authority to act as owner with respect to John's shares in Jolly Rogers. Upon Mary's appointment, only Mary—and not Dean or Sam—was the putative owner of John's shares. Dean and Sam only became owners of Jolly Rogers upon the later distribution of assets from the estate to John's heirs.

EVEN IF THEY WERE OWNERS, THEY EXCEEDED THEIR RIGHTS AS OWNERS

In a small business, where the majority of these problematic cases arise, the business partners are usually the only owners of the company. Owners are entitled to review company books and records and have other statutory rights. All business assets, however, belong to the company, not to the owners, and thus owners may not simply take company documents or records. Personal property of a decedent may be more complicated if it is left in the company offices. Though personal property belongs to the estate and, ultimately, the beneficiaries of the estate, its location in the company offices can give rise to disagreements over whether a particular item is personal or business property. Regardless, all company books and records, including files, tax records, and other business account information belong to the business and not to any individual owner.

Owners also have the power to elect directors or managers with a fiduciary duty to act on behalf of all owners of the company. These directors or managers then have the authority to appoint officers, who retain the same fiduciary duty and are charged with actually operating the business. In closely-held businesses, these roles are often held by the same persons—until someone dies. It is important to understand that, when a business partner dies, only her shares are an asset of the estate to perhaps pass to her heirs. The decedent's position as a director, manager, or officer of the company do not pass, and those seats sit vacant until a successor is elected. The only people authorized to act on behalf of a company are the directors, managers, and officers. Simply becoming a successor owner does not grant someone the authority to act on behalf of the company. A successor owner only has the power to request accountings and review company books and records, and even then she must provide notice prior to exercising this authority.

UNDERSTANDING BENEFICIARY MOTIVATIONS

If the consequences of seizing business documents are so material, then why do individuals still do it? For some offenders, the motivation is avarice. A covetous beneficiary might not want to wait for the conclusion of a probate or trust settlement process, instead choosing to find out for himself how much "his share" of the business is worth. In other cases, the beneficiary and the business partner might not have always seen eye to eye, causing surviving family members to distrust the partner. A person may be driven to abscond with business documents by a fear of being cheated. Even if the family trusts the partner, they may want to know if the business has surplus cash or other benefit plans which could be beneficial to them. The family may feel that they must bring themselves up to speed as soon as possible in order to affect a seamless transfer of authority from the decedent to them.

Usually, however, the motivations are driven less by distrust, and more by simple ignorance. Often, the family simply does not understand its role in the company after the decedent's death. Just as many small business owners have difficulty separating the personal from the professional, and essentially operate their businesses as their alter egos, so too do their families have difficulty with that distinction, especially during a time of grieving. The family might believe they are entitled to the decedent's property without distinguishing between personal or business assets. They might simply view it as "dad's company," and not fully understand the different roles of an owner versus a director, manager, or officer. The family may, in the days after a death, wrongly assume that ownership rights automatically transfer, without understanding the necessity of probating an estate or administering a trust—and so they may fail to understand that, for a time, the proper owner is not the ultimate beneficiary of the business interest but rather the personal representative (once appointed) or administrative trustee.

REPERCUSSIONS OF FAMILY INVOLVEMENT

In the first case, Denny knew that Adam had left Adam Gadgets to him alone, and took great umbrage at Carl's actions. When he discovered that the documents had been taken, he withheld his assent to appoint a personal representative until all items and documents were returned. The resulting deadlock tied up the estate for months and cost all parties unnecessary expenses and aggravation.

In the second case, Bobby had no real love for Dean and Sam and was not looking forward to being in business with them. He established out of the gate that he would tolerate no shenanigans from them, so he had his attorney draft a letter threatening criminal and civil sanctions if the documents were not returned immediately.

Most small companies cannot afford to spend the time and resources necessary to fight these battles. The unauthorized seizure of business documents, even with the best of intentions, will inevitably interfere with the day-to-day operations of the company. Moreover, the surviving loved ones of clients who take these actions wind up spending enormous sums of money unnecessarily. Furthermore, the offenders themselves can be charged with unlawful activity including theft and trespassing. These misguided actions of well-meaning individuals can initiate a domino effect that will delay events, frustrate parties, and poison relationships.

STRATEGIES FOR PROTECTING THE BUSINESS

There are several strategies that attorneys can use to protect a business after an owner's death. The exact strategy to employ depends on whether the attorney is consulted before or after the deceased owner's death.

PRE-MORTEM STRATEGIES

For a small business owner, estate planning is incomplete without business succession planning. We recommend all our business owner clients have a conversation with their business partners sooner, rather than later, about critical transition issues should one of them predecease the other. We encourage our clients to then document their consensus in a shareholder agreement (or equivalent document for non-corporate businesses) or a buy-sell agreement (collectively hereinafter referred to by the generic term "owner agreement" to remain neutral as to the type of business).

