SHAREHOLDER AGREEMENTS IN CANADIAN CLOSE CORPORATIONS

by

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ABSTRACT

This thesis is a selective survey of shareholder agreements in Canadian close corporations. By way of describing these important means to shape the corporate structure of a close corporation, it aims to determine how far Canadian law is adapted to the needs of this numerous type of corporations. After explaining the necessity of shareholder agreements in a close corporation setting and comparing them with the corporate constitution, the work inquires into the function and legality of shareholder agreements in those areas which denote the main structural characteristics of a close corporation: enlargements of the influence of shareholders in management, veto and voting arrangements, restrictions on share transfers and solutions for the case of deadlocks. The study comprises an assessment of the new unanimous shareholder agreement concept and suggests some improvements. Finally, to facilitate the organization of a close corporation, this work proposes the introduction of a set of model rules for them.

RESUME

Cette thèse est une étude sélective des conventions entre actionnaires dans les sociétés fermées (close corporations) au Canada. En décrivant ces moyens importants pour structurer une société fermée, cette étude a pour objet d'examiner l'adaptation du droit Canadien aux besoins spécifiques de ce type fréquent de société. Après avoir étudié la nécessité des conventions entre actionnaires dans le cadre d'une société fermée et les avoir comparées avec les statuts et les règlements d'une société commerciale, une analyse détaillée des fonctions et de la valeur juridique de telles conventions relativement à ces caractéristiques propres aux sociétés fermées est faite: influence plus importante des actionnaires dans l'administration, droit de véto, modalités du droit de vote, restrictions sur le transfert des actions, résolution des impasses (deadlocks). Cette étude évalue le concept nouveau des conventions unanimes entre actionnaires et suggère des améliorations. Sont finalement proposées des clauses types de règlements des sociétés fermées afin de faciliter leur organisation.

A C K N O W L E D G E M E N T

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A. Introduction

Small business is a very important category for corporation law. Although many small businesses operate in non-corporate form (1), the vast majority of corporations are small. In 1978, there were 20,696 small and medium-sized corporations with annual sales in excess of $2 million but less than $20 million which generated $108 billion in sales, compared with the $272 billion earned by 2,338 large corporations (2). If a small business decides to incorporate, its structure is most likely to be that of a close corporation. This term designates a corporation whose shares are held by a closely-knit group of shareholders and are not traded in the stock market (3). In Canada, the given corporate model was primarily designed with large,

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(1) See C. Marfels, Structural Aspects of Small Business in Canadian Economy, 1978, pp. 5-17.

(2) Department of Industry and Commerce, Small Business Secretariat, Small Business in Canada 1981 - A Statistical Profile, p. 6.

(3) A more elaborate description will follow infra pp. 5-7. The most useful figures with respect to close corporations are provided for by tax statistics. The Income Tax Act, S.C. 1970-71-72, c. 63, as am., hereinafter cited as ITA, subjects so-called "private corporations" to a special treatment. They are defined as corporations which are resident in Canada and which are not public corporations nor controlled by a public corporation (ITA s. 89 (1) (f)). A public corporation is a corporation whose shares are listed on a Canadian stock exchange or whose shares are, at least in part, qualified for distribution to the public, which has not less than a certain number of shareholders (300 or 150), whose shares are dispersed in a certain way and whose insiders hold not more than 80% of its shares (ITA s. 89 (1) (g), Income Tax Regulations, Consolidated Regulations of Canada, 1978, c. 945, as am., hereinafter cited as IT Regs., 4800 (1); for the definition of "insider", see IT Regs. 4802). In 1979, 400,076 private corporations faced 3,285 public corporations (source: Statistics Canada).

publicly-held corporations in mind (4). One of the most important means to mould the statutory form to the specific needs of a close corporation is the shareholder agreement. The description of its legal treatment allows one to raise the question of how well adapted Canadian corporation law is to the needs of close corporations.

Shareholder agreements are private contracts and, as such, can contain any legal provision the parties involved agree upon. This thesis focusses on several types of provisions which are characteristic of close corporations: enlargements of the influence of shareholders in management, veto and voting arrangements; restrictions on share transfers and solutions for the case of deadlocks.

Although various articles deal with discrete aspects of shareholder agreements (5), no survey has dealt with all of the areas mentioned under the aspect of how suitable Canadian law is for close corporations.

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(4) D.P. Coates, Shares Transfer and Transmission Restrictions in the Close Corporation, 3 U.B.C. L. Rev. 3:96, 97 (1968); F. Iacobucci and D.L. Johnston, The Private or Closely-Held Corporation, in: J.S. Ziegel, ed., Studies in Canadian Company Law, vol. 2, 1973, p. 75; F. Iacobucci, M.L. Pilkington, J.R.S. Prichard, Canadian Business Corporations, 1977, p.127. See also B.G. Hansen, The Canadian Business Corporations Act - Some General Comments, 6 Anglo-Am. L. Rev. 261, 262 (1977); and L.C.B. Gower, Whither Company Law?, 5 U.B.C. L. Rev. 385, 389 (1981).

(5) See, for example: D.S.M. Huberman, Buy and Sell Agreements for Canadian Close Corporations, 41 Can. Bar Rev. 538-571 (1963); D.P. Coates, Share Transfer and Transmission Restrictions in the Close Corporation, 3 U.B.C. L. Rev. 3:96-142 (1968); R.G. Hatt and W.B. Keevil, The Buy-Sell Agreement, 2 Queen's L. J. 225-254 (1974); D.W. Smith, Buy-Sell Agreements, in: Canadian Tax Foundation 1979 Conference Report, Toronto, Canadian Tax Foundation, 1979, pp. 665-686.

First, it is necessary to define a shareholder agreement, to explain the need for it in a close corporation context and to describe its place among the other means of shaping a close corporation. Then, the judicial consideration and statutory treatment of those shareholder agreements dealing with the above-mentioned areas will be examined. The value of the unanimous shareholder agreement concept, as recently recognized by Canadian legislation, will be assessed. Finally, the adoption of a set of model rules for close corporations will be suggested.

B. Definition, Necessity and Advantages of Shareholder Agreements

I. Definition

A shareholder agreement could be defined as a contract among shareholders, or among shareholders and persons who are not shareholders, in relation to corporate activity (6). This definition implies that the corporation is already in existence. It thus does not include agreements before incorporation, such as pre-incorporation or promoter contracts. These contracts can contain similar provisions to those in a shareholder agreement. However, unlike such agreements, these contracts will for the most part set out the details of a corporation to be established. They will determine how the corporate constitution will be drafted, how the corporation will be financed initially and many other details concerning incorporation. The scope of the following study is limited to shareholder agreements entered into after incorporation.

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(6) See S. Krüger, Pooling Agreements Under English Company Law, 94 L. Q. Rev. 557 (1978); S. Krüger, Corporate Pooling Agreements and Restriction-of-Directors Agreements, 10 Anglo-Am. L. Rev. 73 (1981); a definition more limited in scope is given by A. Robitaille, Les conventions d'actionnaires, 42 R. du B. 147, 151 (1982): "un contrat...entre des actionnaires d'une même compagnie, pour la recherche à une fin commune dans le cours de la vie corporative...régissant l'exercice des droits afférents à la propriété d'actions." This, in Robitaille's opinion, excludes share transfer restrictions as an object of shareholder agreements.

II. Necessity for Shareholder Agreements in a Close Corporation Setting

The close corporation is characterized by several factors. The most important ones are that it consists of a small number of shareholders and that the persons managing the business are often its owners (7). The relation between the shareholders is a close personal one, built on mutual trust and similar to that in a partnership (8). For this reason, the close corporation is often called an incorporated partnership (9). A distinctive characteristic of the close corporation is the fact that its shares are not traded in the

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(7) D.S.M. Huberman, Methods of Resolving Intra-Corporate Disputes, 3 U.B.C. L. Rev. 3: 1, 3 (1968); Coates, supra note 4, p. 97; Iacobucci and Johnston, supra note 4, p. 70; Iacobucci, Pilkington, Prichard, supra note 4, pp. 62, 76; F.H. O'Neal, Close Corporations - Law and Practice, 2nd. ed., 1971 (1982 supplement), paras. 1.02, 1.07.

(8) Huberman, supra note 7, p. 4; D.H. Sohmer, The Buy-Out Provision in Agreements Between Shareholders of Closely Held Companies: Determining the Price, 30 R. du B. 308 (1970).

(9) See, for example, Huberman, supra note 7, p. 3; R.C. Bird, The Allocation of Control in the Organization of a Closely-Held Corporation Under the New Brunswick Companies Act, 21 U.N.B. L. J. 72, 75 (1971); H.G. Henn, Handbook of the Law of Corporations and Other Business Enterprises, 2nd. ed., 1970, p. 506.

public securities market (10). In general, the size of the business, whether measured by capital, earnings or sales, is not a decisive point, although most close corporations are small (11).

The corporate form will have been chosen over a partnership for a number of reasons. The ones commonly given are a partnership's potential unlimited liability, unfavourable tax consequences for partners in using the profits to finance expansion and the threat of a sudden dissolution because of the death of one of the partners or his wish to dissolve his interest in the business. The creation of a separate legal entity by incorporation guarantees limited liability, continued existence and more possibilities for tax planning. Disadvantages of

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(10) O'Neal, supra note 7.

(11) O'Neal, supra note 7, para. 1.03. Regarding this point, it is particularly important to note that in Canada many foreign subsidiaries share most of the characteristics associated with close corporations. These subsidiaries are often of a considerable size. On the degree of foreign ownership in Canadian corporations, see the Report of the Royal Commission on Corporate Concentration, 1978, pp. 181-194. However, as most subsidiary corporations have the mother corporation as their only shareholder, the typical shareholder conflicts which are to be prevented by shareholder agreements do not exist. It is therefore beyond the scope of this thesis to discuss the special problems of subsidiary corporations.

incorporation are the strict separation of ownership and management and the free transferability of shares provided for in the corporation statutes, which is often not wanted in a small business with a partnership structure (12).

Despite incorporation, a close corporation has the tendency to retain partnership characteristics. Thus, its shareholders will try to assure every "partner" a voice in business decisions. The importance of this lies in large part in the fact that many of them invest most of their personal resources in the business. There is also virtually no market for close corporation shares. This results from the fact that an investment in a close corporation often only makes sense if one is prepared to participate actively in the business and is suited to the job. Close corporation shares therefore are not sold very often and thus are difficult to value. These circumstances make the performance of the corporation much more important for the individual shareholder. Shareholders will also seek to limit the free transferability of corporate shares by restricting share transfers. This will help them to realize the partnership principle of <u>delectus personae</u>, that is to say, choice of their fellow partners. However, the close corporation provisions concerning the management and decision-making of the corporation and the transfer of its shares will increase the likelihood of a deadlock with possible detrimental

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(12) See <u>infra</u> next para. and pp. 17, 18 and 57, 58. Other disadvantages of incorporation for a small partnership-like business are the expense and work involved in forming a company and the possible prejudice incurred in complying with statutory disclosure obligations. Their treatment is, however, out of the scope of this thesis.

effects on the business or the shareholders or both. To accomplish the desired ends and limit the problem of a deadlock, a carefully drafted shareholder agreement is most important.

III. Shareholder Agreements and the Corporate Constitution

Deviations from the statutory scheme which are favourable to the needs of close corporations can be contained in any of the three following documents: the documents of the corporate constitution, that is the basic document of the corporation (13) or the document regulating its internal affairs (14), or a shareholder agreement. Members of a close corporation are not always free to choose the document they consider the most convenient. There are statutory provisions which prescribe inclusion in certain documents if particular matters are to be regulated. However, if shareholders are free to decide, there are some practical advantages of shareholder agreements to consider. With respect to this, the enforceability of the constitution or of shareholder agreements is of particular concern.

1. Statutory Provisions Requiring or Allowing Incorporation of Certain Matters in the Corporate Constitution or in Shareholder Agreements

Some provisions often found in close corporations are required to be in the corporate constitution. So,

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(13) Called memorandum of association, articles of incorporation or letters patent, depending on the incorporating jurisdiction.

(14) Articles of association or by-laws.

restrictions on the transfer of the shares of the corporation have to be stated in the articles of incorporation (15). Similarly, share transfer restrictions in fulfillment of private company requirements have to be in the constating document (15 a). If different classes of shares are issued, they must appear in the articles of incorporation (16) and so must provisions for cumulative voting (17) and pre-emptive rights (18). Special majority and quorum provisions can, but need

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(15) Canada Business Corporations Act, S.C. 1974-75-76, c. 33 as am. by S.C. 1976-77, c. 52; 1978-79, c. 9, c. 11; 1980-81-82, c. 43, c. 47, hereinafter cited as CBCA, s. 6 (1) (d); The Corporations Act, S.M. 1976, c. 40/C. 225 as am. by S.M. 1977, c. 57; 1978, c. 30; 1979, c. 7, c. 49; 1980, c. 75; 1981, c. 27, hereinafter cited as MCA, s. 6 (1) (d); The Business Coporations Act, R.S.S. 1978, c. B-10 as am. by S.S. 1979, c. 6; 1980, c. 73; 1980 (No. 2), c. 2; 1980-81, c. 21; 1980-81, c. 83, hereinafter cited as SBCA, s. 6 (1) (d); Business Corporation Act, S.A. 1981, c. B-15 as am. by S.A. 1981, c. 44, hereinafter cited as ABCA, s. 6 (1) (c); Business Corporations Act, S.N.B. 1981, c. B-9.1, hereinafter cited as NBBCA, s. 4 (1) (d), 50 (1); The Business Corporations Act, S.O. 1982, c. 4, hereinafter cited as OBCA 1982, s. 5 (1) (d). This Act, which was given third reading on June 3, 1982, and which received Royal assent June 7, 1982, will come into force in 1983. Throughout this work, reference is made to the new Act.

(15 a) Today contained in the securities acts, see, for example, Securities Act, R.S.O. 1980, c. 466, s. 1 (1) 31.

