Resolving Shareholder Disputes in Canada

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This article, published in July 2009, discusses key issues affecting disputes among shareholders of private corporations in Ontario, Canada. The authors are partners of a Toronto boutique law firm which focuses on the litigation, arbitration and resolution of shareholder and other business disputes.

A more complete discussion of this topic is found in an article by Igor Ellyn, QC and Karine de Champlain called "Shareholders Remedies in Canada", which may found online at www.hg.org/article.asp?id=4818. An article on disputes between spouses involved together in business, see www.ellynlaw.com/PDFs/Ellyn%20Law%20LLP%20Corporate%20Law%20and%20Family%20Law.pdf.

This is article is for information only and is not intended as legal advice. Legal advice is provided only upon consultation with a lawyer. Further information about the authors appears at the end of the article.

The legal matters discussed here are based on the Ontario Business Corporations Act and court decisions decided in Ontario and under similar legislation across Canada. Most businesses are incorporated because of the benefits of limiting liability and potential tax savings. Most businesses have more than one owner or shareholder. The relationship among the shareholders can spawn considerable disagreement. In a surprisingly large number of cases, the disputes among shareholders can lead to angry and complicated litigation with uncertain outcomes. In this article, we discuss the legal issues which arise among shareholders of private corporations, typically with fewer than 10 shareholders.

A business corporation exists because one or more people have decided to set it up. There are hardly any impediments to incorporating a new corporation under Canadian law. In most Canadian provinces, any person over 18 years of age who is of sound mind and not bankrupt, may incorporate a company simply by signing articles of incorporation and presenting them to the appropriate government ministry for stamping and registration. A corporation has a legal personality independent of its owners and managers. A corporation can carry on business; file tax returns; borrow or lend money; and can sue and be sued. Shareholder disputes revolve around how the owners and managers of corporations deal among themselves.

Who runs a corporation?

The people who have authority to make decisions for a business corporation fall into three categories:

1. **Officers:** The President and the Secretary are the only officers who must be appointed but most corporations also have a Vice-President and a Treasurer. Other titles, such as CEO, COO and CFO are descriptive but are not required by law. The officers manage the day-to-day business of the corporation. The officers usually delegate some of their authority to other employees. The officers report to the Board of Directors. In a private business corporation, the officers, directors and shareholders overlap or may even be the same people.

2. **Directors:** The legal management of a business corporation is in the hands of the directors. The number of directors is designated by the Articles of Incorporation and can range from one to any number agreed to by the shareholders. The directors pass resolutions concerning legal and business matters affecting the corporation. Directors' resolutions are passed by majority vote but some resolutions, such as a decision to sell the entire business require a larger majority such as 75% or even unanimity. Each director has one vote. Typical resolutions include (1) banking and borrowing; (2) hiring of accountants or auditors and legal counsel; (3) approval of the actions taken by officers; (4) approval of financial statements; and (5) acquisition of a new business or senior employee. The types of resolutions are determined by the circumstances of the corporation.

   At every meeting of the directors, there must be a quorum. A quorum is the minimum number of directors required in person or by proxy to constitute a valid meeting. This is determined by agreement between the shareholders of the corporation and is set out in the corporation's by-laws. If no quorum exists, business conducted at the meeting is not valid. The method of giving notice of a directors' meeting is also important. If the directors are all in agreement and the business of the meeting is routine, a meeting may not be necessary. All of the business can be done by each of the directors signing resolutions prepared by the corporation's lawyer.

   If there are contentious issues, written notice of the directors' meeting has to be sent, usually 10 days in advance, by the method prescribed by the by-laws of the corporation. The notice of the meeting has to give each director enough information and documents about each topic to be discussed so that he or she can make an informed decision about it. The resolutions of the directors have to be approved or ratified by the shareholders of the corporation. Directors are not required to attend a meeting but if a director's failure to attend prevents the meeting from proceeding due the lack of a quorum, the corporation's business may be hampered and the Court may order that a meeting be held without a quorum.

3. **Shareholders:** The owners or shareholders are the final decision-makers about issues affecting the business of the corporation. Resolutions of the directors have to be approved by the shareholders. As with directors' meetings, a quorum is required for a valid shareholders' meeting and notice must be given in writing with enough information and documents about each issue to enable the shareholders to make an informed decision. Unlike directors, who have one vote each, shareholders have one vote for each voting share of the corporation he or she holds. (Some of the shares may be owned by another corporation but the concept is the same).

   The ownership of the corporation will be determined by the business partners. Sometimes, the ownership is driven by the amount of money a shareholder invests. In other cases, some shareholders provide special expertise or attract business, while others provide financing, and these elements may warrant an ownership share of the corporation. Some corporations reward a loyal employee with a minority shareholding. Some corporations have silent shareholders, who are not active in the daily business but own part of the corporation and therefore have a vote at shareholders' meetings.

   Shareholders are entitled to receive the financial statements of the corporation and to examine the books and records at the corporation's head office. If there are more than five shareholders, the corporation's financial statements have to be audited unless the shareholders vote to waive an audit.