An owner agreement is exactly what it sounds like—a contract between the owners of a company to prospectively address a number of future potential conflicts. Most often, an owner agreement will contain buy-sell provisions specifying certain triggering events that require an owner to sell her equity to the company or its other owners. Triggering events can include an owner's desire to sell her equity to a third party, an owner's bankruptcy or divorce, an owner's

lack of participation in the day-to-day operations of the company (i.e., as an officer or employee), or an owner's death. The philosophy behind each triggering event is the same: to prevent the remaining owners from inadvertently becoming business partners with someone with whom they had no intention of entering into a business relationship, whether that be a third-party acquirer of the shares, an owner's ex-spouse or creditors, an owner who is no longer meaningfully contributing to the company's success, or an owner's heirs.

Buyout rights are often elective, whereby upon a triggering event the company or other owners may—but are not required to—purchase the exiting owner's shares. If they decline to do so, the shares may pass to the proposed new owner. However, if the triggering event is the death of an owner, it is not uncommon to require the company to repurchase the shares from the decedent's estate. The purchase is often funded by life insurance held by the company on the life of each owner, or by each owner on the lives of the other owners. Not only might the remaining owners not wish to be in business with the decedent's heirs, the heirs may not have any interest in retaining ownership of the shares. An agreement requiring the company to repurchase a deceased owner's shares satisfies both interests, allowing the beneficiaries to receive cash in lieu of the shares.

A properly drafted owner agreement can also preemptively address any dispute which may arise around the proper value of the company in the event of a buyout triggered by the agreement. Such an agreement will dictate a system for determining the value of the repurchased shares—whether that be a specific formula or an appraisal methodology (each with advantages and disadvantages).

An owner agreement may also address the operation of the business after the death of an owner. For instance, a provision might direct that after the death or incapacity of a partner, everything not considered normal business activity must be frozen for a specified amount of time—a certain number of days, for example, or until the appointment of a personal representative. Such a provision might prohibit a company from hiring or firing key employees, selling assets, or entering into material contracts other than in the ordinary course of business. This will ensure that the nature of the business does not materially change before a personal representative can be appointed. Once the appointment occurs, all business activity may resume, as the personal representative can then vote the decedent's shares.

While an owner agreement can go a long way in resolving potential conflicts that may arise after the death of an owner, they rarely address situations where an owner is still alive but is incapacitated, and therefore unable to effectively exercise his rights as an owner. To that end, we recommend our business owner clients execute a business power of attorney that clearly identifies who is empowered to take what actions with respect to the owner's business interest during periods of incapacity. Sometimes the appointed agent is the owner's business partner; sometimes it is a trusted family member or professional advisor.

We strongly recommend that our clients keep copies of all business agreements with their estate planning documents. We do this for three reasons:

Owner agreements, business powers of attorney, and similar documents are part of a well-drafted estate plan for a business owner client. They should be stored with other estate planning documents so the entire plan can be viewed and considered as a whole.

It is common for a family to review a decedent's estate planning documents upon his death. If the relevant business agreements are stored with the estate planning documents, then the family will have access to them immediately upon an owner's death and will have a good understanding of their rights, privileges, and obligations regarding the company. This can help obviate the urge to enter the company premises to search for and take company records.

Often the business agreements are more beneficial to the decedent's estate than to the surviving owners. In such a case, it is not unheard of for those agreements to "disappear" from the decedent's office and for the remaining owners to claim that they never existed, or that they existed only in draft form and were never executed. Proving otherwise can be difficult—unless the decedent stored copies of the signed agreements with his estate planning documents outside the company's offices.

POST-MORTEM STRATEGIES

After an owner's death, two steps should be taken as soon as practicable by the attorney probating the estate or administering the trust. First, early in the process the family members should understand their rights to the business assets and that they likely do not have the authority to enter the business premises and take business records. With luck, this conversation can occur before they have already done so.

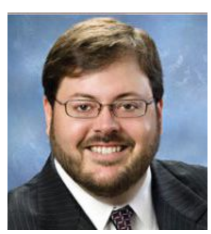
Second, the administrative trustee or personal representative should carefully consider what documents and information relating to the company they may need to meet their fiduciary duties regarding that asset. The trustee or personal representative should write a letter to the president of the company to either request copies of all such documents, or to schedule a time to visit the company premises and review them.

CONCLUSION

The death of an owner in a closely-held company can be messy, especially if the business interest is not passing to his family or if there is a surviving business partner. If not handled properly, this situation can be difficult and expensive for trustees or personal representatives, family members, heirs, and surviving business partners alike. Many potential issues can be resolved in advance, prior to death, through a properly drafted owner agreement. In addition, it is also important to promptly address certain issues after an owner's death both to minimize the likelihood of a family member or business partner acting inappropriately, and to enable trustees and personal representatives to comply with their fiduciary obligations.

ABOUT THE AUTHORS

Scott E. Squillace is the founder of Squillace & Associates, P.C., a boutique law firm in Boston's historic Back Bay. He is the author of the book Whether to Wed: A Legal and Tax Guide for Gay and Lesbian Couples in addition to numerous articles and course material on estate planning. Scott is a frequent speaker on estate planning for the LGBT community and has been quoted by the national press, including the New York Times, Wall Street Journal, Boston Globe, and Associated Press. Prior to doing estate planning, Scott was a corporate lawyer with Skadden Arps and a general counsel for a number of companies.



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