(16) CBCA, MCA, SBCA, ABCA s. 24 (4); NBBCA s. 22 (3); OBCA 1982 s. 22 (4).

(17) CBCA, MCA, SBCA, ABCA s. 102; OBCA 1982 s. 119.

(18) CBCA, MCA, SBCA, ABCA s. 28 (1); OBCA 1982 s. 26 (also, inclusion in unanimous shareholder agreement sufficient).

not, be included (19). A restriction of the directors' power to manage the business and affairs of the corporation is only possible by way of a unanimous shareholder agreement (20).

2. Practical Advantages of Shareholder Agreements

Shareholder agreements can usually be amended or repealed more easily, quickly and with less expense than the corporate constitution, an amendment of which must strictly comply with the statutory requirements (21). The fact that a unanimous shareholder agreement as a contract can normally only be modified with participation of all its parties is an important advantage from the point of view of minority protection; to amend the agreement, every shareholder must consent. At the same time, it could make an amendment very difficult, if the shareholders are not able to compromise on contentious issues. However, a different amendment procedure

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(19) Inclusion in a unanimous shareholder agreement is sufficient: CBCA, MCA, SBCA, ABCA s. 6 (3); NBBCA s. 4 (3); OBCA 1982 s. 5 (4).

(20) CBCA, MCA, SBCA s. 140 (2); Loi sur les compagnies, L.R.Q. 1977, c. C-38, as am. by L.Q. 1979, c. 31; 1980, c. 28, hereinafter cited as LCQ, art. 123.91; ABCA s. 140 (1); NBBCA s. 99 (2); OBCA 1982 s. 108 (2).

(21) M.D. Donner, An Overview of the Use of Organizational Documents to Assist in the Solving of Problems Associated with Closely Held Corporations, in: Closely Held Corporations Seminar of the Continuing Legal Education Society of British Columbia, Vancouver 1982, pp. 9, 10.

can be agreed upon (22). A fact discouraging inclusion in the constitutional documents is that their contents are not confidential, since they are very often public documents (23).

3. Enforcement

a) Provisions of the Corporate Constitution

aa) Order for Compliance

Several Canadian corporation statutes contain provisions dealing with compliance with the rules set by the corporate constitution (24). A complainant, which includes a shareholder, may seek an order requiring the corporation, or a director, officer or employee of the corporation to comply with any provisions of the Act, the articles or by-laws of the corporation or a unanimous shareholder agreement. (24 a) The

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(22) Compare OBCA 1982 s. 108 (6) (a); but see ABCA s. 140 (8).

(23) Everybody has access to the articles of incorporation according to CBCA, MCA, SBCA, ABCA ss. 7, 259; NBBCA ss. 5, 190; OBCA 1982 ss. 6, 269; to the memorandum and the articles of association under the Company Act, R.S.B.C. 1979, c. 59 as am. by S.B.C. 1980, c. 10, c. 50; 1981, c. 2, c. 4; 1981, c. 21, hereinafter cited as BCCA, s. 188 (3), (4); creditors have access to the articles of incorporation, by-laws and unanimous shareholder agreements according to CBCA, MBA, SBCA s. 21 (1) (and everybody under these sections if the corporation is a distributing one, which will not be the case with a close corporation); to articles of incorporation and by-laws under ABCA s. 21 (3) and NBBCA s. 19 (3); to letters patent and by-laws according to LCQ art. 106 and the Companies Act, R.S.P.E.I. 1974, c. C-15 as am. by S.P.E.I. 1975, c. 83; 1976, c. 28; 1980, c. 2, c. 15; 1981, c. 6, hereinafter cited as PEICA, s. 52 (1).

(24) CBCA, MCA, SBCA, ABCA s. 240; NBBCA s. 172; OBCA 1982 s. 252.

(24 a) See, however, the restrictive interpretation of this remedy in Re Goldhar and Quebec Manitou Mines Ltd. (1975) 9 O.R. (2d) 740 (Div. Ct.), where it was held to apply only to "the rectification of simple 'mechanical' omissions of a type that lend themselves to summary disposition."

court can also make any further order it thinks fit to remedy the non-compliance.

bb) Derivative Action

A breach of the corporate constitution can give rise to a cause of action for a derivative suit if it does not give a personal right of action (25). The introduction of the statutory derivative action into Canadian corporate law (26) removes some of the problems caused by the rule in Foss v. Harbottle (27) for an action by a shareholder on behalf of the corporation. However, the shareholder must still get leave of the court and the action is subject to certain conditions precedent.

b) Shareholder Agreement

A shareholder agreement is a contract. It is enforceable by the same remedies and with the same limitations as any other contract. Where specific performance is possible, the court may enforce the agreement in equity (28). Another remedy is damages for breach, but the damages

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(25) Which may well be the case: see S.M. Beck, An Analysis of Foss v. Harbottle, in: J.S. Ziegel, ed., Studies in Canadian Company Law, vol. 1, 1967, pp. 581 ff..

(26) See CBCA, MCA, SBCA, ABCA ss. 232, 233; BCCA s. 225; NBBCA ss. 164, 165; OBCA 1982 ss. 245, 246.

(27) (1843) 2 Hare 461, 67 E.R. 189 (Ch.).

(28) See, for example, for a voting agreement Puddephatt v. Leith [1916] 1 Ch. 200.

awarded may not reflect the actual loss. In _Ringuet_ v. _Bergeron_ (29), the Supreme Court of Canada recognized a remedy in a shareholder agreement providing that for a breach of the agreement the wrongdoer would gratuitously transfer his shares to the other parties in equal parts. But this case arose in the civil law jurisdiction of Quebec where there is no doctrine of relief from penalty or forfeiture clauses (30); in a common law jurisdiction a similar provision would probably be struck down (31). These limitations have to be borne in mind when shareholders agree on extra-judicial remedies for default, such as loss of dividends or voting rights, or forced sale of shares for some predetermined value (32).

There is a further means of enforcing the underlying understandings of the members of a close corporation as laid down in a shareholder agreement. It is the oppression remedy contained in the BCCA and all CBCA-modelled statutes (33).

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(29) [1960] S.C.R. 672.

(30) See arts. 1133 and 1135 of the Quebec _Code civil_.

(31) For the distinction between (allowed) liquidated damages and (forbidden) penalties see G.H.L. Fridman, _The Law of Contract in Canada_, 1976, pp. 583-589, and 1980 supplement, pp. 172-175; S.M. Waddams, _The Law of Contracts_, 1977, pp. 272-277; and the cases cited in both treatises.

(32) Coates, _supra_ note 4, pp. 116-117.

(33) BCCA s. 224; CBCA, MCA, SBCA, ABCA s. 234; NBBCA s. 166; and OBCA 1982 s. 247.

With the help of this remedy, the court can intervene if the interests of a shareholder have been unfairly prejudiced. "Unfairly prejudicial" has been defined as conduct which is "unjust and inequitable" (34). Behavior which is "unjust and inequitable" has long been under scrutiny in connection with the statutory rules for dissolution of a corporation by court order (35). In a landmark English decision, Ebrahimi v. Westbourne Galleries Ltd. (36), it was said that small corporations which can be considered partnerships in a corporate form can be dissolved if any of the fundamental understandings of the "partnership", such as a right of all members to participate in management, have been violated (37). Such a fundamental underlying understanding might well be laid down in a shareholder agreement (38). The big

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(34) Diligenti v. RWMD Operations Kelowna Ltd. (1976) 1 B.C.L.R. 36, 42 ff. (S.C.).

(35) CBCA, MCA, SBCA, ABCA s. 207 (b) (ii); NBBCA s. 141 (b) (ii); OBCA 1982 s. 206 (1) (b) (iv); BCCA s. 295 (3) (a); The Companies Act, R.S.N. 1970, c. 54 as am. by S.N. 1971, No. 14, No. 16; 1972, No. 11, No. 51; 1973, No. 6; 1974, No. 30, No. 57; 1975, No. 14; 1975-76, No. 47, 1977, c. 104; 1978, c.5, c. 35; 1979, c. 54, hereinafter cited as NCA, s. 138 (e); Companies Winding-Up Act, R.S.N.S. 1967, c. 47, s. 4; Winding-Up Act, R.S.P.E.I. 1974, c. W-7 as am. by S.P.E.I. 1974 (2nd.), c. 65; 1981, c. 36, s. 22; Loi sur la liquidation des compagnies, L.R.Q. 1977, c. L-4 as am. by L.Q. 1979, c. 31, art. 24. See also infra pp. 85-87.

(36) [1973] A.C. 360 (H.L.).

(37) See infra p. 86.

(38) See infra pp. 87, 88.

advantage of the oppression remedy is that it allows the courts not only to enforce the agreement by ordering specific performance or damages to be paid, but also by working a considerable interference with the internal affairs of the corporation (39).

A contract normally can only be enforced by and against the parties to it. Often enforcement of a shareholder agreement may affect the corporation's rights, obligations or other legal relations (40). Because the corporation is an entity separate and apart from its shareholders, it is not bound by a shareholder agreement to which it is not a party even though all its shareholders are parties. Therefore, it seems desirable to make the corporation party to a shareholder agreement (41).

IV. Conclusion

For all these reasons, the use of shareholder agreements seems likely to be common in close corporations.

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(39) See, for example, the possibilities laid out in CBCA s. 234 (3) (a) - (n).

(40) For example if a third party acquires shares in contravention of a shareholder agreement, it is the corporation which can refuse registration of this party as shareholder.

(41) Compare Slone and Holt v. Margolian, Sidler and Margolian's (Truro) Ltd. (1957) 8 D.L.R. (2d) 115 (N.S.S.C.).

Although it is not possible to get empirical data on that, the fact that shareholder agreements are so often the subject of professional (42) or academic (43) discussion indicates that they are a most important planning tool for this kind of corporation. Even if certain provisions have already been included in the corporation's constitution, it still seems useful to repeat them in a separate shareholder agreement because of the above-mentioned practical advantages, the increased chances of enforcement and validity (44).

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(42) See, for example: B.N. Apple, Shareholders' Agreements Special Lectures of the Law Society of Upper Canada, 1968, pp. 41-64; Law Society of Upper Canada, Department of Continuing Education, Lectures 1976: Shareholders and Shareholders Agreements; English, Shareholder Agreements: General Considerations, in: K.C. Woodsworth, ed., Commercial Law - Transcript of a Continuing Legal Education Seminar Held in Richmond, B.C., in November 1978, 1979; Donner, supra note 21, pp. 10-21.

(43) See the literature already mentioned at note 5 and G. McCarthy, Shareholder Agreements, Canadian Business Corporations Act Meredith Memorial Lectures, 1975, pp. 465-474; I.R. Campbell, Get the Most Value From Your Shareholders' Agreements, 110 CA Mag. 5:30-34 (1977), P. Finn, Shareholder Agreements, 6 Aust. Bus. L. Rev. 97-104 (1978); H.S. Campbell, Non Tax Aspects of Buy-Sell Agreements, in: L. Sarna, ed., Corporate Structure, Finance and Operations, 1980, pp. 407-430; A. Robitaille, Les Conventions d'actionnaires, 42 R. du B. 147-176 (1982).

(44) The so-called "bulwark" principle: see R.A. Kessler, Drafting a Shareholders' Agreement for a New York Close Corporation, 35 Fordh. L. Rev. 625, 638, 640 (1967).

C. Shareholder Agreements to Influence Management

I. Reasons Why Shareholders in Close Corporations Want Influence on Management

The fact that shareholders exert considerable influence on management is one of the hallmarks of a close corporation. People become members of such corporations expecting to earn their livelihood through employment in managerial positions (45). This serves a need of this kind of business, as small close corporations often cannot afford to hire outside people for management positions who are less willing to take risks and make sacrifices should times get rough. Even an investor or a member of a family corporation who has inherited his shares is likely to want close contact with and influence in the business. Shares in a particular close corporation often represent a large proportion of their personal resources. Because it is almost impossible to sell their interest, they must be in a position to step in and protect it by being able to influence management. While the influence of a shareholder not holding a management position may be very limited in everyday affairs, he might, for example, want a voice in determining general policies adopted by the corporation, or in hiring and firing decisions.

Canadian corporate law does not take this fact sufficiently into account. The distribution of management powers is geared towards the needs of a widely-held corporation. It charges the board of directors with the independent management of the corporation's business. This makes perfect sense for such a corporation because giving management powers to its dispersed shareholders could make the decision-making process too slow, complicated and costly,

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(45) Huberman, supra note 7, p. 3.

and often unworkable. In close corporations, however, there are only a few shareholders, who are generally familiar with the corporations's affairs, and who have the need for powers that allow them to control or intervene, as described above. They can very well participate in the decision-making process.

The statutory distribution of management powers will first be described. After an overview of the other possibilities for shareholders to influence management, such as resolutions or amendments of the corporate constitution, a discussion of the often futile attempts of shareholders to interfere with management by shareholders agreements will follow. Finally, the statutory unanimous shareholder agreement will be scrutinized.

II. Statutory Allocation of Power to Manage

The organs to which management powers could be allocated are the board of directors and the general meeting of shareholders. The division of power between them depends on which incorporation system a corporation is subjected to.

In the case of memorandum and articles of association corporations (46) the division is based upon a provision which appears in the model articles of association of the statutes and which applies unless otherwise provided. This provision is to the effect that the directors are to manage the business of the corporation and may exercise all of its powers which are not required to be exercised by the general meeting (47). Shareholders who disagree with the action of

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(46) I.e. in British Columbia, Newfoundland and Nova Scotia.