The most important aspect of share ownership is "control". A shareholder or group who owns the majority (more than 50%) of the voting shares will be in position to control the activities of the corporation subject to certain restrictions agreed among all the shareholders or imposed by law. Some shareholder decisions, such as the sale of the entire business of the corporation require a higher majority or even unanimity.

Minority shareholders have to live with the fact that the majority shareholders have a right to run the corporation even if the minority disagrees. However, the majority must comply with the terms of a unanimous shareholders agreement, if one exists, and treat the minority shareholders fairly. The majority shareholders are not permitted to "oppress" the minority shareholders.

Rights of Shareholders

Shareholders have three basic rights: 1) The right to vote at valid shareholders' meeting after receiving proper notice and documents; 2) The right to attend a meeting of shareholders; and 3) the right to accurate and complete information about the affairs of the corporation, including the articles of incorporation and any amendments, the directors' register, the by-laws, minutes of directors and shareholders' meetings and the financial statements, whether audited or not. When these rights are not respected, a shareholder may have a right to sue the shareholders who failed to respect the rights of the minority.

Unanimous Shareholders Agreement

Even though it is not required by law, many shareholders make a unanimous shareholders agreement which sets out the ground rules for the operation of the corporation. Shareholder agreements can cover a wide variety of topics including but not limited to:

1) the management positions and responsibilities of the shareholders;

2) the method for valuing the shares of the corporation;

3) the method for adding or removing shareholders for misconduct, death or inability to function in the management of the business;

4) the mechanism for valuation and sale of the whole business of the corporation;

5) the method for determining management salaries, bonuses and dividends;

6) non-competition and non-solicitation clauses to prevent a departing shareholder from taking a key part of the corporation's business and thereby damaging the corporation and its remaining shareholders;

7) a buy-sell provision, sometimes called a "shotgun" clause, which permits a shareholder to offer to buy the shares of the other shareholders subject to the right of these other shareholders to the offering shares at the same price;

8) succession arrangements to spouses or the next generation upon death or disability of a shareholder;

9) life insurance on key management employees and shareholders;

10) the special majority or unanimity required for certain types of corporate decisions such as the sale of the whole enterprise of the corporation or commencing a new enterprise; and

11) dispute resolution including arbitration and choice of law provisions.

Shareholder Disputes and Arbitration

The dispute resolution clause of a unanimous shareholders agreement usually provides that all disputes among the shareholders are to be resolved by arbitration and not by the courts. It typically states where the arbitration will be held. If all the parties are in Ontario, Ontario law will apply. If some parties are located elsewhere, the arbitration clause may specify which law, i.e., of which province or country, is applicable. There may also be reference to the procedural rules and the method for selecting the arbitrators.

Courts in Ontario give a very high degree of respect to a dispute resolution clause which requires all disputes to be resolved by arbitration. However, not all disputes involving the rights of minority shareholders are referred to arbitration even when there is a mandatory arbitration clause. Where there is a claim for "oppression" under the Business Corporations Act, a minority shareholder may be permitted by the Court to continue his or her lawsuit even though the unanimous shareholders agreement contains a mandatory arbitration clause.

Oppression Remedy

Under the Ontario Business Corporations Act, a minority shareholder is entitled to "relief from oppression" when his or her reasonable legitimate expectations from the majority shareholders have not been met. Legitimate expectations are found by looking at the articles of incorporation, the by-laws, the resolutions of the directors and the shareholders and the unanimous shareholders agreement, including any amendments of it and by general commercial and business practices.

For example, if the shareholders were accustomed to receiving an annual dividend but the dividend is not distributed fairly or not at all without reasonable justification, a court might find this change oppressive. If majority shareholders conceal information about the business from the minority shareholders by excluding the minority shareholder from decision-making or falsifying documents, that is also oppressive to the minority.

Another example of oppression might occur if the majority shareholders act in a way which violates the terms of the unanimous shareholders agreement. In some corporations, the removal of a minority shareholder from his or her position in the management of the corporation could be an act of oppression by the majority. Each of these examples has its roots in unfair behaviour by the majority which runs contrary to the reasonable expectations of the minority shareholder as a shareholder, employee or creditor of the corporation. Typically, there is more than just a single incident. The majority shareholders are usually looking to remove the minority shareholder from the business or take financial advantage of the minority.

While the aggrieved shareholder usually holds only a minority of the shares, the remedies discussed in this article are available to any shareholder who can show that he or she has been oppressed by another shareholder.

What can the Court do if it finds that a shareholder has been oppressed?

The oppression remedy is a powerful remedy for a minority shareholder to obtain redress for unfair conduct by the majority. If a judge finds the conduct of the majority shareholder to be oppressive, an order can be made to rectify the oppression in the most efficient way. This can be done by 1) the payment of money, 2) by directing the majority to buy the aggrieved shareholder's shares for a reasonable price (as determined by professional valuation), 3) by reinstating the aggrieved shareholder to his or her former position in the business, or 4) by holding an auction at which all of the shareholders have the right to purchase shares of the corporation. A judge also has the power to cancel the exercise of a "shotgun" buy-sell if the court finds that it has not been exercised fairly. The appropriate remedy will depend on the circumstances of the corporation.

