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Shareholder Disputes in Closely-Held Family or Partnership-Like Corporations - What You Need to Consider as the Potential Acquirer

Introduction

The Principals at Campbell Valuation Partners Limited ('CVPL') have rendered valuation and shareholder dispute advice in a substantial number of family and non-family shareholder disputes across a broad range of industry sectors ranging in size (by value quantum) from very small to very large. Based on our experience we have found that most shareholder disputes ultimately result in a shareholder or a group of shareholders acquiring the shares of another shareholder or group of shareholders (referred to herein as the 'Remaining Shareholder(s)' and the 'Departing Shareholder(s)', respectively). Among other things, these transactions provide liquidity to the Departing Shareholder(s) in circumstances where liquidity may otherwise not readily be available and they leave the Remaining Shareholder(s) operating the subject company where that company may have a different capital structure than it did prior to an acquisition of the Departing Shareholder(s). Accordingly, it is critical that the Remaining Shareholder(s) be aware of and properly consider a myriad of factors when entering into a process that may result in the acquisition of the shares held by the Departing Shareholder(s).

Where Departing Shareholder(s) hold a minority interest in a company, it often is difficult, if not impossible for them to identify and successfully negotiate the sale of their shares to a third party acquirer. Typically the market for shares held by Departing Shareholder(s) is limited to the Remaining Shareholder(s). In order to achieve liquidity, the following two options may be available to the Departing Shareholder(s):

- attempt to engage in a process with the Remaining Shareholder(s) that might result in the sale of their shares to the Remaining Shareholders. It may be the case that such a process is set out in a previously agreed shareholders' agreement. In the absence of a shareholders' agreement, the Departing and Remaining Shareholder(s) must as a first step negotiate the terms and rules of the process the two parties wish to adhere to prior, during and after any negotiations that might take place between the parties; and,
- exercise their legal rights in an attempt to achieve liquidity.



Where a Shareholders' Agreement Exists

Where a shareholders' agreement exists, the specific provisions contained therein can have a significant impact on the quantum of discount, if any, for both non-control and liquidity. Shareholders' agreements that are unanimous shareholders' agreements are distinguishable in that unanimous shareholders' agreements override (to the extent allowed by corporate statutes) corporate by-laws and governance documents, whereas shareholders' agreements that are not unanimous shareholders' agreements do not.

In some cases, a shareholders' agreement will specify that a majority shareholder is to receive a ratable portion of en bloc value, or stipulate the quantum of discount (if any) to be applied to minority shareholdings. Further, where a shareholders' agreement specifies no minority discount that may only apply in circumstances of certain triggering events.

By definition, a minority shareholder does not have de jure or de facto control, and hence cannot elect a majority of the board of directors. However, the ability to exercise some degree of influence on the company as a whole may be provided in a shareholders' agreement. Accordingly, where a shareholders' agreement exists, a minority shareholder might enjoy elements of 'negative control' pursuant to his or her ability to block other shareholders from making certain changes to the business that are undesirable from the minority shareholder's perspective. Where such provisions exist, it is important that they be carefully scrutinized to assess in what circumstances that influence can be brought to bear and the degree of influence that accrues to individual shareholders.

Shareholders' agreements (and articles of incorporation) often contain provisions regarding restrictions on the transfer of shares. Such restrictions might include:

- the requirement for approval from other shareholders or the board of directors; or,
- a right of first refusal.

Restrictions on transfer often impair the ability of the shareholder to control the risk-reward parameters of his or her investment because he or she cannot freely choose to divest of that business interest. As a result, in the absence of the ability to control the risk and return of the corporation itself (which control is rare for a minority shareholder), a discount for non-control may be warranted.

When assessing the impact of a shareholders' agreement on the value of a minority shareholding, it is important to determine whether or not a new shareholder would be subject to the existing agreement. Where this is not the case (which would be rare), and an external



transaction is assumed, the provisions contained in the shareholders' agreement may not be applicable, and that factor should be considered in the valuation.