(47) First Schedule, Table A of the respective statutes: BCCA art. 10.1; NCA art. 55; NSCA art. 128.

the directors are limited to showing their disapproval by exercising their right to vote the directors out or to change the corporation's constitution (48). In articles of incorporation jurisdictions (49) and the letters patent jurisdictions which still exist (50) the division of powers between shareholders and directors is effected by the statute itself, which vests in the directors the management of the business and affairs of the corporation (51). The division

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(48) See, for example, L.C.B. Gower, Gower's Principles of Modern Company Law, 4th. ed., 1979, pp. 144 ff.; R.R. Pennington, Company Law, 4th. ed., 1979, pp. 523-524; K.A. Aickin, Division of Power Between Directors and General Meeting as a Matter of Law, and as a Matter of Fact and Policy, 5 Mel. U.L. Rev. 448 (1967); B. Slutsky, The Relationship Between the Board of Directors and the Shareholders in General Meeting, 3 U.B.C. L. Rev. 3: 81 (1968); D.L. Larson, Control of Corporate Litigation in the Light of the Doctrine of Constitutional Contract and Bamford v. Bamford, 5 U.B.C. L. Rev. 363 (1970). But compare G.D. Goldberg, Article 80 of Table A of the Companies Act, 1948, 33 Modern L. Rev. 177 (1970); M.S. Blackman, Article 59 and the Distribution of Powers in a Company, 92 S.A. L. J. 286 (1975); and G.R. Sullivan, The Relationship Between the Board of Directors and the General Meeting in Limited Companies, 93 L.Q. Rev. 569 (1977), who hold a different opinion. According to them, the last sentence of Art. 80 Table A Companies Act, 1948 (U.K.), which says that the transfer of management powers to the directors is "...subject, nevertheless,...to such regulations,... as may be prescribed by the company in general meeting...",gives the general meeting a residual power to intervene in management affairs.

(49) Federal, Manitoba, Saskatchewan, Alberta, New Brunswick, Ontario, Quebec.

(50) Prince Edward Island and Quebec.

(51) CBCA, MCA, SBCA, ABCA s. 97 (1); NBBCA s. 60 (1); OBCA 1982 s. 115 (1); LCQ arts. 83 and 123.72; PEICA s. 27.

of power is therefore very similar in all Canadian jurisdictions, though in some it is statutory, while in others it flows from a general practice followed under a more permissive statute.

III. Possibilities for Shareholders to Influence Management by Simple Resolution or Amendment of the Corporate Constitution

The ways shareholders can try to interfere with this order once it is set up include majority resolutions of the general meeting dealing with management matters or changes of the corporate constitution shifting management powers permanently from the board in their favour. To understand to what extent such an influence is possible, it is necessary to examine the relationship between the general meeting and the board. There are two different approaches to this question in Canada: the one of the English-modelled memorandum of association jurisdictions and the one of the letters patent or articles of incorporation jurisdictions.

For the memorandum jurisdictions, the situation is virtually the same as in England: initially, in the English corporation law of the latter part of the 19th century, acts of the directors were regarded as always subject to control by the majority of the general meeting, because the general meeting was equated with the company (52). This principle was overruled in Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame (53) where it was decided

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(52) For dicta pointing in this direction see Foss v. Harbottle (1843) 2 Hare 461, 492, 493, 67 E.R. 189, 203 (Ch.); MacDougall v. Gardiner (1875) 1 Ch.D. 13, 22, 25, Isle of Wight Ry. Co. v. Tahourdin (1883) 25 Ch.D. 320. See also Gower, supra note 48, p. 143.

(53) [1906] 2 Ch. 34 (C.A.).

that, although the relationship between the board and the general meeting was primarily based on a contract contained in the memorandum and articles of association, it was by this contract that the shareholders had agreed to delegate the management powers of the company to the directors. Any shareholder interference with management therefore required a change of the memorandum or the articles of association (54). The Automatic case was later confirmed by several decisions (55). Likewise, in Canadian memorandum jurisdictions the memorandum and the articles of association constitute a contract between each of the shareholders and the company (55 a). The allocation of power to manage ultimately depends on the articles of association (56). These can be altered by the shareholders; but once the articles vest the power to manage in the directors, that arrangement cannot be undone by the general meeting except by an amendment of the articles.

In the letters patent jurisdictions all management power is vested by statute in the board of directors (57).

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(54) See the literature cited supra note 48; again, there exists considerably literature for a contrary view, see ibid..

(55) See, for example, Gramophone and Typewriter Ltd. v. Stanley [1908] 2 K.B. 89 (C.A.); Salmon v. Quin and Axtens [1909] 1 Ch. 311 (C.A.); Shaw and Sons (Salford) Ltd. v. Shaw [1935] 2 K.B. 113 (C.A.); Scott v. Scott [1943] 1 All E.R. 582 (Ch.).

(55 a) E.E. Palmer, D.D. Prentice, B.L. Welling, Company Law, Cases, Notes and Materials, 2nd. ed., 1978, pp. 2-2,3.

(56) V.E. Mitchell, A Treatise on the Law Relating to Canadian Commercial Corporations, 1916, p. 72.

(57) Supra note 51.

As long as there are no express provisions for shareholder control of the board's activities, it is clearly established that the directors are entitled to manage the affairs of the company without any interference whatsoever from the members (58).

Under the statutes modelled on the CBCA, incorporation is now done by means of filing articles of incorporation and the issuance of a certificate of incorporation. This method makes incorporation a matter of right (59) rather than a matter of ministerial discretion, as in the letters patent jurisdictions. However, it does not change the essential character of corporations formed under these statutes. Such corporations still rely primarily on the incorporating statute itself to effect the division of power between board and general meeting (60). As the power to manage is granted to the directors by the Act, shareholders have no direct influence on management, neither by resolution nor by amendment of the constitutional documents, as long as they do not use a unanimous shareholder agreement (61).

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(58) The Quebec Agricultural Implements Co. v. Etienne Hébert (1874) 1 Q.L.R. 363 (Cir. Ct.); Cann v. Eakins (1891) 23 N.S.R. 475 (N.S.C.A.); Re Hydro-Electric Power Commission of Ontario and Townships of Thorold and Pelham (1924) 55 O.L.R. 431, 435. (S.C., App. Div.).

(59) See CBCA and MCA s. 8; NBBCA s. 6: "... the Director shall issue a certificate of incorporation". Similarly SBCA, ABCA s. 8, OBCA 1982 s. 6.

(60) B. Slutsky, The Division of Power Between the Board of Directors and the General Meeting, in J.S. Ziegel, ed., Studies in Canadian Company Law, vol. 2, pp. 166, 167, note 5 (1973); Iacobucci, Pilkington, Prichard, supra note 4, p. 18; Palmer, Prentice, Welling, supra note 55 a.

(61) For this, see infra pp. 38, 39.

To summarize, in memorandum jurisdictions the shareholders have the possibility of structuring the management powers according to their needs by design of the articles of association. But once this is done, no intervention by majority resolution that has not been specifically allowed for by the modified articles is possible. No other jurisdiction tolerates any shareholder interference with management, except by way of a unanimous shareholder agreement as provided for by the CBCA and statutes based on it. For the needs of a close corporation, this management structure laid out by the statute is often amended by shareholder agreements trying to interfere with management.

IV. Agreements Fettering Directors' Discretion

1. Scope and Validity

The described distribution of power and the mentioned need for shareholder influence on management in close corporations explain why shareholders often try either to bind the directors by agreement or to agree among themselves on matters which are within the powers of the directors. Such agreements are incompatible with the common law rule that the discretion of the directors may not be fettered.

Agreements that conflict with this rule can take several forms: often shareholders enter into agreements in which they try to determine in advance particular corporate policies normally left to the board of directors. A shareholder agreement may designate the officers of a corporation and other employees and fix the salaries to be paid. Other agreements specify the circumstances in which dividends may be declared. Going even further, an agreement can try to subject all directors' actions to shareholder supervision or approval.

Besides the reasons for such agreements mentioned above (62), there is a distinct need for agreements on tenure and compensation in a close corporation context. A person acquiring a substantial interest in a close corporation typically wants to participate actively in the corporation affairs as a employee and perhaps as a director and a principal officer. He may have given up other employment with seniority and other accumulated benefits to work full-time for the corporation. He may have no income other than his salary. By contracting for a certain tenure and compensation, he is doing no more than satisfying a legitimate need for security to participate in the distribution of profits.

All these efforts to limit the power of the directors have met with hostility by the courts. The distribution of power by statute or by the corporate constitution provides that it is the directors who manage the corporation (63). In the exercise of these powers, the directors stand in a fiduciary relationship to the corporation (64). They are therefore always obliged to act bona fide in the best interests of the corporation (65). If they fetter their

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(62) Supra p. 17.

(63) Supra pp. 18-20.

(64) Re Iron Clay Brick Manufacturing Co. (1889) 10 O.R. 113 (Ch. D.); Sun Trust Co. v. Bégin [1937] S.C.R. 305.

(65) See, for example, Percival v. Wright [1902] 2 Ch. 421; Sun Trust Co. v. Bégin, supra note 64; Peso Silver Mines Ltd. v. Cropper (1966) 58 D.L.R. (2d) 1 (S.C.C.); codified in CBCA, MCA, SBCA, ABCA s. 117 (1) (a); NBBCA s. 79 (1) (a); OBCA 1982 s. 134 (1) (a).

discretion by a contract they will not, it is said, be able to fulfill this duty (66). Canadian courts therefore declared such agreements invalid (67). Later on, their policy became less clear (68). Finally, legislation intervened with the introduction of the unanimous shareholder agreement.

In Motherwell v. Schoof (69), the court had to decide on the validity of a shareholder agreement which provided for the appointment of the plaintiff as general manager and president of the corporation for as long as he wished. The court declared this part of the agreement invalid because it contravened the provisions of the Dominion Companies Act under which the company was incorporated and which charged the directors with the management of the corporation and the appointment of officers.

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(66) See Pratte J. in Bergeron v. Ringuet [1958] B.R. 222, 236, cited with approval by Judson J. in Ringuet v. Bergeron supra note 29, p. 683: "[Le directeur] est un administrateur chargé par la loi de gérer un patrimoine qui n'est ni le sien,... ni celui des actionnaires, mais celui de la compagnie, une personne juridique absolument distincte à la fois de ceux qui la dirigent et de ceux qui en possèdent le capital-actions. En cette qualité, le directeur doit agir en bonne conscience, dans le seul intérêt du patrimoine confié à sa gestion. Cela suppose qu'il a la liberté de choisir, au moment d'une décision à prendre, celle qui lui paraît la plus conforme aux intérêts sur lesquels la loi lui impose le devoir de veiller". See also Atlas Development Co. v. Calof and Gold (1963) 41 W.W.R. 575, 575-576 (Man. Q.B.); J. Smith, Corporate Executives in Quebec, 1978, p. 267; R.A. Harris, Ringuet v. Bergeron, 19 U. Toronto Fac. L. Rev. 149, 152 (1961).

(67) Motherwell v. Schoof [1949] 4 D.L.R. 812 (Alta S.C., T.D.).

(68) Ringuet v. Bergeron, supra note 29.

(69) Supra note 67.

In Ringuet v. Bergeron (70), the plaintiff sued on a shareholder agreement between him and the defendant which provided for his election as director and his nomination as general manager, secretary and treasurer of the corporation. The majority of the Supreme Court of Canada held that the agreement was enforceable. A clause which provided for unanimity of all resolutions of the parties concerned was upheld as meaning only the general meeting. This would not contravene public order (71) or the Quebec Companies Act, which vested management powers exclusively in the directors. Judson J. stated for the majority:

> "It is no more than an agreement among shareholders owning...the majority of the issued shares of a company to unite upon a course of policy or action and upon the officers whom they will elect. There is nothing illegal or contrary to public order in an agreement for achieving these purposes. Shareholders have the right to combine their interests and voting powers to secure such control of a company and to ensure that the company will be managed by certain persons in a certain manner." (72)

The appointment of officers is a management power conferred by statute on the board of directors. Here there was at least a slight impingement on this power which appeared to be immaterial to the Supreme Court. This decision does not seem reconcilable with the holding in Motherwell v. Schoof on the same question. In fact,

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(70) Supra note 29.

(71) The corporation was incorporated in Quebec; therefore this allusion was to arts. 13 and 990 Code civil.

(72) Supra note 29, p. 684.

some writers considered the Ringuet decision an implied recognition by the Supreme Court of the right of the shareholders to interfere with the management of a corporation (73). But it is unclear to what extent or under what circumstances such a right exists.

J. Smith (74), on the other hand, upholds the opinion that the court ruled the agreement as binding only on the shareholders (75). The clauses which concerned the election of officers or their remuneration were merely indicative as to how the shareholders wished the directors to act. Judson J. took a realistic view of the fact that, in close corporations, corporate policy is for all intents and purposes controlled by shareholders, with or without any shareholder agreement. However the decision in Ringuet v. Bergeron may be interpreted, the judgement was not detailed enough to modify such a clear decision as Motherwell v. Schoof. In a case arising after Ringuet, a unanimous shareholder agreement requiring unanimity for all resolutions of the corporation was held to be invalid because it fettered the directors' discretion (76).

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(73) Y. Caron, De l'action réciproque du droit civil et du common law dans le droit des compagnies de la Province de Québec, in J.S. Ziegel, ed., Studies in Canadian Company Law, vol. 1, p. 128; J. Chouinard, Commentaire: Ringuet v. Bergeron, 39 Can. Bar Rev. 469, 473 (1961); Bird, supra note 9, p. 78; R.W.V. Dickerson, J.L. Howard and L. Getz, Proposals for a New Business Corporations Law for Canada, vol. 1, 1971, hereinafter cited as Dickerson Report, para. 191.

(74) Supra note 66 p. 268.

(75) See also Harris, supra note 66, pp. 154-155.

(76) Atlas Development Co. v. Calof and Gold, supra note 66.

2. Possible Reasons for Directors' Independence

No substantive explanation has been given by the courts for their rigorous defence of directors' independence in a close corporation, with its distinctive need of shareholder influence in management. This is not only of interest for the jurisdictions which have not yet introduced statutorily permitted unanimous shareholder agreements to limit the directors' powers (76 a): even under those statutes modelled after the CBCA , agreements which are less than unanimous encounter the mentioned problem. The question may be asked whether there is any reason for such a restrictive attitude. What were the reasons which led to the introduction of an independent board into the corporate structure ? What is the situation today?

