Stock Management Trusts for Business Succession

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One of the challenges regarding business succession of small and medium-sized enterprises, is preventing the diffusion of shares held by the owner-manager (the ***Owner***).

If the majority of the assets of the ***Owner*** are the shares in the Owner's company (the ***Shares***), the Owner faces a dilemma. The Owner would likely want to leave benefit from the Shares as inheritance to the business successor as well as the Owner's heirs. However, the Owner would prefer to leave the voting rights attached to the Shares to business successor rather than the heirs.

In such cases, a Stock Management Trust, as discussed in this report, can resolve the dilemma.

The Owner may convert the Shares into a Stock Management Trust (ie the Shares are converted to trust property held and managed by a trustee through a trust contract), and define all heirs (the business successor and other heirs) as the beneficiaries upon the Owner's death (I define this scheme using the Stock Management Trust as the ***Scheme***).

Then, according to the terms of the trust instruments for this Scheme, the trustee is subject to the directions of the business successor by way of the exercise of the right to instruct how to exercise the voting rights attached to the Shares (the ***Instruction Rights***).

In this case, all heirs would benefit from the Share dividends, while preventing the dispersion of voting rights by allowing the business successor to exercise the Instruction Rights.

In this report, we examined two legal issues in the Scheme.

1. The first issue we address is the possibility that the trust contract under the Scheme is invalid in relation to a 1983 court case which held that a "***stock management trust agreement which does not give the opportunity of voting to settlor and beneficiary is invalid in terms of the Companies Act***".

In conclusion, the scope, use and purpose of this Stock Management Trust are different from the court case of 1983, and should not be held invalid when compared with precedent case law.

2. The second issue we address is, under the premise that the business successor is liable for the duty of care and duty of loyalty in exercising the Instruction Rights, we considered the relationship between how the Instruction Rights are exercised and the duties of care and loyalty, respectively (the ***Relationship***), under situations (1) and (2) below. Further, we have assumed that there are three objectives of the Stock Management Trust as follows: (i) maintenance and development of business; (ii) succession of company management to the next generation; and (iii) distribution of dividends to beneficiaries.

(1) The first situation is a capital increase or merger (***Case I***). While this case could meet objective (i) if the voting rights attaching to the Shares included in the trust property go below the majority of all the voting rights as a result of the Case I, objectives (ii) and (iii) would be at risk. In addition, the exercise of the Instruction Rights regarding the capital increase or merger could benefit the business successor and his/her interested parties at the expense of the interests of the other beneficiaries.

(2) The second situation is surplus dividends. If you use a surplus for the business without paying the dividends, it would meet objective (i), but could be problematic in relation to objective (iii).

For each situation described above, we examine the Relationship and propose clauses to be included in the contract to manage the Instruction Rights in this Scheme.