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LIVING TRUSTS HOLD SURPRISES FOR OWNERS OF CLOSELY-HELD BUSINESSES

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Living trusts are useful estate planning tools. They avoid the publicity, delay, hassles and fees of probate proceedings and are an elegant way to solve several estate tax problems. Closely-held business interests held in living trusts avoid the necessity of a public, less-than-thorough valuation of the business in the probate proceeding. A husband and wife who have just signed their living trust can walk out of their estate planner's office knowing that they have done well by their families. Unfortunately, they might not have done as well by the other shareholders.

Example. A, B, C and D each holds 25% of the outstanding shares of a California corporation, and the four of them are the directors. While A and B vote together, they can stop any initiatives of C and D. A puts A's shares into a living trust of which A and A's spouse Z are the trustees. The trust gives the trustees the power to vote shares held in trust, and says nothing more about voting. After a few years, A and Z disagree about many things, including how the shares should be voted. At a shareholder's meeting, A votes to elect A as a director and Z votes to elect Z as a director. The corporate secretary splits the votes of A and Z. Cal. Corp. Code § 704(3). A and Z would tie for the fourth board seat. The three-member board of B, C and D might fill the vacancy by electing a friend of C and D to the fourth seat. Now C and D are in control. (In an new election to break the tie, C and D might vote for Z, who would take the fourth board seat. This would also disadvantage A and B, but C and D probably would prefer their own nominee to Z, whose vote might be difficult to predict.) H. Marsh, Jr., R Finkle, L Sonsini, MARSH'S CALIFORNIA CORPORATION LAW, ch. 12 at fn. 20 (4th ed. 2004). Or C and D, with or without Z's vote, could amend the bylaws to provide for a fifth director, which they could elect if A and Z split their votes. A and B are both disadvantaged and B asks, "How could this happen?"

Buy-Sell Agreements. Shares are freely transferable. Unless the shareholders restrict this right in a buy-sell agreement or shareholders agreement, a shareholder is free to transfer shares to anyone, including a spouse or trustee. The first and best line of defense is a buy-sell agreement that addresses this issue. It can apply equally to all of the outstanding shares and all shareholders. Here is a provision that addresses these concerns:

> A Shareholder [defined by name] during his or her life may transfer Shares to a trust, but only if (1) the trust is established by the Shareholder for the benefit of such Shareholder or such Shareholder and the Shareholder's spouse, and (2) the Shareholder serves as sole trustee (or, if the Shareholder's

spouse is a party to this Agreement, either the Shareholder serves as sole trustee or both the Shareholder and the Shareholder's spouse serve as the sole trustees) of the trust until the Shareholder's death or incapacity. Any Shares so transferred shall remain subject to all of the provisions and restrictions of this Agreement and the Shareholder, both individually and as trustee of the trust, shall continue to be considered a "Shareholder" for purposes of this Agreement. (If a spouse is a trustee, the spouse shall continue to be considered a spouse of a Shareholder with respect to the Shares held in the trust.)

The parties intend that each Shareholder's Shares shall retain their community or separate property character, which this Agreement is not intended to affect. The rights of a spouse of a Shareholder in the Shareholder's Shares shall be limited to the extent of any community property or other joint ownership interest, if any, that the spouse may have or acquire in the Shares. As between a Shareholder and the Shareholder's spouse, the Shareholder shall exercise the sole management and control of the Shares to the fullest extent permitted by law, even if the stock certificate representing the Shares bears the names of both the Shareholder and the Shareholder's spouse. To the extent permitted by law, the parties agree to waive the provisions of Section 704 of the Corporations Code so that only the vote of the Shareholder shall be respected, even if the Shares are registered to the Shareholder and someone else.

Community Property Law vs. Corporate Law. Shareholders who get along well trust each other not to transfer shares in a way that will hurt the other shareholders. But transferring to a living trust is so common and innocuous, no one worries about it. The estate planner has as clients the couple in the estate planner's office, and is not answerable to the other shareholders. (However, many estate planners will encourage the owner of a closely-held business to enter into a buy-sell agreement with the other shareholders.) In fact, naming only one spouse as trustee will make the estate planner nervous. "They both have a community property interest in the shares now," the estate planner reasons. "Why not make them both trustees of their community property?"

Estate planners are familiar with Family Code Section 1100(d), which provides:

> [A] spouse who is operating or managing a business or an interest in a business that is all or substantially all community personal property has the primary management and control of the business or interest. Primary management and control means that the managing spouse may act alone in all transactions but shall give prior written notice to the other spouse of any sale, lease, exchange, encumbrance, or other disposition of all or substantially all of the personal property used in the operation of the business …, whether or not title to that property is held in the name of only one spouse.

However, Section 704(3) of the Corporations Code requires the corporate secretary to respect the vote of each spouse or trustee named on the stock certificate, unless one of them provides the secretary with written notice why the secretary should not

count the other's vote and documents the basis for the conclusion. Because neither the Family Code provision nor the Corporations Code provision states that one supersedes the other, it is unlikely that the corporate secretary will be persuaded that the Family code provision allows the secretary to ignore Z's vote if Z is a shareholder of record.

Shares Held by Individuals. With this in mind, the best practice for titling shares not in trust is to use the name of the shareholder who is active in the business and nothing else, relying on the presumption that property acquired during marriage is community property. Cal. Fam. Code § 760. Adding ", a married man" or ", a married woman" by itself indicates that someone intended the presumption to apply, but it does not add to the fact that the shareholder is married and the shares are not separate property. If the non-active spouse wants to see his or her name on the certificate, my strong preference is to use "A, as the community property of A and Z, husband and wife." This usually will satisfy Z, but it should not entitle Z to vote the shares, because it only indicates that Z has a community property interest in the shares. In contrast, "A and Z" or "A and Z, husband and wife, as their community property" each makes Z a shareholder of record and permits Z to vote pursuant to Corporations Code Section 704.

Shares Held in Trust. With a living trust, the trust instrument should create a subtrust to hold shares of a closely-held business. This is especially true when the shares are separate property acquired by gift or inheritance. Here is a sample provision:

With respect to shares of Company, Trustors intend that only A shall exercise the powers set forth in [the Powers of Trustee provisions], so long as A serves as a Trustee of the trust. Title to such shares shall be held in the name of A, as Special Trustee. If A becomes unwilling or unable to act as Special Trustee, the successor Trustee provisions of this trust instrument shall apply.

This is in addition to special trust provisions for holding shares of a closely-held business and S corporation shares.

Addressing these issues with a subtrust or by keeping a non-active spouse's name off the stock certificate is a temporary, partial solution. That horse is in the barn, but the barn door is still open. In contrast, the buy-sell agreement or shareholders agreement can apply equally to all shares and all current and future shareholders.

Put the Shares in the Trust. A final note – The living trust cannot avoid probate for those assets that the owners do not put into the living trust during their lifetimes. A corporate attorney who handles a stock certificate for even a moderately wealthy client should ask the client if the client has a living trust. If so, the shares probably should be transferred to the living trust. The estate planner who wrote the trust can quickly confirm this and can provide the exact wording for title to the shares. If the client does not have a living trust and has not recently considered his or her estate plan, the corporate attorney should advise the client to sit down with an estate planner.

Most principals of successful closely-held businesses should have a living trust, especially if they are married or have children. But the trust should have a special subtrust to hold shares of the business, to avoid problems among shareholders.

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