Where a Shareholders' Agreement does not Exist

Where no shareholders' agreement(s) exist, in quantifying a discount for non-control, (and a discount for illiquidity) consideration must be given to the fact and time-specific relationship among the shareholders. The relevant factors that should be considered in such circumstances include:

- the applicable corporation and securities legislation, jurisprudence and trends related thereto;
- the prevailing relationships between and amongst shareholders;
- the size of a particular business interest, both in absolute and relative terms;
- the shareholder's level of involvement in the business;
- the historic and prospective dividend yield on the investment; and,
- whether the shareholding has, or may have 'nuisance value'.

Rights and Entitlements of Remaining Shareholder(s) and Departing Shareholders(s)

Whether or not legal action is threatened, the Remaining Shareholder(s) should understand the legal rights of the Departing Shareholder(s) with respect to achieving liquidity. This will assist the Remaining Shareholders' in better understanding their bargaining position. Departing Shareholders essentially have four legal avenues when trying to obtain a court-ordered buy-out of their shares:

- a claim of oppression;
- a claim of 'deadlock';
- a claim of 'lack of confidence' in the management of the subject company; and,
- a claim to an appraisal remedy in circumstances where a minority is entitled to dissent from a 'fundamental change' initiated by the corporation.



Courts will find that oppression occurred where a corporation '*unfairly disregarded the interests or legitimate expectations*' of any shareholder or director (OBCA, s.248). Oppressive conduct may occur in a broad variety of ways. Based on case law the following types of circumstances either alone or in combination have been found to constitute oppression:

- the corporation failed to provide, at the request of the minority shareholders or directors, the financial and other information to which they were entitled. Typically, if this is the only oppressive conduct, a court will not order a buy-out of shares but will order a less harsh remedy (e.g. that disclosure be provided and that annual shareholder meetings be held);
- the minority shareholder was unjustifiably squeezed out of the management of the corporation, and/or terminated from a position in management, when the shareholder had a legitimate expectation of participating in the management decisions of the corporation;
- the majority shareholders generally treated the corporation as their own property, and acted without regard to the interests of the minority. Examples of this include circumstances where the majority caused the corporation to:
 - undertake transactions or commitments unfairly prejudicial to the minority,
 - make speculative investments in companies owned by the majority or otherwise act in favour of the majority and against the interests of the minority,
 - pay dividends or provide income only to themselves and not the minority, or
 - fail to hold shareholders' meetings and circulate statutorily prescribed notices and information; and,
- the majority amended the articles of the corporation to change the attributes of shares held by minority shareholders, or otherwise changed the capital structure of the corporation, to the prejudice of the minority.

Where oppressive conduct has been found by the court, the court may, depending on the magnitude of the oppressive conduct found, order the majority shareholder(s) to buy-out the shares of the minority shareholder(s) without a minority discount. Accordingly, when the Remaining Shareholder(s) are negotiating with the Departing Shareholder(s) it is important to assess the likelihood of their past behaviour constituting oppression. The greater this likelihood the weaker is the Remaining Shareholders' bargaining position in general, but specifically with respect to minority discount.



Under s.207 of the *OBCA*, courts have the power to wind-up a company where it is 'just and equitable' to do so. In a closely-held family or partnership-like corporation, courts have traditionally found that the 'just and equitable' test is met where the corporation is 'deadlocked'. In such a situation, as an alternative to winding-up the corporation, a court may make any order it sees 'fit', which often is the less harsh remedy of a buy-out of one shareholder's or group of shareholders' stake. A corporation will be found to be 'deadlocked' where:

- there is an actual 'deadlock' between equally powerful shareholders, or
- the acrimonious relationship of the parties 'precludes all reasonable hope of reconciliation and friendly co-operation' such that the corporation is 'likely doomed' to failure within a reasonable time.¹

If the shareholder or group of shareholders being bought-out as a result of a court finding of 'deadlock' was an active shareholder who participated in the management of the corporation, then courts are more likely to order the buy-out occur without minority discount.²