Directors have long existed as part of the structure of corporations. For example, the Bank of England and the ill-fated South Seas Company each had boards of directors prior to the first English general incorporation statute in 1844, and even as early as 1742 these directors were held to a standard of care (77). The first English statute to recognize the existence of the board and its right to manage the business of the company is the Companies Clauses Consolidation Act (78). However, the existence of a board of

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(76 a) British Columbia, Newfoundland, Nova Scotia, Prince Edward Island.

(77) Charitable Corporation v. Sutton, 2 Atk. 400, 26 E.R. 642 (1742).

(78) 8 & 9 Vict., c. 16, ss. 81-100 (1845).

directors was not regarded as an inherent quality of a corporation. This is indicated by the change in the English statute in 1862 to omit the requirement (78 a), if it was in fact a requirement, of the earlier statute. It was not restored until 1929 (79). In the Sutton's Hospital Case (80), the first great English corporation decision, the board is not mentioned as one of the things "of the essence of a corporation", and it is also omitted from the list of corporate powers as set forth by Lord Coke (81).

The creation of a board of directors was not a legislative reaction to some spectacular event; the board simply was accepted in the course of time, as a concession to normal business practice (82). Even if it were constitutionally possible for the general meeting to exercise all the powers of the company, it clearly would not be practical for the day to day administration to be handled by such a cumbersome piece of machinery.

Once accepted, the board grew more and more independent: at first still susceptible to shareholder majority decisions in the general meeting (83), it became the agent of the company as a whole (84). Its significance in

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(78 a) Companies Act, 1862, 25 & 26 Vict., c. 89. See also In re Bulawayo Market and Offices Co. [1907] 2 Ch. 458, 463.

(79) Companies Act, 19 & 20 Geo. 5, c. 23, s. 139.

(80) (1613) 10 Coke 23 a, 29 b, 77 E.R. 960, 968-969.

(81) (1613) 10 Coke 23 a, 30 b, 77 E.R. 960, 970.

(82) R. A. Kessler, The Statutory Requirement of a Board of Directors: A Corporate Anachronism, 27 U. Chi. L. Rev. 696, 704 (1960).

(83) See for example Foss v. Harbottle, supra note 29.

(84) Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame, supra note 53.

the corporate structure changed from a mere concession to existing business practice to a statutory requirement. However, in the English-derived memorandum jurisdictions, the board can still be stripped of its power to manage by appropriate provisions in the memorandum or articles of association (85).

In the U.S., the independence of the board was fostered by the so-called concession theory. According to this theory, incorporation and its advantages are granted by the state and, in return, the incorporated entity must strictly comply with certain norms set by the state, for example the requirement of a board with powers to manage. This formalistic view of the requirement of a board has often been given as a reason to strike down efforts of the shareholders to increase their influence in the corporation (86).

A similar view of incorporation was taken in Canada's letters patent and articles of incorporation jurisdictions: the corporation is subject to the statute which prescribes a certain management structure and provides that the directors shall manage the corporation (87).

Thus, the requirement of an independent board of directors developed as a concession to business practice as

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(85) In the memorandum statutes, the board requirement is laid down in BCCA s. 132 and NSCA s. 79. There is no such requirement in the NCA: in this respect, it resembles the English act of 1862.

(86) See, for example, Manson v. Curtis 119 N.E. 559 (N.Y. 1918); Long Park Inc. v. Trenton-New Brunswick Theatres Co. 77 N.E. 2d 633 (N.Y. 1948). See for a review of cases Krüger, *supra* note 6, pp. 86-89.

(87) CBCA, MCA, SBCA, ABCA s. 97; LCQ art. 123.72; NBBCA s. 60 (1); OBCA 1982 s. 115; PEICA s. 20. See also Palmer, Prentice, Welling, *supra* note 55 a, pp. 2-2,3. In the CBCA-modelled statutes, however, the directors' powers are subject to unanimous shareholder agreements. For this, see *infra* pp. 38-45.

it exists in widely-held corporations, gradually changing into an obligation over the course of time.

Another reason for the protection of directors' independence which has to be considered is the fundamental principle of corporation law that the directors must act bona fide in what they consider is in the best interests of the corporation (88). If their discretion is fettered, it is said that directors cannot obey this rule. What constitutes the "interests of the corporation"? How much different are they from the interests of the shareholders that they could justify the independence of the directors from shareholder interference with management even under close corporation circumstances?

In pursuing the interests of the corporation, which, of course, has a separate personality of its own, directors are not expected to act on the basis of what is economically advantageous for the corporate entity; they may very well have regard to the interests of the members (89). Nor do the interests of the corporation mean the advantage of the majority of the shareholders, but rather that of "the majority plus the minority - all in fact who, being shareholders, constitute the very substance... of the incorporated body" (90). It was said that it is not

> "the sectional interest of some (it may be a majority) of the present members or even... of all present members, but of present and

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(88) It is not clear how far this principle is applicable in Quebec: see for example J. Smith, supra note 66, pp. 174-182. No attempt is made in this thesis to deal with Quebec's special situation.

(89) Gower, supra note 48, p. 577 ; and see Evershed M.R. in Greenhalgh v. Arderne Cinemas [1951] Ch. 286, 291 (C.A.).

(90) Martin v. Gibson (1907) 15 O.L.R. 623, 632 per Boyd, C..

> future members of the company... on the footing that it would be continued as a going concern, [balancing] a long-term view against short term interests of present members" (91).

The view that a director must consider future shareholders' interests is also indicated in some earlier Canadian cases (92).

It seems as if only the interest of the shareholders, and presumably creditors (93), present and future, can be taken into account; the interests of the consumers of the company's products and even employees are, legally-speaking, irrelevant (94). If the company is a going concern, a regard to these other interests will serve the members' interests. So, in fact, they have to be kept in mind. "[A] rebellious staff, hostile trade unions, dissatisfied customers and an aggrieved public or government are not conducive to the future prosperity of the company."(95).

There are indications that the strict common law position could be changing in Canada. In Teck Corp. v.

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(91) The Savoy Hotel Ltd. and the Berkeley Hotel Co. Ltd. : Investigation under s. 165 (b) of the Companies Act 1948, Report of Mr. E. Milner Holland, (H.M.S.O. 1954), p. 16; as cited by Gower, supra note 48, p. 578. See also Gaiman v. National Association for Mental Health [1970] 2 All E.R 362, 374 (Ch.D.).

(92) In Re Hess Mfg. Co. (1894) 23 S.C.R. 644; Denman v. Clover Bar Coal Co. (1913) 48 S.C.R. 318; Fullerton v. Crawford (1919) 59 S.C.R. 314.

(93) See Walker v. Wimborne (1976) 50 A.L. J.R. 446 (Aust. H.C.), noted by R. Barrett in 40 Modern L. Rev. 226 (1977); see also H.A.J. Ford, Principles of Company Law, 2nd. ed., 1978, p. 345; Gower, supra note 48, p. 578.

(94) Parke v. Daily News [1962] Ch. 927.

(95) Gower, supra note 48, p. 578, Ford, supra 93, p. 344.

Millar (96) Mr. Justice Berger made the following obiter statements regarding what are the best interests of a corporation:

> "A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders.
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> I appreciate that it would be a breach of their duty for directors to disregard entirely the interest of a company's shareholders in order to confer a benefit on its employees: Parke v. Daily News Ltd., [1962] Ch. 927. But if they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company." (97)

These general remarks can be seen as a revolutionary step towards a much wider conception of the "interest of a corporation" which the directors have to pay regard to (98). However, Berger J's. statement could also be interpreted as a reaction to a particularly harsh opinion expressed by E.E. Palmer (99), cited in Teck (100): "... [N]o interest outside of those of the shareholders can be legitimately considered

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(96) (1973) 33 D.L.R. (3d) 288 (B.C.S.C.).

(97) Ibid., p. 314.

(98) See for example J. Smith, supra note 66, p. 176.

(99) Directors' Powers and Duties, in : J.S. Ziegel, ed., Studies in Canadian Company Law, vol. 1, 1967, p. 371.

(100) Supra note 96, p. 314.

by the directors." It could be saying nothing more than that the interests outside the corporation have to be considered in order to serve the shareholders' interests well. Since Teck, there has been no Canadian decision ruling explicitly on the question of what is represented by the interests of the corporation. In Rustop Ltd. Estate v. White (101) two directors, who were also the only shareholders of the corporation, caused it to make a gift of $26,650.00 to another corporation owned by them. Hart J.A. held that they had breached the fiduciary duties they owed to the corporation because they only took into account their own interests, that is, those of the present shareholders. But even the most conservative opinion acknowledges that it is not only the present shareholders who are relevant for the interests of the corporation, but also the interests of, for example, future shareholders (102). Therefore, Rustop is reconcilable with the traditional concept of the corporation's interests.

The recently reformed ABCA now contains a provision which allows a director elected by a special class of shareholders or by employees or creditors to take their interests into consideration (103) because he otherwise would be in danger of breaching his fiduciary duty to act in the best interests of the corporation. Nevertheless, one has to be careful with conclusions on the legislators' opinion as to the general concept of a corporation's interests: the report discussing the new act considered it better to leave the law on this matter to develop in the hands of the judges (104).

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(101) (1979) 36 N.S.R. (2d) 207 (S.C., App.Div.).

(102) See supra note 91.

(103) ABCA s. 117 (4).

(104) University of Alberta Institute of Law Research and Reform, Proposals for a New Alberta Business Corporations Act, vol. 1 (Report), August 1980, hereinafter cited as Wilson Report I, p. 65.

However, it expressly refrains from including the interests of the employees in the concept of the interests of the corporation (105).

In summary, the duty of directors to act in the best interests of the corporation still means to act in the interest of present and future shareholders as a whole, and perhaps also its creditors.

3. Do These Reasons Justify Directors' Independence in Close Corporation Circumstances?

Before evaluating the possible reasons for protecting directors' independence, the particular factual situation of a board of directors under close corporation circumstances should be pointed out. Here, majority shareholders exercise effective control over the decisions of the directors (106). It seems quite unrealistic that directors, in making corporate decisions, act completely independently and without regard to the principal shareholders. Directors normally follow the wishes of the shareholders who elect them; in close corporations, with their identity of ownership and management, the board is often little more than a "perfunctory statutory appendage" or a "fictional or vestigial legal organ" (107). In the light of this

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(105) "...[W]e do not think that the principle that the directors should act in the interests of the corporation should be endangered (as we think it would be) by a provision suggesting that the interests of the employees are the interests of the corporation..." (Wilson Report I, <u>supra</u> note 104, p. 66).

(106) O'Neal, <u>supra</u> note 7, para. 5.16.

(107) Bates, <u>The Board of Directors</u>, 29 Harv. Bus. R. No. 1, 76 (1940), and Mace, <u>The Board of Directors in Small Corporations</u>, 1948, p. 3, both cited in Huberman, <u>supra</u> note 7, p. 18, notes 101 and 102.

special situation, the historical reason given for the independence of the board, in terms of it being a mere concession to business practice for the convenience of widely-held corporations, seems inapplicable to close corporations.

As for the duty of the directors to act in the best interests of the corporation, the case is less clear. According to this formula, the directors have to balance the interests of the present and future shareholders and probably creditors (108). If the shareholders are allowed a greater say in management, they will, of course, first consider their own interests. A shareholder agreement, executed by all members, would represent the interests of all current shareholders. If one is to allow them to take over the management from the directors, sufficient safeguards for the other interests that directors would normally have to balance must be available.

One group whose interests probably (109) have to be taken into account are the creditors. The creditors' interests are to get a return on their debt financing of the corporation and eventually to get their capital back. A very important safeguard already in place protecting the interests of creditors is the statutory rules for the maintenance of capital, for example regulating reductions of capital, distributions of dividends, the acquisition of its own shares by a corporation or loans or other means of financial support by the corporation to its directors and shareholders. Furthermore, in a close corporation, creditors often negotiate for personal liability of the shareholders

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(108) See <u>supra</u> pp. 31-35.

(109) See <u>supra</u> note 93.

as a security on their loan. Taking into account the protection creditors already have, it does not seem necessary to protect their interests by an independent board of directors, given the need of shareholders for influence on management in close corporation circumstances.

The interests of future shareholders must also be balanced by the directors, which would be less likely when present shareholders control the management. The question is whether their interests can weigh so heavily that they render an agreement tranferring certain management powers of the directors to the shareholders void because it fetters the directors' discretion. Professor Gower thinks it cannot, but its validity could be attacked by the company to whom the fiduciary duties are owed if at a later stage a new member is able to take action on its behalf (110).

This solution is appropriate, as it seems almost impossible for the directors to ascertain the intentions of all future shareholders. Held against the massive and understandable interests of the present shareholders in a close corporation, it is justifiable that the protection given to the interests of future shareholders is limited to a right to avoidany agreement found to be severely damaging their interests.

In summary, the reason for protecting the directors' independence and discretion is to make it possible for them to act in the best interests of the corporation and thus to balance present and future shareholders' and creditors'

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(110) Gower, supra note 48, p. 583; for the same view, see O'Neal, supra note 7, para. 5.24.

interests. This is most compelling for widely-held corporations. It seems, however, to be less important in the case of close corporations. If all shareholders participate in a shareholders agreement enabling them to interfere with management, the most important part of the corporation's interests is being taken care of; such an agreement should be valid (111).

V. New Statutory Position: Unanimous Shareholder Agreements as a Means of Shifting Management Power

The CBCA modifies the common law so as to validate a unanimous shareholder agreement notwithstanding that it restricts the discretion of the directors (112). The restrictions on the powers of the directors may be total or only partial (113). Expressly subjected to unanimous shareholder agreements in the statute are the following matters: the directors' power to manage the corporation (s. 97 (1)), to make by-laws (s. 98 (1)), to issue shares (s. 25 (1)), to designate officers (s. 116), to fix remuneration (s. 120), and to borrow (s. 183 (1)). The agreement has to be in writing. In the event of such agreement, the shareholders are, to the extent that restrictions of the directors powers exist, deemed to assume the duties and liabilities imposed upon the directors by the statute and by common law, and the directors are relieved of such duties and liabilities (114).

