BusinessAdvisor
a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON

VOLUME 39
NUMBER 3
MARCH
2023

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About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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THE DEATH OF A BUSINESS OWNER: How Trusts and Entities Help

by Mary Hanson

When a business owner dies the employees of the business, vendors, customers, and other parties to contracts with the business may feel a vulnerability close to panic due to uncertainties about ownership, control, and continuation of the business. The stress would be less if business owners took steps to provide for a smooth transition of control of the business. The use of trusts is key to facilitating a prompt transfer of control and authority to take the best courses of action for the business.

Operation of a business as a corporation or LLC owned by a trust provides the best situation for unimpaired continuation of the business in the event of the death of a business owner. A sole proprietorship without a trust has little likelihood of survival unless the business is quickly sold or distributed to an heir after the death of the business owner.

Business owners should be aware of the benefits of trusts, corporations, and LLCs in the event of their deaths.

When a Business Owner Has No Trust or Entity

In California when a sole owner of business dies and the business is not incorporated or operated under an LLC and the business assets are not held in a trust, the business, along with other assets or property owned by the deceased individual, are disposed of in accordance with California probate law. California probate law, like that of other states, limits the continued operation of a sole proprietorship to a certain period of time. In California the business must be sold or liquidated within six months from the appointment of an administrator or executor ("personal representative") of the estate, unless the probate court approves continuation of the business beyond that limit.

Probate is a formal legal process in a state probate court in which a personal representative is appointed to administer the estate of the deceased individual and distribute the estate assets to the beneficiaries of the estate. Having the assets or ownership of a business go through the probate process is not an ideal situation for a business. First, it typically takes a number of weeks before an executor is authorized by the probate court to administer the estate of the deceased business owner, including the assets of the business. Any delays resulting from inaction or disputes do not help the business situation. Until a probate court has authorized an executor or administrator to act on behalf of the estate, the lack of clear control impairs management of the business and the business is likely to lose employees, customers, and sales.

Once a personal representative is appointed by the court that person has authority to manage the business and may obtain authority to sell the business. If continued operation of the business requires new management, additional funds, or replacement employees, immediate sale of the business may be necessary and the personal representative may utilize expedited probate procedures to sell the business before it suffers further deterioration.

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Trusts

The use of a trust avoids probate. To make use of a trust a business owner creates a trust to hold all the assets he or she owns, including business assets, shares of stock in a corporation, and ownership interests in LLCs. In the event of the business owner's death, the trustee of the trust changes from the business owner to the successor trustee named in trust documents. Upon the death of the business owner, the trust is administered outside of probate in accordance with the terms of the trust document. The successor trustee controls the business assets without any filing in probate court and without the naming of a personal representative.

The authority of the successor trustee is established in the trust document, which may provide broad powers or may impose limitations or requirements on the successor trustee. In any event, the trust avoids probate and facilitates the prompt implementation of the business owner's plan for disposition of the business.

For a business owner operating a business as a sole proprietorship, the use of a trust is essential for facilitating the continuation – or prompt sale – of the business after the death of the owner. The successor trustee could run the business, sell the business, or do whatever the trust indicates is to be done with the business. The terms of the trust define the authority and powers of the trustee.

Corporations

Even without the use of a trust, a corporation may offer some insulation from the delays and requirements of probate procedures in the event of the death of the sole shareholder of a corporation.

A corporation continues whether or not the corporation's owners (shareholders) are deceased. The corporation continues as a "person" under the law, a taxpayer for tax purposes, an employer to its employees, and a party to its contracts. If there are employees of the corporation who are operating the business or are capable of operating the business, the business has the ability to continue. If the cash flow of the business is positive, paychecks are signed, and there are no other critical weaknesses in the business, the business may continue well, even as the deceased owner's shares of stock go through probate.

If the deceased owner was not only the sole shareholder, but also the sole director and all the officers (president, secretary, and treasurer of the corporation), there is greater vulnerability. But as long as the business of the corporation can be continued until the personal representative obtains authority and control from the probate court, the business may face a good outcome. The personal representative of the estate is effectively the sole shareholder and may name a Board of Directors, which then names new officers. The Board of Directors may hire new management, hire consultants to advise on disposition of the corporation, or continue operation of the business until the ultimate disposition of the shares of stock to beneficiaries, or the sale of the business.

