

Addressing the Four “D’s” in Family Shareholder Agreements: Decisions, Death, Disability and Disputes



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in Family Shareholder
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When creating a family-owned business, most people believe their relationships with their family members (and soon to be business partners) will remain harmonious. But for many of these businesses, difficulties will arise which the family members never imagined. Unfortunately, often the most emotionally charged differences arise in family contexts and can have devastating effects, similar to matrimonial disputes. These concerns will be addressed under four headings: Decisions, Death, Disability and Disputes.

There are several reasons why shareholders of a corporation may wish to supplement the articles and by-laws of a corporation with a shareholder agreement. A shareholder agreement provides a contract for those matters which are permitted under the *Ontario Business Corporations Act* (“OBCA”) and are not contrary to statutory or common law. The usual rules of contract law apply to shareholder agreements; for example, the agreement must have a binding effect, there must be certainty of subject matter, and there must exist terms and provisions for termination of the contract. The benefit is that as a private law contract, the terms of the shareholder agreement may be kept confidential between the parties, whereas the articles of a company are generally public. Furthermore, if the shareholders foresee that the company’s business

will regularly change, requiring frequent revisions to corporate documents, a shareholder agreement provides more flexibility to make changes, while generally being less cumbersome and expensive to revise.

Also, if shareholders are directors, or are associated with directors, certain matters can be dealt with at the shareholder level whereas directors may be restricted. This is useful where a director has a conflict of interest, and is subject to s.132 of the OBCA, which disqualifies the director not only from voting, but from even attending the meeting at which the vote takes place. Shareholders, on the other hand, are not subject to s.132, and may vote as they see fit.

Dealing with matters at the shareholder level also affords the use of s.108 of the OBCA, where a shareholder agreement may provide for an agreement on how votes will be exercised. Contrast this with directors, who, under s.134 of the OBCA, must act in the best interests of the corporation and specifically prevents any contracting out of these obligations (except pursuant to a unanimous shareholder agreement, discussed below).

Creating a unanimous shareholder agreement (“USA”) can radically change the rights and obligations of both shareholders and directors by restricting the powers of the directors. Only a USA may displace particular provisions of a corporation’s articles; in fact, there are numerous references throughout the OBCA providing that the articles and by-laws of a corporation may be subject to what may otherwise be provided for in a USA. A USA can also be binding upon future assignees without their consent, contrary to the traditional rules of contract law. This can be particularly useful in a family business situation, where shares in the business are commonly transferred to subsequent generations or to spouses, none of whom are parties to the shareholder agreement.

Used in these ways, a shareholder agreement can provide shareholders with both the power and flexibility to effectively and efficiently adapt to changes in the business, make meaningful decisions, and use anticipated mechanisms to resolve disputes.

Decisions

Take note of certain key provisions in a shareholder agreement that may impact the future of the business. In a family business context, cultural, religious and family issues can raise a special need for sensitivity and planning. These include:

Voting

Two or more shareholders can regulate and agree on voting through a shareholder agreement, often referred to as a pooling arrangement. In a family business, where shareholders often have equal voting power, a pooling arrangement can help to avoid voting deadlocks that might otherwise threaten the stability of the company.

Appointment of Directors and Officers

Decisions on who will be appointed or how they will be appointed can be set as provisions.

Threshold for Decision-Making

Provisions can be made to impose higher thresholds for decision-making than are required under the OBCA. For example, a shareholder agreement can call for a special majority or even unanimity in voting matters where the OBCA calls only for a simple majority, which can be very useful for decisions considered critical to the family business.

Proportionality of Shares

Stipulations can be set up to maintain the proportionality of shares within the family business and are helpful in regulating family control as the business grows. For example, the shareholder agreement can provide for pre-emptive rights to acquire new shares, so that existing family shareholders can retain their respective proportions of control and equity in the company.

Share Restrictions

Controls on who may become a shareholder are important in a privately held corporation. A shareholder agreement can impose restrictions on issuances and transfers of shares, which ensures the continued operations and growth of the corporation is accompanied by a plan that keeps control of the corporation in the appropriate hands. A restriction on transferring shares will even apply as against a transfer of shares under a will, as occurred in *Frye v. Sylvestre*. In that case, the five siblings owned equal shares in the family business and negotiated a shareholder agreement signed by all of the siblings. The shareholder agreement provided that any transfer of shares required the approval of at least three of the four shareholders with capacity. The articles of the corporation contained the standard provision regarding the approval of the directors to the transfer of shares. The agreement further stipulated that any shareholder wishing to sell their shares must first offer them to the corporation, then on a *pro rata* basis to the other shareholders, and finally to a third party on not less favourable terms.

Some years later one of the siblings died and transferred all of his shares by will to one of his sisters. Another sibling challenged the validity of this transfer. The court determined that the clause

restricting transfer was broad enough to include transfer by testamentary disposition. The testator was bound by the provisions of the agreement and had no right to transfer by his will his shares in the family business to his sister. As such, the estate of the deceased was also bound by the agreement, and the shares were to be sold in accordance with the requirements of the agreement.

Borrowing and Financing

Shareholders can agree on the terms of future borrowing and financing, and individual provision of guarantees and indemnities in the shareholder agreement, preventing potential disputes.