As previously mentioned, under s.207 of the *OBCA*, courts have the power to wind-up a company where it is 'just and equitable' to do so. In a closely-held family or partnership-like corporation, courts have traditionally found that the 'just and equitable' test is met where one shareholder or group of shareholders has a 'justified lack of confidence' in the other equal or majority shareholders, and thus in management of the corporation. Courts likely will find that a justified lack of confidence exists when the following circumstances are found alone or in combination:

- managers/controlling shareholders conducted themselves with a lack of probity, or improper or fraudulent conduct; and,
- one shareholder launched an unjustified personal attack on the other (e.g. accused the other of dishonesty), and threatened to cut the other out of the business, such that the other shareholder (the target of the attack) is 'justified' in losing confidence in the perpetrator.

Typically, if this test is met, then the court will either order a winding-up of the corporation or a buy-out of shares without minority discount.

A right to dissent from a 'fundamental change' initiated by a corporation enables a minority shareholder to require to company in which he or she holds shares to purchase them at 'fair value', where the company initiates certain 'fundamental changes from which he or she elects to dissent. Exercise of a dissent remedy enables minority shareholders to withdraw from the

¹ See e.g., *Re Bondi Better Bananas Limited and Vallario*, [1951] O.R. 845 (C.A.), and *Stel-Van Homes Ltd. V. Fortini*, [2001] O.J. No. 2243 (S.C.J.).

² See e.g. *Wittlin v. Bergman* (1994), 25 O.R. (3d) 761 (C.A.); and *Gold v. Rose*, *supra*.



corporation rather than be subjected to 'fundamental changes' proposed by the majority. At the same time, the majority is permitted to carry out such changes if it is willing to risk that minority shareholders will exercise their right of dissent.

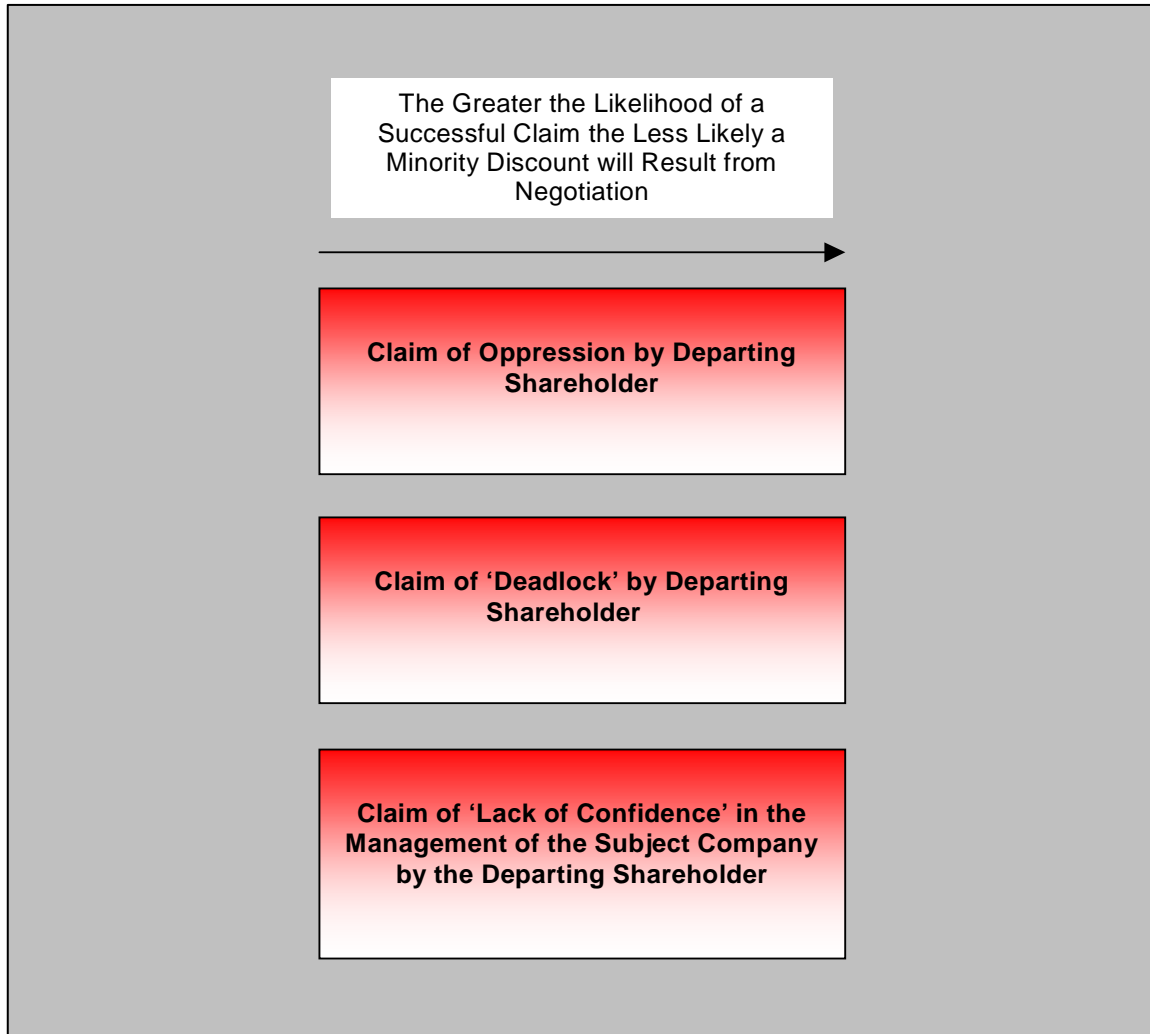
A statutory dissent remedy is available in all jurisdiction except Prince Edward Island and Quebec. Under those jurisdictions where an appraisal remedy is available the circumstances which create an appraisal right are:

- the passage of an amendment to the articles of incorporation of a company to add, change, or remove any provisions restricting or constraining the issue, ownership, or transfer of shares or any restriction upon the business or businesses that the corporation may carry on;
- an amalgamation with a corporation other than its wholly owned subsidiary, its parent corporation other than its wholly owned subsidiary, or its sister corporation, if both are wholly owned subsidiaries of the same corporation;
- the continuation of the corporation under the laws of another jurisdiction;
- the sale, lease, or exchange of all, or substantially all, of the corporation's property; and,
- an amendment to the incorporating articles or memorandum which diminishes the rights or conditions attached to a class or series of shares, which amendment otherwise creates an entitlement to a class vote.

Typically, where an appraisal remedy is awarded, a court will order the buy-out of a minority's shares without minority discount.



Based on the foregoing, the greater the likelihood that a court would order a buy-out of the Departing Shareholder(s) pursuant to anyone of the aforementioned findings, the less likely a minority discount will successfully be negotiated by the Remaining Shareholder(s).



The Process

Role of Advisors

Fair Market Value – the Right Measurement?

Specific Considerations for the Remaining Shareholders(s)



***Applicability of Minority Interest Discount
Consideration to be Paid to Departing Shareholder(s)***





Independence

- *Brenda Pregantes – newspaper interview re: ‘independence’*
- *Letter to Specific Lawyers along the following lines:*

Dear _____:

Given the well publicized events of recent weeks it is evident that Public Accounting Firms and Investment Dealers are increasingly going to be held to a different ‘standard of non-conflict’ in their opinion giving and consulting practices than historically has been the case. With this in mind it occurs to us that since disputes involving business value typically take months or years to resolve, that selection of experts to act in such matters should weight this factor more heavily than perhaps has been the case in the past.

Campbell Valuation Partners Limited has always maintained and conducted its assignments from a vantage point of absolute independence and non-conflicted position. We would ask you to reflect on this when you and your clients require business valuation advice.

Yours truly,