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(111) For a similar conclusion, albeit without explanation, see Iacobucci and Johnston, supra note 4, p. 133.

(112) S. 140 (2).

(113) McCarthy, supra note 43, p. 469; M. Martel and P. Martel, La compagnie au Québec: Les aspects juridiques, 1982, p. 26-7; Wilson Report I, supra note 104, p.24; Robitaille, supra note 6, pp. 169-170.

(114) S. 140 (4). This, presumably, includes all fiduciary duties, such as the duty to act in the best interests of the corporation.

This scheme has been followed by Manitoba, Saskatchewan, Quebec, Alberta, New Brunswick and Ontario (115) and is included in a legislative proposal for Newfoundland (116). At the time of writing this thesis, no similar proposals exist in British Columbia, Nova Scotia or Prince Edward Island (117).

Although the unanimous shareholder agreement has been welcomed as an important and useful planning technique in a close corporation (118), the unanimity requirement and the tranfer of liability provision in CBCA s. 140 (4) deserve a closer look. After this, the question will be asked whether the unanimous shareholder agreement concept goes far enough in shifting management power to the shareholders.

1. Unanimity Requirement

The primary purpose of the unanimity requirement is minority protection: every shareholder must participate in the decision of whether to shift management power from the directors to the shareholders. Some doubts have been entertained whether such protection is necessary. An alternative would be to rely on minority protection devices given elsewhere in the statute (119), and to admit majority

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(115) MCA, SBCA s. 140 (2); LCQ art. 123.91; ABCA s. 140 (1); NBBCA s. 99 (2); OBCA 1982 s. 108 (2).

(116) Proposals for a New Company Law, tabled in the House of Assembly in June 1978, s. 229.

(117) Letters from the British Columbia Minister of Corporate and Consumer Affairs, the Nova Scotia Deputy Provincial Secretary and the Prince Edward Island Department of the Provincial Secretary - Corporations Division.

(118) Iacobucci, Pilkington, Prichard, *supra* note 4, p. 162.

(119) For example, the oppression remedy in CBCA s. 234, 235, the appraisal remedy in CBCA s. 184, the winding up on just and equitable grounds in CBCA s. 207.

agreements (120) fettering directors' discretion. This would considerably facilitate decision-making and management of a close corporation.

Because the views of the shareholder majority do not represent the interests of the corporation (121), an admission of majority agreements would be a serious interference with the board's function of looking after the best interests of the corporation. Even if the parties to this agreement could be held liable as directors, it seems arguable that a minority shareholder should be able to rely on the fact that the directors will manage the business of the corporation unless their discretion is fettered by unanimous shareholder agreements to which such a shareholder has consented.

The unanimity solution also takes into account that a minority in a close corporation, where unanimous shareholder agreements will mostly be used, is exposed to a considerably greater danger of oppression than a minority in a publicly-held corporation. Minority shareholders can lose their jobs, which at the same time would mean the loss of their salary and of a return on their investment. They have no market in which to dispose of their shares when aggrieved because of action of the majority. There is no public control of the behavior of the majority in power as in the case of a widely-held corporation, where the general meeting has a strong interest in being well informed of the directors' activities (122).

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(120) See the discussion of the Delaware corporations law, which does so, in Iacobucci, Pilkington, Prichard, supra note 4, p. 79, and Robitaille's proposal, supra note 6, p. 176.

(121) Supra p. 31.

(122) On the need for minority protection in a close corporation, see also p. 46.

The minority protection provided for by the unanimity concept is a useful precaution in a close corporation, especially having regard to such a fundamental structural change as the shift of management power. It should not be replaced by reliance on other parts of the statute.

Furthermore, the unanimity requirement is useful because it limits the scope of corporations in which the shareholders can take over management. From a practical point of view, it will only be possible for close corporations with few shareholders to have such agreements. Also, it is a partnership principle that important decisions have to be made unanimously. As close corporations have often been compared with partnerships, it seems appropriate that such an important decision as the one concerning the management structure of the corporation should be taken unanimously.

The importance of the unanimity requirement helps solve the problem of what happens if a share is transferred without conspicuous reference on it to the unanimous shareholder agreement. Under most statutes, the agreement is ineffective against the transferee unless he has actual knowledge of it (123). Although he becomes a shareholder, he is not deemed to be a party to the agreement. Thus, the shareholder agreement is no longer unanimous. A question not answered by most of the statutes is what happens to the rest of the agreement. Does it still bind the other shareholders although it is not unanimous? Bindingness would seem to be against the declared legal policy; and bindingness would also engage the concerns raised regarding reliance on the traditional allocation of power and minority protection.

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(123) CBCA, MCA, SBCA s. 45 (8); NBBCA s. 47 (8); OBCA 1982 s. 56(3). In all other cases, a transferee is deemed to be a party to the agreement under these statutes: CBCA, MCA, SBCA s. 140 (3); NBBCA s. 99 (4); OBCA 1982 s. 108 (4).

The agreement should thus come to an end as a unanimous one. If it does, the directors may not know that they are liable again. What will happen to shareholders who still act on the agreement? Their acts will be void. Probably the only thing they can do against this is to keep informed about the dangers threatening unanimity. Thus, the continuing shareholders have a strong incentive to make sure that the transferee becomes party to the agreement. In addition, reasonably careful investigation by the purchaser can be expected because of the normal caution involved in buying into a small business operated essentially on a partnership basis (124). Although the admission of an innocent shareholder seems unlikely, cases of this kind cannot be ruled out. It is regrettable that the legal consequences are not clear.

In Quebec, LCQ art. 123.93 provides that an innocent shareholder can avoid the contract of sale within six months if he shows that he was not aware of the agreement at the time of the sale. No mention of the agreement on the share certificate results in a presumption against him having had knowledge. After the 6-month period he is in any case considered a party to the agreement. Similarly, the ABCA makes an innocent buyer, in principle, a party to the agreement; the unanimous shareholder agreement stays valid (125). He has to communicate his objection to the sale to the corporation within 30 days after he acquires actual knowledge of the existence of the agreement (126). Thereby he becomes entitled to demand reimbursement for his shares according to the statutory rules governing the appraisal

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(124) W.G. Hall, The New Maryland Close Corporation Law, 27 Md. L. Rev. 341, 357 (1967).

(125) ABCA s. 140 (3).

(126) ABCA s. 140 (4).

right (127). If the appraisal value is less than the price the buyer paid, he can sue the seller for the difference (128). The Alberta solution is more favourable to the transferee in not putting an absolute time limit on his option to rescind.

2. Extent of Shareholder Liability

CBCA s. 140 (4) and the corresponding sections in SBCA, MCA, ABCA, NBBCA, LCQ, OBCA 1982 stipulate a transfer of directors' duties and liabilities to the shareholders party to a unanimous shareholder agreement "to the extent that the agreement restricts the powers of the directors to manage the business and affairs of the corporation...".

This "scope of authority" rule is relatively easy to apply if an act has been fully performed under the responsibility of either the directors or the shareholders. Thus, if a unanimous shareholder agreement transfers to the shareholders the power to buy back shares or to pay dividends, and they do this in violation of statutory solvency tests, they are jointly and severally liable to compensate the company for the amount paid out illegally. But the assumption of liability by the shareholders in the agreement is not always so clear: it could, for example, simply make the exercise of the directors' powers subject to shareholder approval (129) or grant to them a right of intervention (130) In such a case would the shareholders or the directors be considered solely liable, or would both share liability? Probably, both directors and shareholders are liable in a way similar to joint tortfeasors.

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(127) ABCA s. 140 (5).

(128) ABCA s. 140 (6).

(129) McCarthy, <u>supra</u> note 43, p. 471.

(130) See Robitaille, <u>supra</u> note 6, p. 170, with more examples.

There is a section in the CBCA-modelled statutes which makes directors liable for up to 6 months of wages if the corporation is not able to pay (131). This liability is not linked to any action performed by directors but simply to the fact that they are the ones in office. For this "intrusion on the principle of limited liability" (132) it is the opinion of the author that it is enough if a shareholder becomes party to a unanimous shareholder agreement which somehow restricts the powers of the directors to manage. Although some statutes speak of the directors being relieved of their liabilities in this respect (132 a), it is not clear to what extent they will be relieved if the shareholders claim only a part of the directors' powers. Presumably, the shareholders and directors would again both be liable, with the employee having the choice of claiming the full or partial amount from any individual shareholder or director.

3. Does the Statute Go Far Enough?

It is quite possible under the new statutes to have directors without any management rights or duties. Such directors seem to have no usefulness. Beyond that, individuals vested with nothing but the title "director" could be misleading to outsiders and the corporation will be liable for their actions within certain limits (133).

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(131) CBCA, MCA, SBCA, ABCA s. 114; LCQ art. 96; OBCA 1982 s. 131.

(132) Iacobucci, Pilkington, Prichard, supra note 4, p. 327.

(132 a) CBCA, SBCA s. 140 (4); ABCA s. 140 (7); OBCA 1982 s. 108 (5).

(133) Compare CBCA, MCA, SBCA, ABCA s. 18 (d); OBCA 1982 s. 19 (d), NBBCA s. 16 (d), all statutory modifications of the indoor management rule, and Iacobucci, Pilkington, Prichard, supra note 4, pp. 104-106.

What sense does it make for the statute to insist on their existence? However, the new statutes do not go as far as providing for direct shareholder management by abolishing the board of directors altogether. Such a provision is contained in the Delaware statute (134). It seems most desirable that Canadian statutes follow this example (135).

4. Conclusion

The unanimous shareholder agreement allows the incorporators or subsequent shareholders substantial flexibility in designing the corporate structure and will assist them in molding it to the particular needs of a close corporation. The provisions which shift duties and liabilities from the directors to the shareholders while ensuring that a properly notified transferee will also be bound are important complements to the unanimous shareholder agreement. Except in Quebec and Alberta, the legal consequences of an admission of an innocent third party seem unclear. Equally uncertain is the extent of shareholder and director liability arising from a unanimous shareholder agreement. A provision that would allow the shareholders to do away the board altogether would be desirable.

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(134) Delaware General Corporation Law, para. 351, which requires the inclusion of such a clause in the certificate of incorporation. In Canada, the relevant document would be the unanimous shareholder agreement, which, in present law, is already designed to restrict the powers of the directors.

(135) See Robitaille's proposition pointing in this direction, supra note 6, p. 172.

D. Veto Agreements and Voting Agreements

I. Veto Agreements

A veto agreement, either at the shareholder or at the director decision level, serves the purpose of giving a single member or a minority group of members an opportunity to control the decisions of the general meeting or the board of directors. The need for minority protection is especially urgent in a close corporation. Often, the majority of the shareholders is identical with the management of the corporation. This gives the majority a chance to represent its interests directly through management. Outside control mechanisms, for example securities legislation, the stock exchange, institutional investors and the financial press, do not have any major role in relation to close corporations. A shareholder in a close corporation is much more "locked in" the corporation compared to a shareholder of a widely-held corporation. He invested a considerable part of his fortune in the corporation and is often earning his living by working for it. These should be reasons enough for him to be careful about decisions to leave the corporation in case of a conflict with the majority. Furthermore, the sale of his shares is made very difficult since there is practically ~~no~~ market for close corporation shares and their transfer is often subject to restrictions (136). This often results in an awkward situation where the only persons to whom he can sell his shares are the same ones who made his life difficult when he was a member: the majority shareholders. Often, they will pay him a price which is only a fraction of the shares' actual value. Veto agreements can provide a

(136) See <u>infra</u> pp. 57, 58.

shareholder or director minority with effective protection already in the decision-making process. The statutory remedies (137) can, if they exist, in most cases only repair the damage, whereas the protection by agreement is preventive.

1. Veto Powers for Shareholder Action

Veto provisions can be all-embracing (138), covering all decisions which come before the general meeting, or they can be limited to specific kinds of decisions. They can fix a higher majority than the one required by statute, or even unanimity. Although these provisions enlarge the possibility for the single shareholder to control the decision-making process, they do not mean that the powers of the shareholders, as a whole, are extended: special majorities can only be required for decisions already within the province of the shareholders.

2. Veto Powers for the Board of Directors

High voting requirements for shareholder action usually do not give the power to veto important management matters, because these are within the province of the directors. To provide a veto over these kinds of decisions, such as the selection of officers, changes in officers' salaries, the making of basic policy decisions or the declaration of dividends, unanimity or a high vote must be

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(137) Derivative action, oppression remedy and appraisal remedy.

(138) M.N.R. v. Aaron's Ladies Apparel Ltd. (1967) 60 D.L.R. (2d) 448, 454-459 (S.C.C.).

required for <u>director</u> action.

Such provisions have been held invalid on the basis that they fetter directors' discretion:

> "With respect to the directors of the company, an agreement requiring unanimity in every decision is inconsistent with their duty to decide matters affecting the welfare of the company...in accordance with their best judgment, and such an agreement by directors is void." (139)

It is not clear why the fetter rule was applied in this context, because even with a higher majority or unanimity requirement the single director is always free to make a decision in what he considers the best interests of the corporation (140).

This type of holding has has been overruled by the CBCA-modelled statutes, which allow special majorities in articles of incorporation and unanimous shareholder

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(139) <u>Atlas Development Co.</u> v. <u>Calof and Gold</u>, <u>supra</u> note 66.