Employees

All matters pertaining to employment, including who is employed, remuneration and terms, can be addressed. This is important where questions of hiring relatives are likely to arise. Having shareholders agree at the outset of their relationship as to which rules are to govern the employment matters in their corporation may prevent uncomfortable situations.

Business Activity

Provisions that regulate the business activity of the corporation, or set out and restrict the type of business the corporation is involved in, are highly recommended. In a family context, given that there are usually few shareholders initially, each with significant control, it is important that these shareholders agree on their respective visions for the corporation early on and implement an agreement governing its operation and growth. In addition, a shareholder agreement can provide for issues that may be particularly sensitive to the family, such as cultural and religious issues or devoting resources to specific charitable, communal or religious purposes.

If guidelines for decision-making are not set out in the shareholder agreement, the court may end up making the decisions instead, as was the case in *Pusateri v. Trozzo*. In *Pusateri*, a family-owned business comprised of two retail food corporations, was passed down to the second generation. The son

and his wife owned 52% of the corporations, while the daughter and her husband owned 48%. Some years later after the son passed away, there was a breakdown in the shareholder relationship, and both sides agreed that the corporations should be wound up. However, without a shareholder agreement in place, it was left to the court to determine how the wind-up was to take place. The majority shareholder sought an order that the minority shareholders sell their shares at fair market value, while the minority shareholders sought an order for sale by private auction, with only the shareholders being entitled to participate.

The court concluded that a court supervised auction process was appropriate. While perhaps the least intrusive option in this case, an auction cannot guarantee that the ultimate buyer is the best party to ensure the continued prosperity of the business. Had a shareholder agreement addressing this issue been in place, the sale process could have been contractually implemented and significant litigation costs avoided.

*Learn about the other three 'D's',
Death, Disability and Disputes,
in the Spring 2008 edition.*

*Excerpt from
"Addressing the Four "D's" in Family Shareholders'
Agreements: Decisions, Death, Disability and Disputes,"
presented at the "Family Owned Business" conference on
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Professional Notes

Howard Black presented his paper "Avoiding Trial" at the OBA program "Passing of Accounts: Getting Cost Effective Results" on November 29.

Timothy Dunn, Kenneth Kallish and **Catherine Francis** presented "The Companies' Creditors Arrangement Act: Impact on the Rights of Secured Lenders" to the RBC Special Loans Group on November 14.

Joan Jung became a contributor to the Society of Trust and Estate Practitioners newsletter, *STEP Inside*. On September 8, she was a panelist at an OBA seminar "Taxation of Real Estate Transactions: A User's Guide." On October 29th, Joan presented "Recent Ontario Business Law Changes and Related Tax Considerations" at the Canadian Tax Foundation 2007 Ontario Tax Conference.

Kenneth Kallish was quoted in "Culling Counsel Abroad" that appeared in the November 2007 issue of *Lexpert Magazine*.

David Louis and **Samantha Prasad** published their book *Tax & Family Business Succession Planning, 2nd ed.* with CCH Canadian Limited and became members of the editorial board for CCH's *Canadian Income Tax Act with Regulations*. **David Louis** and **Michael Goldberg** hosted a CCH webinar on "Taxation of Private Businesses" on February 4 with Meritas members William Cooper, Boughton Law Corporation; Ray Hupfer, McLennan Ross LLP; and Robert Korne, BCF.

Stephen Nadler's article "Navigating the Litigation Landscape in Canada" was published in the Jan/Feb edition of the American Bar Association's *Business Law Today*. He and **Steven Pearlstein** presented papers at an OBA conference on "Mortgage Enforcement" on December 4. **Stephen Nadler**

presented his paper "Power of Sale" and **Steven Pearlstein** chaired the conference and spoke on "Pre-Payment Penalties."

Hartley Nathan, Q.C., released *Nathan's Company Meetings, 7th ed.*, which provides practical rules and guidelines for the call and conduct of effective meetings. The book is published by CCH Canadian limited.

Steven Pearlstein spoke on "*The Mortgage Brokerages, Lenders and Administrators Act, 2006*" at the Six Minute Real Estate Lawyer presented by the Law Society of Upper Canada on November 14. He also presented "Documenting Mortgage Loans to Partnerships, Limited Partnerships and Trusts" on February 25, 2008 at a conference on "Complex Challenges in Commercial Mortgage Transactions" hosted by the Law Society of Upper Canada.

Minden Gross LLP participated in the RealLeasing forum held on October 4. **Stephen Messinger** spoke on "New Developments and Challenges in Retail Leasing" and **Stephen Posen** was part of a panel on rights of first refusal, first offers and special rights for tenant downsizing or expansion. The Leasing Group also took part in the 2008 ICSC Whistler Conference in January. **Stephen Posen, Stephen Messinger, Leonard Baranek** (Real Estate Group), **Michael Horowitz** and **Adam Perzow** all took part.

Firm News

Stephen Posen, Aaron Grubner and Brian Temins were retained as Canadian counsel to the U.S. law firm of Latham Watkins LLP to act on the \$2.556 billion financing by an affiliate of Goldman Sachs, a leading global investment banking firm, to finance the acquisition of a Canadian paper mill and lumber company.