An individual owner without a trust who wants to improve the prospects of smooth continuation of the business in the event of his or her death would be wise to make sure there is another person on the Board of Directors. California law provides that a

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remaining director has the authority to fill a vacancy on the Board of Directors caused by the death of a director. The new Board of Directors could fill management vacancies without the delays resulting from probate requirements.

Corporations Owned by a Trust

If the shares of stock in a corporation are held by a trust (i.e., the 100% business owner created a trust and the trust was named as the shareholder of the corporation), then upon the death of the business owner, a successor trustee controls the trust which is the corporation's shareholder. The trust ownership keeps the shares out of probate court and enables the successor trustee to operate the business (or to sell it, liquidate it, or any other action, provided that the trust document gives that authority). The successor trustee, as the sole shareholder, can name himself or herself or someone else as the new Board of Directors to replace the deceased owner. The Board of Directors can name new officers, can hire consultants or advisors or new employees to continue the business or to provide guidance on continuation or disposition of the business.

If the business or the corporation are not sold while under the control of the trustee, the shares would ultimately be distributed to beneficiaries of the estate in accordance with the terms of the trust document.

Corporations Owned by Two or More Shareholders

A corporation with two or more shareholders may be even less vulnerable to deterioration in the event of the death of one owner. If a co-owner provides management and leadership, the impact of the death of one shareholder may be less. A California corporation with 2 or more shareholders is supposed to have 2 or more directors. In the event of the death of a director, remaining directors may fill the director's seat left vacant by the death of one director and the Board of Directors can fill any offices left vacant by the death of the individual. The operation of the corporation may continue with little disruption, especially if the surviving shareholder played a management or leadership role in the corporation.

Although the continuing Board of Directors can run the corporation and operate the business while a deceased shareholder's estate is in probate, any action that requires a shareholder vote faces a challenge. Until a personal representative is appointed (and thus has the powers of a shareholder) getting a valid shareholder vote may be impossible. However, since shareholders only vote on major actions taken by a corporation, problems only arise if the corporation can't continue without addressing a significant matter requiring a shareholder vote.

Shareholders of a corporation don't control the day-to-day matters of the corporation. Shareholders who are also officers of the corporation may carry a great deal of authority as President, Secretary, Treasurer, or key employee, but those management roles are separate from the ownership rights of a shareholder. The major actions requiring a shareholder vote include the sale of all the assets of the business, filing for bankruptcy, and other major structural changes. A business may continue for a long time without needing the vote of shareholders. However, in the event of a death that significantly impairs the

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Publisher's Note

If the business is one that requires a contractor's license a deceased business owner who held the required license must be replaced by a qualified owner or employee within 90 days of the death in order to maintain the license. Professional corporations, which have licensing requirements for shareholders, directors, and officers, must address the licensing requirements within 6 months or risk loss of the certification for the profession.

A deceased business owner's shares of stock, membership interests in an LLC, or other business assets may also be affected by shareholder agreements, buyout agreements, option agreements, or buy/sell agreements that impact the ownership of the business. Good planning takes these agreements into account and avoids conflicts between trust documents and agreements affecting ownership of the business. A trust document that provides for distribution of a business in conflict with agreements with other parties or licensing requirements will not work as intended.

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business, such significant actions may be needed. The sale of the business as a sale of assets or sale of stock would require a valid representative of the deceased shareholder's estate, either as a trustee or a personal representative with the authority to sell.

LLCs

Key features of a corporation mentioned above do not apply to California LLCs. The Articles of Organization of a California LLC must state whether the LLC is managed by either all the members (the owners) of the LLC or by one or more managers. The Operating Agreement of an LLC establishes management of the LLC, rights of members to approve certain actions, transfer of membership interests, and other provisions that are important in the event of the death of an LLC member. Because California LLCs may be structured in many different ways, anyone dealing with an LLC (including a probate court, a trustee, an attorney, a lender, a supplier, a buyer, etc.) must review the Articles of Organization and the Operating Agreement of an LLC in order to know who has authority to act on behalf of the LLC and who has authority to approve or consent to disposition of the assets of the LLC.

The use of a trust as the owner of the membership interest in the LLC provides the best scenario for prompt authority to take any action necessary for continued management or disposition of the assets of an LLC.

The best advice for business owners is to have a trust and to operate businesses through a corporation or LLC that is owned by the trust. BA