(140) See also the later decision <u>M.N.R.</u> v. <u>Aaron's Ladies Apparel Ltd.</u>, <u>supra</u> note 138. The clause in this case said: "6. That all motions put before any meeting of shareholders or directors of the company shall require the unanimous consent of all its members..." (<u>ibid.</u>, p. 454); it was held to apply only to shareholders' meetings. Hall J. referred extensively to <u>Ringuet</u> v. <u>Bergeron</u>, <u>supra</u> note 29, where a clause forcing a director to vote with the majority of the directors party to the agreement was held to apply only to shareholders' meetings. The wording of the clause was: "11. Dans toutes assemblées de ladite compagnie, les parties aux présentes s'engagent et s'obligent à voter unanimement sur tout objet qui nécessite un vote. Aucune des parties aux présentes ne pourra différer d'opinon avec ses co-parties contractantes en ce que concerne le vote" (<u>ibid.</u>, p. 674). In this case, it is evident that the discretion of the directors is fettered.

agreements (141). It may also not be valid for memorandum jurisdictions, where the powers to manage can be allocated by the articles of association. If this is possible, it should be equally legal to fetter directors' discretion by fixing a higher majority for board decisions.

Even if these uncertainties concerning validity were tolerable, veto provisions for the board only make sense if the shareholder in question is assured representation on the board. This can be done by executing a shareholder agreement which permits him to designate a director or by instituting cumulative voting, or by classifying the corporation's shares, distributing a separate class of shares to each shareholder, and providing for the election of a director or a specified number of directors by each class of shares.

3. Assessment of Veto Powers

The disadvantages of a veto scheme are that veto provisions give no power to initiate action towards fulfilling a certain corporation policy. They slow down the decision-making procedure and considerably increase the chances that a deadlock will occur, either in the general meeting or on the board, which will paralyse the corporation and render it unable to conduct its affairs. Finally, an unscrupulous shareholder minority can abuse the veto provisions to extort unfair concessions from the other shareholders (142). A veto arrangement thus requires a

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(141) CBCA, MCA, SBCA, ABCA s. 6 (3); NBBCA s. 4 (3); OBCA 1982 s. 5 (4).

(142) Finn, <u>supra</u> note 43, p. 103.

careful balancing of the safeguards necessary to protect minority shareholders and the freedom of action which is beneficial to the corporation. So, provisions should be tailored to meet the specific problems rather than establish a broad requirement for unanimous action by shareholders or directors on all matters which may come before them (143).

II. Voting Agreements

Whereas it is relatively easy to point out the function of veto agreements and their usefulness for close corporations, voting agreements are harder to describe because they come in many different forms and often serve different purposes. What they all have in common is the agreement of shareholders that, in exercising voting rights, the shares held by the parties to it shall be voted as therein provided (144). Voting agreements are of the utmost importance for closely-held corporations. Here, equality of control is often a feature of the business bargain. As the right to vote for directors is the most important right of shareholders, it is not uncommon that they agree to elect themselves, or their nominees, as directors. But as well all other matters shareholders can vote on can be the object of voting agreements, such as modifications of the corporate constitution, nomination of auditors and their remuneration,

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(143) C. Israels, Corporate Practice, 3rd. ed., p. 90 (1974).

(144) Compare CBCA s. 140 (1).

or the voting out of office of directors. Voting agreements assure a smooth functioning of the general meeting as a company organ and a certain continuity in the corporation's policies, in so far as they depend on the general meeting.

1. Validity

Utilization of a voting agreement is not inconsistent with corporation law. The right to vote is a property right inherent in share ownership (145) and an agreement on how to vote is no more than a lawful exercise of this right. It is also firmly established that a shareholder can deal with the voting rights of his shares separately from his proprietary right in the shares (146). A shareholder may vote his shares according to his own private interest (147).

The legality of voting agreements at common law has been recognized in Canada (148), but this rule is stated as subject to the qualification that the agreement must be for a lawful purpose (149). Thus a voting agreement may not be used

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(145) M.A. Pickering, <u>Shareholders' Voting Rights and Company Control</u>, 91 L. Q. Rev. 248, 250 (1965).

(146) <u>Puddephatt</u> v. <u>Leith</u>, <u>supra</u> note 28.

(147) See, for example, <u>Pender</u> v. <u>Lushington</u> (1877) 6 Ch. D. 70, 75; <u>North-West Transportation Co.</u> v. <u>Beatty</u> (1887) 12 App. Cas. 589, 593 (P.C.)

(148) <u>Motherwell</u> v. <u>Schoof</u>, <u>supra</u> note 67; <u>Ringuet</u> v. <u>Bergeron</u>, <u>supra</u> note 29; <u>M.N.R.</u> v. <u>Aaron's Ladies Apparel Ltd.</u>, <u>supra</u> note 138.

(149) <u>Motherwell</u> v. <u>Schoof</u>, <u>supra</u> note 67.

to supersede the directors' statutory right to manage the company or to bind their discretion (150). This is why voting agreements of shareholders, who are directors at the same time, for votes on the board of director have generally been held invalid (150 a). The CBCA-modelled Canadian statutes now expressly provide for the legality of voting agreements, giving statutory form to the case law (151). Voting agreements have to be in writing to fall within the statute and to be enforceable (152).

2. Enforcement

A voting agreement may be enforced by injunction (153). It may be desirable to provide for more drastic remedies such as a forced transfer of shares by the offending party against a modest indemnification (154). The parties will be bound only by the express terms of their agreement

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(150) See _supra_ pp. 24-28 and Robitaille, _supra_ note 6, pp. 157-163. However, under newer corporation statutes a restriction of the directors' powers by way of unanimous shareholder agreements is possible, see pp. 38 ff.

(150 a) See _supra_ pp. 24-28.

(151) CBCA, MCA, SBCA s. 140 (1); ABCA s. 139.1; NBBCA s. 99 (1); OBCA 1982 s. 108 (1).

(152) See provisions _supra_ note 151 with exception of MCA s. 140 (1).

(153) _Greenwell_ v. _Porter_ [1902] 1 Ch. 530; _Puddephatt_ v. _Leith_, _supra_ note 28 ; _Turvey and Mercer_ v. _Lauder_ (1956) 4 D.L.R. (2d) 255 (S.C.C.).

(154) Coates , _supra_ note 4, pp. 116, 117, but see the limits to this pointed out _supra_ p. 13 by the law concerning penalty clauses.

and additional provisions will not usually be implied (155).

3. Reinforcement by Irrevocable Proxy or Voting Trust

a) Irrevocable Proxy

An irrevocable proxy is an irrevocable authorization given by a shareholder to another person to vote his shares. It is questionable whether such a proxy can be executed under Canadian law. As the proxy is an agent and therefore is subject to the general law of agency (156), his authority can only be irrevocable if he has a special interest in exercising the voting right (157). The concept of interest has been interpreted very broadly in the United States (158), but it is not clear what is meant by it under English or Canadian law in the case of voting proxies. Probably, the

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(155) Pickering, _supra_ note 145, p. 256; _Greenhalgh_ v. _Mallard_ [1943] 2 All E.R. 234 (C.A.); _Greenhalgh_ v. _Arderne Cinemas Ltd._ [1946] 1 All E.R. 512 (C.A.).

(156) Gower, _supra_ note 48, p. 538-541.

(157) W. Bowstead, _Bowstead on Agency_, 14th ed. by F.M.B. Reynolds and B.J. Davenport, 1976, pp. 423-424. Whereas in England some of the problems arising in the context of irrevocable powers are dealt with by the _Powers of Attorney Act, 1971_, s. 4, there are no such provisions in the only two Canadian powers of attorney acts, i.e. the _Power of Attorney Act_, R.S.B.C. 1979, c. 334, and the _Powers of Attorney Act_, R.S.O. 1980, c. 386.

(158) Compare O'Neal _supra_ note 7, para. 5.36

interest of an unregistered transferee or an equitable mortagee is sufficient (159). It has been suggested that proxies, as a special category of agency, follow their own rules in this respect and that only valuable consideration has to be given (160). It is however doubtful whether the courts would follow this opinion.

In any event, irrevocable proxies come under the statutory provisions dealing with proxies. So, OBCA 1982 s. 110 (2) and BCCA s. 175 (4) limit the duration of a proxy to one year (161); under some of the CBCA-modelled statutes, it is only valid for the meeting in respect of which it was given (162). Also, the statutes resolve the uncertainty concerning the revocability of a proxy in favour of the donor, who can revoke it at any time (163). Non-compliance with proxy-regulation provisions can lead to the meeting being declared invalid and to an injunction restricting a purportedly elected board from acting (164).

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(159) See L. Getz, The Alberta Proxy Legislation: Borrowed Variations on an Eighteenth Century Theme, 8 Alberta L. Rev. 18, 38 (1970).

(160) Pickering, supra note 145, pp. 262-263.

(161) In Ontario only for offering corporations.

(162) CBCA, MCA, SBCA, ABCA s. 142 (3).

(163) CBCA, MCA, SBCA, ABCA s. 142 (4); BCCA s. 175 (8); OBCA 1982 s. 110 (4).

(164) Charlebois v. Bienvenu [1967] 2 O.R. 635 (H.C.); Babic v. Milinkovic (1972) 22 D.L.R. (3d) 732 (B.C.S.C.), affirmed by (1972) 25 D.L.R. (3d) 752 (B.C.C.A.).

b) Voting Trust (165)

A voting trust is created by a trust agreement among all or some of the shareholders transferring title to their shares to voting trustees, who in return issue to the shareholders certificates of beneficial interest, usually called "voting trust certificates". The trustees vote the shares in accordance with the terms of the trust agreement.

Only a few Canadian decisions deal with the validity of voting trusts, but on the basis of what they say, it seems that a voting trust will be upheld as valid (166) and will be enforced as long as it does not purport to interfere with the directors' power to administer the affairs of the corporation (167). The reported cases on voting trusts deal mainly with whether the object of the voting trust takes undue advantage of those shareholders not beneficiaries under the trust, or whether it promotes the best interests of all shareholders.

The main advantage of a voting trust is that it is a method of circumventing the statutory proxy provisions. At the same time, it is a very effective means of securing the

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(165) As to the law relating to, and use of, voting trusts see generally J.A. Leavitt, The Voting Trust: A Device for Corporate Control, 1941.

(166) Turvey and Mercer v. Lauder, supra note 153 (voting trust enforced; validity not questioned); Ringuet v. Bergeron, supra note 29 (by implication); Re Sydney and Whitney Pier Bus Service [1944] 3 D.L.R. 468, 473 (N.S.S.C.) (dictum); Motherwell v. Schoof, supra note 67, at p. 817 (voting trust upheld in part); see also Waschysyn v. Kildonian Ice and Fuel Co. [1937] 1 W.W.R. 572 (Man.C.A.). But see Birks v. Birks [1980] C.S. 730, where a voting trust was declared void ab initio as being an institution foreign to Quebec law.

(167) Motherwell v. Schoof, ibid..

result of a voting agreement because the voting trustee has a fiduciary duty to vote the shares in the manner set forth in the agreement.

III. Conclusion

Canadian corporation law leaves enough room for veto agreements at both the shareholders' and the directors' levels. The only limitation is the notorious rule that the discretion of the directors may not be fettered by veto provisions concerning directors' decisions. The reasons why this rule is applied in this context are not clear. The CBCA-modelled statutes now allow such provisions to be included in the articles of incorporation or unanimous shareholder agreements.

As far as voting agreements are concerned, they enjoy equal liberties under Canadian law. Their enforcement is assured by such means as voting trusts, whereas the possibility of giving a valid irrevocable proxy seems rather doubtful and limited to the statutes not modelled on the CBCA.

E. Share Transfer Restrictions

I. Introduction

Share transfer restrictions are one of the outstanding characteristics of close corporations. They can be laid down in shareholder agreements. The following chapter will consider the importance of the statutory rules dealing with share transfers and of the nature of shares for the extent to which share transfer restrictions are permitted. An interesting question is whether a transmission by law can be restricted by a shareholder agreement. As share transfer restrictions in shareholder agreements are contractual provisions, the parties can agree on all sorts of restrictions. In the course of this work, only absolute restrictions and the restrictions most currently found can be described: consent restrictions, the right of first refusal, the option to buy at a certain price and buy-sell agreements.

II. Necessity in Close Corporations

Shareholders in a close corporation often devote themselves full-time to corporate affairs. Because the circle of shareholders is small, most of them are in constant and intimate contact with each other. They know and trust each other well. A transfer of shares can therefore have grave consequences for the management of the corporation. A new shareholder, who wants to participate in management in the same way as his predecessor, may lack his experience, integrity and other personal qualities. Members of a close corporation often get together because their talents and experience are complementary. If a shareholder cannot, or does not want to, do the work which was previously done by the transferor of the share, the business can be seriously threatened (168). Furthermore, the allocation of management power and ownership in a close corporation is often the result of a long and complicated bargaining process. In order not to jeopardize the distribution once achieved, and to preserve the relative interests of the owners, the shareholders will agree on share transfer restrictions.

These restrictions, on the other hand, should not be drafted too narrowly. Every shareholder should have the opportunity to dispose of his shares, for example, in the case of serious disagreement, disability or retirement. The position of his heirs in case of his death should also be taken into consideration. Shares in a close corporation are usually difficult to sell, there being virtually no market for them. Directly linked with the problem of marketability is the danger for a minority of shareholders of being "squeezed out" of the corporation at an unfair price (169). That is why share transfer restrictions are often linked with provisions giving the shareholder a certain way out of the business. Such provisions also can serve as a means to resolve deadlocks.

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(168) This possibility is evident in the case where the transferee inherited the shares, Huberman, supra note 5, pp. 541-543.

(169) See, for example, F.H. O'Neal, "Squeeze-Outs" of Minority Shareholders - Expulsion or Oppression of Business Associates, 1975 (1982 supplement), pp. 41 ff..

III. Distinction Between Share Transfers and Transmissions for the Purpose of Restrictions

Share transfer restrictions can refer to share transfers, *i.e.* transfers by agreement, and to share transmissions, *i.e.* transfers by operation of law. The courts have not been consistent in recognition of a distinction between share transmissions and other transfers (170). In some cases, they applied share transfer restrictions on transmissions (171). According to them, such restrictions seem to be valid (172). However, what their legal consequences are, is unclear. The shares cannot, for example in case of the death of a shareholder, remain with their old owner. They must either be forfeited or, as in partnership law, entitle the transmittee to the profits without making him a member of the corporation (173).