A Court's decision to remedy oppression is intended to compensate the minority shareholder not to punish the majority. However, if the Court finds that the majority shareholder has acted fraudulently or has breached his fiduciary duty to the minority shareholders, punitive and other damages can also be awarded. When a court finds oppression, the share value attributed to the minority shareholder is not subject to a minority discount as it might be if the minority shares were sold in a commercial transaction.

Breaches of fiduciary duty can include the failure of the majority shareholder to provide full, fair and frank disclosure of all matters affecting the corporation's business. If one or more shareholders has removed assets, income or business of the corporation or is competing with the corporation, that may also be a breach of fiduciary duty in addition to oppression.

What other remedies are available?

The Court also has the power to order that a directors' or shareholders' meeting take place for the purpose of conducting specific business affecting the corporation. The Court can also authorize the commencement of a derivative action. This is a lawsuit by the corporation against a "rogue" shareholder. For example, if the majority shareholder has improperly taken some of the assets out of the corporation or has spent the corporation's money without authority, the corporation will have to sue the rogue. Of course, the rogue shareholder will not authorize a lawsuit against himself. In such a case, the court can authorize another shareholder to start and manage a lawsuit in the corporation's name against the rogue shareholder.

The Court also has the power to order an investigation of the financial affairs of the corporation by a court-appointed auditor. In the most extreme cases, the Court can direct that the corporation be wound up on the basis that it is "just and equitable" to do so. A "just and equitable winding-up" means that the court directs that the business be sold, perhaps to one or more shareholders and that the assets of the corporation, net of any liabilities, be divided among the shareholders. Special circumstances must exist for this remedy to be considered by the court, including a deadlock among shareholders, which are paralyzing the corporation.

What happens in shareholder litigation?

These litigation procedures described above require detailed evidence and strategic considerations by an experienced shareholders' dispute lawyer. Apart from the evidence of the minority shareholder, the value of the business has to be determined. This process is always more complicated than it appears to a lay person. The valuation of a business is a specialized skill provided by a chartered business valuator, a chartered accountant with valuation training. Before valuing the shares, the valuator may have to assess whether the majority shareholders have removed some money or assets from the corporation unfairly, whether by fraud or by misuse of the funds for an unauthorized purpose.

There are also income tax considerations. The value of shares is affected how shares are sold. If the corporation redeems the shares for cancellation, the shareholder will receive a taxable dividend. If the shares are purchased by another shareholder, the selling shareholder may be able to claim an exemption from capital gains taxes. There are also other tax issues. Advice from a tax accountant or lawyer is required to identify the most efficient way to dispose of the shares. This creates further disagreement because a tax arrangement beneficial to the seller will be less favourable to the buyer.

These remedies take some time to implement. The trial of a shareholders' dispute lawsuit will not take place for many months or even years after it is commenced. Therefore, the court also has the power to grant interlocutory or temporary relief to ensure that the interests of the minority shareholders are preserved until the trial or hearing. The Court's objective is to preserve the current situation without pre-judging the case.

Shareholder litigation is often characterized by hard feelings among the disputing shareholders. These are people who were in business together and their relationship has soured. It is much a like a divorce. Each side proceeds to gather its evidence which supports or denies the existence of oppression and other offensive conduct. Valuation of the shares may also be complicated by lack of proper disclosure and accounting issues. We have seen cases where the majority shareholders "stonewall" by refusing to provide proper information. This makes the litigation more time-consuming.

Amid the hard feelings and expense involved in these kinds of cases, lawyers in this field keep their eye on opportunities to make a settlement. While many shareholder dispute cases go to trial, the great majority of them settle before the trial through direct negotiations or mediation. Settlements are driven by the uncertainty of the outcome and the effort of all parties to limit legal and accounting expenses.

A settlement may also be more efficient for income tax purposes than a court judgment. Uncertainty relates not only to whether the Court will find the majority shareholders' conduct oppressive but also the disagreement between the valuation experts for each side. Valuation of shares is as much art as it is accounting and valuators may disagree radically on how much the corporation's shares are worth.

What should I do if I think the majority shareholder is oppressing me?

The first step to take is to fully document all events as promptly as possible after they occur. Make notes and send emails but care must be taken not to make statements which could adversely affect a minority shareholder's position. Timing is important for notices of meetings and buy-sell notices. Delay in obtaining legal and financial advice could have a very significant impact on the eventual result. If you get written notice of shareholders or directors meeting without details of the matters to be discussed, you may not be able to complain about an adverse vote if you fail to complain about it in advance and just attend and vote.

If events are happening in the business which are being concealed from a minority shareholder or if financial information is being hidden, prompt action is necessary. First, you must ensure that no damage is done to the business. Second, if you delay in taking legal steps or in having your lawyer write a letter to the majority shareholders to complain of the offensive action, you may be taken to have approved of the improper acts of the majority shareholders. The best advice is to get legal advice as soon as possible.

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