BY GLENN STEPHENS

No Shareholders' Agreement

What happens when life insurance is paid without a proper business deal?

Life insurance advisors who work in the business market are all familiar with the advantages of having a properly funded shareholders' agreement. In theory, the agreement is drafted in a way that, among other things, allows for a tax-efficient buyout on a shareholder's death. At the same time, insurance is arranged with the appropriate ownership and beneficiary designations so that if a shareholder dies the proceeds can be readily applied toward the purchase as stipulated in the agreement.

As illustrated by the case of *Brown v. Laurie Estate*, however, the theory does not always hold up in practise. Brad Brown and Lachlan Laurie were friends who started a jewellery store business in London, Ontario, in 2014. As part of the business arrangement, each of them personally acquired an insurance policy on the life of the other shareholder and named himself as beneficiary of any proceeds payable on the other's death. Premiums were paid by the corporation, although apparently these were treated as a credit toward each shareholder's compensation, and were therefore taxable to them. Beyond that, the corporation was not involved in the arrangement.

Within a very short time after the issuance of the policies, Lachlan was diagnosed with terminal cancer. He died in November 2015, and insurance proceeds of $250,000 were paid to Brad as beneficiary of the policy on Lachlan's life. A dispute arose between Brad and Lachlan's widow, Donna, as to how the proceeds were to be dealt with. Donna took the position that Brad was obliged to use the proceeds to purchase Lachlan's shares of the corporation, while Brad argued that there was no agreement in place and that he was entitled to retain the proceeds.

This and other issues were argued before a judge of the Ontario Superior Court in 2018. Having no formal shareholders' agreement to put into evidence, Donna relied on certain other evidence, including the insurance advisor's notation on the insurance application that the purpose of the insurance was "buy sell." There was also a handwritten note on the agent's file reporting a discussion with Brad and Lachlan about a "buy sell."

For Brad's part, he was not only able to rely on the absence of a written agreement, but on an email that Lachlan had written him in May 2015, after he had become ill. In this email, Lachlan essentially suggested that Brad use $50,000 of the proceeds to help sustain the business, and then requested that he divide the remaining $200,000 between the two families. Brad argued that this email was a clear indication that Lachlan believed that no buy-sell agreement existed.

The judge ruled in Brad's favour in June 2018. He found that no agreement existed, and that notes made by the insurance advisor only implied that preliminary discussions regarding a buy-sell agreement had taken place. He placed significant weight on the above email that Lachlan had written to Brad a few months before Lachlan's death. The court seemed satisfied that the two shareholders had a business relationship and mutual pecuniary interests, and that these factors were sufficient to justify the insurance arrangement even in the absence of a buy-sell agreement that would apply on death. In short, there was insufficient evidence to overturn Brad's rights as the beneficiary of the policy.

The Ontario Court of Appeal fully agreed with the lower court, and dismissed Donna's appeal in a judgment dated March 2019.

At first blush this may appear to be an unfair and unreasonable windfall to Brad, especially when the evidence indicated that the value of Lachlan's shares was substantially less than the proceeds Brad received. Nonetheless, it is hard to escape the conclusion that the court decisions were legally correct given the lack of evidence that an agreement existed.

A few lessons may be taken from this case:

1. Clients should document their intentions. It seems reasonably clear that no buy-sell agreement existed between the two shareholders, but there also wasn't a document clearly indicating the parties' intentions regarding how to deal with the proceeds. A clearer statement might have allowed the parties to avoid litigation.

2. Consider corporate ownership of insurance. While these policies were personal, suggestions in the judgments hinted that the insurance was at least partly intended to assist the business in the event of a shareholder's death. In that case, the preferred route would have been to have the corporation be the owner and beneficiary of the policies. This might not have been enough to avoid a dispute between the parties, but it would have put the funds under the control of both Brad and Donna/Lachlan's estate, as the two shareholders of the corporation, and would have made a settlement of the case more likely.

3. Consider a "temporary" shareholders' agreement. There are many circumstances where insurance is placed on the lives of shareholders where no shareholders' agreement yet exists. In these circumstances, it is recommended that the parties execute what is essentially a temporary agreement that would deal with the buyout of a deceased shareholder, and with the use of the insurance proceeds, if the death occurs before the more comprehensive agreement can be completed. In the *Brown* case, such an agreement could have provided for a buyout of Lachlan's shares at fair market value, and for any surplus proceeds to remain with Brad (or with the corporation, if that is what the agreement provided). This would likely have been enough to keep the parties out of court.

GLENN STEPHENS, LLP, TEP, FEA, is the vice-president, planning services at PPI Advisory and can be reached at gstephens@ppi.ca.