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(170) The English decision *Moodie v. W. and J. Shepherd Ltd.* [1949] 2 All E.R. 1044, 1050, 1054 (H.L.) ruled that a restriction of a transmission is possible but must be clearly laid down in the articles of association. Compare also *Scott v. Frank F. Scott (London) Ltd.* [1940] Ch. D. 794 (C.A.); *Re Bentham Mills Spinning Co.* (1879) 11 Ch. D. 900 (C.A.); *Re W. Key and Son Ltd.* [1902] 1 Ch. 467.

(171) *Re Phillips and La Paloma Sweets Ltd.* (1921) 51 O.L.R. 125 (S.C., in Chambers) (sheriff seizing shares under writ of execution); *Re Fox Johnson and Co.* [1942] 2 D.L.R. 784 (Ont. H.C.) (trustee in bankruptcy of shares); *Re The Barn Ltd. and Moldowan Estate* (1963) 41 W.W.R. 444 (B.C.S.C.) (executor of deceased shareholder).

(172) Coates, *supra* note 4, p. 108, citing *Re The Barn Ltd. and Moldowan Estate*, *supra* note 171. See also *Re Harvey's Stores Ltd. and Harvey* (1979) 6 B.L.R. 223 (B.C.C.A.).

(173) Coates, *supra* note 4, p. 112.

The CBCA-modelled statutes contain provisions for the legal consequences of share transfer restrictions on transmissions (174). The corporation has to treat the person who furnishes the evidence that he is the legal transmittee as a registered shareholder. If he is the successor of a deceased shareholder, he is entitled to become a registered holder, subject to specific conditions (175). Thus, a transfer restriction cannot prevent a share transmission. This is a clear solution, protecting the proprietary rights of the member whose shares are the object of a transmission (176). The needs of the close corporation have to be dealt with by other means in this context (177).

IV. Statutory and Judicial Rules for Transfer, Transferability and Ways of Restricting Them

Shares of close corporations are transferred in the same way as the shares of other corporations. Whereas a

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(174) CBCA, MCA, SBCA, s. 47 (2); ABCA s. 47 (2) (subject to unanimous shareholder agreement); NBBCA s. 49 (2); OBCA 1982 s. 67 (2).

(175) CBCA, MCA, SBCA, ABCA s. 47 (7); NBBCA s. 49 (7); OBCA 1982 s. 67 (7).

(176) University of Alberta Institute of Law Research and Reform, Proposals for a New Alberta Business Corporations Act, vol. 2 (Draft Act and Commentary), August 1980, hereinafter cited as Wilson Report II, p. 84.

(177) For example, with options for the other members of the corporation to purchase them or buy-sell agreements: see infra pp. 75-83.

transfer, according to some mostly older corporation statutes, is only valid after registration of the transaction on the books of the corporation (178), the CBCA-modelled statutes make it possible to transfer shares upon delivery of the share certificates (179).

Under the first group of statutes, shares are in principle freely transferable (180). Share transfer restrictions can be included in the corporate constitution or in shareholder agreements. In English-modelled registration systems they can be included in the articles of association (181); in British Columbia, the restriction must also be noted on the share certificate (182). In letters patent systems, a restriction by letters patent is possible and even necessary for obtaining the status of a private company (183), whereas a restriction by by-laws has been consistently

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(178) NSCA s. 31 (2); PEICA s. 51; LCQ art. 71 (1); Iacobucci, Pilkington, Prichard, _supra_ note 4, p. 127; D.D. Prentice, _The Transfer of Shares: Part 6 of the CBCA 1975_, 23 McGill L. J. 565, 573 (1977).

(179) CBCA, MCA, SBCA, ABCA ss. 56 (1), 60; OBCA 1982 ss. 69 (1), 72. According to NBBCA s. 46 (2), only shares traded on a stock exchange are transferable by delivery of the certificate.

(180) PEICA s. 39: "The stock of a company shall be deemed personal estate for all purposes and is transferable...". To the same effect are BCCA s. 19 (6); LCQ art. 46; NCA s. 31; NSCA s. 28.

(181) Compare BCCA s. 58; NSCA s. 28.

(182) BCCA s. 51 (1) (e).

(183) PEICA s. 1 (e); compare also, for example, _Elsley's Frosted Foods Ltd._ v. _Mid White Oak Square Ltd._ (1976) 14 O.R. (2d) 479, 480 (H.C.).

declared invalid by the courts (184).

If the restriction is included in the corporate constitution, it is valid against a third party transferee. If the restriction is laid down exclusively in a shareholder agreement, it has to be noted on the share certificate to be valid against third parties (185). The corporation has to be party to the agreement to be able to refuse the registration of the transferee on its books (186).

Under the CBCA-modelled statutes, shares are also freely transferable (187). Concerning share tranfer restrictions, the CBCA and the other modern statutes make a distinction between corporations distributing their shares to the public (188) and other corporations. Under some of

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(184) Re Imperial Starch Co. (1905) 10 O.L.R. 22, 25 (H.C.); Re Good and Jacob Y. Shantz Son and Co. (1911) 23 O.L.R. 544, 550, 551 (C.A.); Re Belleville Driving and Athletic Assoc. (1914) 31 O.L.R. 79, 80, 81 (C.A.); Ontario Jockey Club Ltd. v. McBride [1927] A.C. 916 (P.C.); Montgomery v. Beardmore and Toronto Hunt Ltd. (1929) 36 O.W.N. 99, 100, 101 (H.C.); Emerson v. Provincial Secretary-Treasurer [1941] 2 D.L.R. 232 237 (N.B.C.A.). According to these decisions, the statutory power of the directors to regulate the transfer of shares by means of by-laws does not extend to restricting transfer.

(185) See Ontario Jockey Club Ltd. v. McBride, supra note 184; Re Belleville Driving and Athletic Assoc., supra note 184, pp. 85, 86; W.K. Fraser and J.L. Stewart, Company Law of Canada, 5th. ed. by J.L. Stewart and M.L. Palmer, 1962, p. 237.

(186) Barnard v. Duplessis Independent Shoe Machinery Co. (1907) 31 C.S. 362.

(187) CBCA, MCA, SBCA, ABCA s. 44 (3); NBBCA s. 45; OBCA 1982 s. 53 (3).

(188) Ontario: offering them to the public.

them, only the latter may freely restrict any transfer of shares (189), whereas the former are reduced to making restrictions which limit foreign influence or fulfill requirements under Canadian law for the granting of licences to carry on business, such as broadcasting, television, or the exploration of certain natural resources, or other requirements concerning publishers of newspapers or financial intermediaries, such as banks, insurance or investment companies, brokers, dealers and underwriters (190). In Ontario, Quebec and New Brunswick, a corporation which adopts a share transfer restriction may not offer any of its shares to the public (191). A share transfer restriction is only valid if it is included in the articles of incorporation (192) as well as noted on the share certificate (193).

Although the statutes regulate the transfer of shares and the ways and means of restricting this, they say nothing about the extent to which these restrictions are valid; this is left for the courts to decide.

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(189) CBCA, MCA, SBCA s. 45 (8.1); ABCA s. 45 (9).

(190) CBCA, MCA, SBCA, ABCA s. 168.

(191) OBCA 1982 s. 42 (2) (except if a transfer restriction is for a purpose resembling those allowed under the CBCA); LCQ art. 46; NBBCA s. 50 (2).

(192) CBCA, MCA, SBCA s. 6 (1) (d); ABCA s. 6 (1) (c); NBBCA ss. 4 (1) (d), 50 (1); OBCA 1982 s. 5 (1) (d).

(193) CBCA, MCA, SBCA, ABCA s. 45 (8); OBCA 1982 s. 56 (3); no such provision exists in New Brunswick: see NBBCA s. 47 (8).

V. Validity of Share Transfer Restrictions

1. Interdependence Between Transferability and Legal Nature of Shares

The question of the validity of share transfer restrictions has been linked with the legal nature of shares. Shares have both contractual and property aspects (194). They can incorporate contractual rights because in some jurisdictions the corporate constitution is interpreted as a contract whose parties are the members and the corporation (195); and its constitutional documents, the memorandum and the articles of association, define the rights granted by the shares (196). The contractual nature of shares favours far-reaching transfer restrictions, because contractual rights can be determined to be completely inalienable.

On the other hand, shares are recognized, in law as well as in fact, as being objects of property which are bought, sold, mortgaged and bequeathed (197). If shares were essentially property, the rule prohibiting restraints on alienation would become operative. The freedom to restrain the alienation of shares thus varies, depending on whether the contract or the property rule is applied (198).

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(194) Wilson Report I, <u>supra</u> note 104, p. 84.

(195) See <u>supra</u> p. 21.

(196) Gower, <u>supra</u> note 48, p. 398.

(197) Gower, <u>supra</u> note 48, p. 400.

(198) Henn, <u>supra</u> note 9, p. 553.

2. Legality of Share Transfer Restrictions and the Different Incorporation Systems in Canada

In principle, shares are freely transferable under Canadian law (199). While it is clear that corporations can impose restrictions on the transfer of shares, the permissible scope of such restrictions is rather uncertain. There is a substantial theoretical difference between letters patent and articles of incorporation jurisdictions, on the one hand, and memorandum jurisdictions, on the other. Its practical impact, however, seems to be less important than expected.

a) Memorandum Jurisdictions

If any limitation on share transfer restrictions exists in memorandum jurisdictions, it operates within a very narrow compass, since the courts have not been willing to fetter the autonomy of corporations in this area. They have tended to emphasize the contractual nature of the shareholders' interest, as is done in England. As Professor Gower has pointed out, "English law has always regarded shares of stock as creatures of the company's constitution and therefore as essentially contractual choses in action." (200). This view of the problem allows one to consider all

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(199) See the statutory provisions mentioned <u>supra</u> notes 180 and 187, and <u>Re Good and Jacob Y. Shantz Son and Co.</u> (1910) 23 O.L.R. 544, 549 (C.A.); <u>Re Polson Iron Works Ltd.</u> (1912) 4 D.L.R. 193, 195 (Ont. H.C. in Chambers); <u>Ontario Jockey Club</u> v. <u>McBride</u> [1927] A.C. 916, 923 (P.C.).

(200) L.C.B. Gower, <u>Some Contrasts Between British and American Corporation Law</u>, 69 Harv. L. Rev. 1369, 1377 (1956), citing <u>Commissioners of Inland Revenue</u> v. <u>Crossman</u> [1937] A.C. 26, and <u>Borland's Trustee</u> v. <u>Steel Bros. & Co.</u> [1901] 1 Ch. 279.

sorts of transfer restrictions as valid (201). Because of the presumption that shares are freely transferable, clear evidence is required that the transferability of any given share has been curtailed (202). Whenever two interpretations of the scope of restriction are possible, the courts will select that one which limits the scope of the restriction most (203). If, therefore, it is not clear whether a restriction applies to any transfer or only to a transfer to non-members (204), the courts have always adopted the narrower construction.

The validity of the contractual concept in the memorandum jurisdictions was challenged in Edmonton Country Club Ltd. v. Case (205). The question before the court was the validity of a provision in the articles of association

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(201) Edmonton Country Club Ltd. v. Case [1975] 1 S.C.R. 534, 549, 550.

(202) Re Smith and Fawcett Ltd. [1942] Ch. 304, 306 (C.A.).

(203) See, for example, Re Pool Shipping Co. [1920] 1 Ch. 251 (Ch. D.); Moodie v. W. and J. Shepherd Ltd. [1949] 2 All E.R. 1044, 1054 (H.L.).

(204) Greenhalgh v. Mallard [1943] 2 All E.R. 234 (C.A.); Roberts v. Letter "T" Estates Ltd. [1961] A.C. 795 (P.C.).

(205) [1975] 1 S.C.R. 534.

conferring on a majority of directors the power to refuse to register a transfer of shares "in their absolute discretion". Although the validity of the restrictions was upheld by the majority, Laskin J., in his dissent, considered absolute discretionary restrictions on the transfer of shares to be invalid. To be upheld, such restrictions would have to stipulate "some standard which would be amenable to judicial control" (206). Laskin J., reached this conclusion on the grounds that "shares in a public company are a species of property and as such are entitled to the advantage of alienability free from unreasonable restrictions" (207). To reconcile proprietary and contractual aspects of shares and their implications on the permissible scope of transfer restrictions Laskin J. referred to the reasonableness test found in American law (208). The contractual nature of

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(206) Ibid., p. 551.

(207) Ibid., p. 552.

(208) Edmonton Country Club Ltd. v. Case, supra note 205, pp. 553, 554. In the U.S., a share transfer restriction is upheld if it is reasonable in the circumstances (O'Neal, supra note 7, para. 7.06; J.R. Kemper, Annotation: Validity of "Consent Restraint" on Transfer of Shares of Close Corporation, 69 A.L.R. 3d 327 (1976)). The factors considered are the number of shareholders, the size of the company (In Re West Waterway Lumber Co. 367 P. 2d 807, 811 (Wash. 1962)), the type of restriction (Security Life and Accident Ins. Co. v. Carlovitz, 38 So. 2d 274 (Ala. 1949)), and the need for it in the circumstances (Lawson v. Household Finance Corp. 152 A. 723, 727 (Del. 1930)). This is particulary favourable for close corporations. A restriction is inherently more reasonable when applied to a small corporation with only a few shareholders who are active in the business and frequently members of the same family (First National Bank of Canton v. Shanks 73 N.E. 2d 93 (Ohio C.P. 1945)); Coleman v. Kettering 289 S.W. 2d 953 (Tex. Civ. App. 1956); Mathews v. U.S. 226 F. Supp. 1003 (D.N.Y. 1964); In Re West Waterway Lumber Co. 367 P. 2d 807 (Wash. 1962)).

the constitutional documents in memorandum jurisdictions should not be in the way of such a test:

> "I cannot be persuaded that the form of incorporation can have such a remarkable effect upon the permissible scope of a power to regulate or prescribe conditions for the transfer of stock in a public company." (209)

Although in Canada itself there are some older cases which made reasonableness the yardstick in measuring the limits of restrictions (210), no court has followed Laskin's recommendation as yet.

b) Letters Patent and Articles of Incorporation Jurisdictions

The approach of the memorandum jurisdictions to share transfer restrictions cannot be valid for the other Canadian jurisdictions, in which the corporate constitution is not considered a contract, but rather a privilege granted by the state. For the freedom to restrict the transferability of shares, this distinction was drawn in Canada National Fire Insurance Co. v. Hutchings (211):

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(209) Edmonton Country Club v. Case, supra note 205, p. 553.

(210) Smith v. Canada Car Co. (1873) 6 P.R. 107, 109 (Ont. Common Law Chambers); Re Good and Jacob Y. Shantz Son and Co. (1911) 23 O.L.R. 544, 558, dissenting judgment by Meredith and Magee JJ. A..

(211) [1918] A.C. 451 (P.C.).

> "There is...for the present purpose no analogy between companies in the United Kingdom which are formed by contract... under memorandum and articles of association...and Canadian companies which are formed under the Canadian Companies Act... by letters patent..." (212)
>
> "Canadian companies...are pure creatures of statute..." (213)

According to this, it is not freedom of contract which determines the extent of transfer restrictions, but the statute alone. For example, the statute does not allow share transfer restrictions to be fixed in the by-laws (214). Besides that, the statute is explicit about shares being in principle transferable, subject to provisions in the letters patent or articles of incorporation. The statutes say nothing, however, about the permissible extent of restrictions. In spite of theoretical differences from the memorandum jurisdictions, this matter might be at the disposition of the corporation in the same way as it is under the English-modelled statutes.

VI. Single Forms of Restrictions

Within the limits of the legal rules just explained, a broad variety of transfer restrictions with variations and

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(212) Ibid., p. 456.

(213) Ibid..

(214) See supra note 184.

combinations is possible, which have to fit the specific circumstances and problems of each close corporation. The following is a description of some basic types of restrictions, most of them currently in use in Canada by close corporations.

1. Absolute Restrictions

Absolute restrictions are invalid (215). They are a most obvious offence against the property aspect of shares (216).

2. Consent Restrictions

a) General Nature

Consent restrictions are the transfer restrictions most used in practice. The mechanics of them are that no transfer is valid or effective until it has been approved by the directors, shareholders or both.

The most obvious disadvantage of consent restrictions is that a shareholder wishing to sell his shares is virtually at the mercy of the group with the right of consent. He is very vulnerable to a "squeeze-out", with his fellow-shareholders refusing their consent to a sale to an outside

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(215) Coates, supra note 4, p. 101, citing Ontario Jockey Club Ltd. v. McBride, supra note 184, and Re Ogilvy (1966) 58 D.L.R. (2d) 385 (Ont. H.C.). Coates limits his statement in so far as he considers an absolute restriction for a limited time as possibly valid. The Ontario Jockey Club decision does not seem unequivocally to support the invalidity of absolute restraints:"...may be invalid..."; Ontario Jockey Club Ltd. v. McBride, supra note 184, p. 923.

(216) Re Ogilvy (1966) 58 D.L.R. (2d) 385, 399-403 (Ont. H.C.).

purchaser (who may have been hard to find), at the same time with them offering to buy his share at a low price.

b) Validity

Consent restraints have consistently been upheld as valid in Canada, as in England (217). The parties having the right of refusal, in most cases the directors, do not have to give reasons if they do not agree to the transfer (218). However, directors must act bona fide in the best interests of the company, in order to obey their fiduciary duties to the corporation. On the other hand, the courts will assume that the directors did so (219). The corporate constitution can forbid the directors to refuse their consent except for certain reasons. In this case, they have to cite these

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(217) For example: Leiser v. Popham Bros. Ltd. (1912) 6 D.L.R. 525 (B.C.S.C.); Re Phillips and La Paloma Sweets Ltd. supra note 171; Edmonton Country Club Ltd. v. Case, supra note 205; Re Smith and Fawcett Ltd. [1942] 1 All E.R. 542 (C.A.).

(218) Re Phillips and La Paloma Sweets Ltd., supra note 171; Re Bondi Better Bananas Ltd. [1952] 1 D.L.R. 277, 284 (Ont. C.A.); Re Shoal Harbour Marine Service Ltd. (1956) 20 W.W.R. (N.S.) 312, 314 (B.C.S.C.); Re Gresham Life Assurance Society, Ex parte Penney (1873) L.R. 8 Ch. App. 446, 450, 452; Re Coalport China Co. [1895] 2 Ch. 404, 407 (C.A.); Berry v. Tottenham Hotspur Football Co. [1935] 1 Ch. 718, 726 (Ch. D.).

(219) Re Phillips and La Paloma Sweets Ltd., supra note 171; Re Bondi Better Bananas Ltd., supra note 218; Re Shoal Harbour Marine Services Ltd. (1956) 20 W.W.R. (N.S.) 312, 313, 314 (B.C.S.C.); Re Smith and Fawcett Ltd., supra note 217, p. 545; Charles Forte Investments Ltd. v. Amanda [1963] 2 All E.R. 940, 946 (C.A.).

reasons when they refuse a transfer (220). If the directors give reasons, the courts can examine them, and decide whether they were within the given guidelines and suitable to them (221).

3. Right of First Refusal

a) Description and Validity

If he has agreed to a right of first refusal, any shareholder desiring to sell his shares must first offer them to the other shareholders *pro rata* or to the corporation (222), subject to the same conditions under which the prospective *bona fide* purchaser is willing to buy. A right of first refusal has been upheld as valid (223).

The right of first refusal overcomes the main disadvantage of the consent restriction in that the seller is no longer at the mercy of the remaining shareholders. He can sell, in any event, either to the other shareholders or to

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(220) *Duke of Sutherland* v. *British Dominions Land Settlement Corp.* [1926] Ch. 746; *Berry* v. *Tottenham Hotspur Football Co.*, *supra* note 218.

(221) *Re Bede Steam Shipping Co.* [1917] 1 Ch. 123 (C.A.); *Re Smith and Fawcett Ltd.*, *supra* note 217.

(222) If this can lawfully be agreed on: see *infra* pp. 74, 75.

(223) See, for example, *Ontario Jockey Club Ltd.* v. *McBride*, *supra* note 184.

the outsider. But it may not solve his problem of not being able to find a _bona fide_ purchaser because there is no outside market for his shares, a situation which is normal in a close corporation.

If the right of refusal is not exercised, the right of the shareholder to sell his shares to the third party can be left open for a limited period of time, for example, 90 days (224). It is material that it is made clear whether the other shareholders are entitled to take up all or any part of the shares offered or whether, if not all the shares are taken up, the holder is to be entitled to sell to others the whole block offered or simply those not taken up (225).

b) Right of First Refusal for the Shareholders or the Corporation

An important question to be decided is who will be favoured by the right of first refusal, the remaining shareholders or the corporation. A number of factors suggest that in many situations granting a right of first refusal to the corporation may be a more suitable means of preserving the enterprise than giving it to shareholders.

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(224) I.R. Campbell, _supra_ note 43, p. 34.

(225) The cases indicate that the latter will be held in case of doubt: _The Ocean Coal Co._ v. _The Powell Duffryn Steam Coal Co._ [1932] 1 Ch. 654; _Re Champion and White Ltd._ [1943] 1 D.L.R. 283, 286 (B.C.S.C.), reversed on other grounds [1943] 2 D.L.R. 145 (B.C.C.A.).

If the corporation buys the shares, and is not required to cancel them (226), it is then in a position to make attractive offers of the shares to persons with the skill and experience to satisfactorily fill the vacancy left by the withdrawing shareholder. The corporation also may be in a better position than some of the shareholders to have cash readily available. If one or more of the shareholders are not in a financial position to pick up the shares offered to them, the proportion of shareholdings may be drastically changed. This is less likely to happen if the corporation has the option to purchase.

However, it must be ascertained that the corporation can legally purchase its own shares. The purchase of its own shares by the corporation was always regarded as dangerous. It can harm creditors by impairment or reduction of capital; and it empowers the directors to alter or manipulate the control of the corporation and influence the price of the corporation's shares on the stock market (227). As a result, the purchase of its own shares by the corporation was

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(226) The question of what happens to the shares once they have been repurchased is answered differently under the different corporation statutes: see BCCA s. 262 (1); CBCA, MCA, SBCA s. 37 (1), (5); ABCA s. 37 (1), (6); NBBCA s. 36 (2), (4); OBCA 1982 s. 35 (1), (6). Under most of them, the corporation has the choice to cancel them or restore them to the status of authorized but unissued shares.

(227) Iacobucci, Pilkington, Prichard, supra note 4, p. 120.

prohibited by the common law. This was first decided in the English case Trevor v. Whitworth (228), a case which has often been applied in Canada (229). An early and frequently made exemption from this rule was the statutory admission of redeemable shares (230). The purchase of its own common shares was generally permitted only recently in most Canadian jurisdictions (231), subject to certain solvency tests. These limits have to be borne in mind when a shareholder agreement is drafted with the corporation as optionee.

4. Option to Buy at a Certain Price

a) General

The option to buy at a certain price is the same as the right of first refusal, with the exception that the conditions of the sale have been determined by the parties

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(228) (1887) 12 A.C. 409 (H.L.).

(229) See, for example, Common v. McArthur (1898) 29 S.C.R. 239, 245, 254; Alberta Rolling Mills Co. v. Christie (1919) 58 S.C.R. 208, 218 ff.; Zwicker v. Stanbury [1954] I D.L.R. 257, 270 (S.C.C.); Moore v. Northwood (1960) 22 D.L.R. (2d) 698 (Man. C.A.); McInnis v. Tignish Fisheries Ltd. (1961) 30 D.L.R. (2d) 749 (P.E.I.C.A.); Hamer v. National Forest Products (1964) 44 D.L.R. (2d) 757 (B.C.S.C.). For details on the development of the English and Canadian case law see R.L. Phillips, The Concept of a Corporation's Purchase of Its Own Shares, 15 Alberta L. Rev. 324 (1977).

(230) PEICA s. 86; OBCA 1982 s. 32 (1); BCCA s. 259 (a); CBCA, MCA, SBCA, ABCA s. 34 (1); LCQ art. 123.53; NBBCA s. 33 (1); NCA s. 49; NSCA s. 46.

(231) BCCA s. 259; CBCA, MCA, SBCA, ABCA s. 32 (1); LCQ art. 123.56; NBBCA s. 31 (1); OBCA 1982 s. 30 (1).

in advance and that the event triggering the option is not an outside offer, but, for example, disability, retirement or other termination of employment, dissension, or bankruptcy of the selling shareholder. The pre-determination of the price makes the deal more calculable for the buyers and thus helps to solve a serious problem, that of the funding of the purchase.

An option agreement usually states at what date the option becomes effective, how long it lasts, how it is to be exercised and the time limit for completing the deal after notice has been given of the intention to exercise it. The option period must be long enough to give the optionee a reasonable chance to raise the necessary funds, but it must not be too long, as the inducements to exercise the option may change.

With the option scheme, parties are confronted with the problem of valuing the shares of the close corporation in advance albeit there is no market for them. A lot has been written on share valuation in general and in a close corporation in particular (232) and as it is more an

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(232) See Coates, supra note 4, p. 118; Hatt and Keevil, supra note 5, p. 235; Huberman, supra note 5, p. 556; G. Ovens, Methods of Valuation for Privately-Owned Businesses and Closely-Held Companies, 36 Can. Bar Rev. 57 (1958); Sohmer, supra note 8; H.S. Campbell, supra note 43, pp. 415-418. For share valuation generally, see, for example, I.R. Campbell, Business Valuation for Business People, 1981; I.R. Campbell, Canada Valuation Service, 1978, updated to October 1982; I.R. Campbell, The Principles and Practice of Business Evaluation, 1975; P.E. McQuillan, P.H. Doherty, G.E.B. Graham, Valuation of Businesses - A Practitioner's Guide, 2nd. ed. 1979; G. Ovens and D.I. Beach, Business and Securities Valuation, 1972; B. Graham, D.L. Dodd, S. Cottle, Security Analysis - Principles and Technique, 4th. ed. 1962.

economic that a legal question (233), only a broad review of the subject will be given here.

b) Share Valuation in a Close Corporation

As a shareholder agreement granting an option to buy is a contract, the valuation formula must be clear and certain, for any uncertainty destroys the effectiveness of the agreement (234).

One possibility is to adopt a fixed formula to determine the price, such as book value or capitalization of earnings. The book value will not reflect any value for intangible assets, such as goodwill; and as the capitalized earnings method combines two uncertainties - the average annual earnings and the capitalization rate - it seems similarly unsuitable (235).

Another method is the use of an outside appraiser or arbitrator. This method is often very expensive and leaves the difficult task of determining the value to an outside third person.

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(233) One would expect the matter of share valuation to be subject to more litigation, considering that it has an undeniable impact on the effectiveness of a share transfer restriction: the more the value arrived at by the particular method deviates from the real value to the disadvantage of the shareholder, the more prohibitive is the effect of a provision which obliges the transferor to offer them to his co-shareholders or the corporation for that price. However, the courts seem unwilling to intervene in a valuation process agreed on by the parties; no Canadian case on this point could be found.

(234) Brimacombe v. Dennison [1953] 4 D.L.R. 827 (B.C.S.C.).

(235) Coates, supra note 4, p. 119.

A further possibility would be that the parties themselves periodically agree on a price. This seems to be the most favourable method because it involves the judgment of the shareholders who know the future potential, reasons for past performance, how much it depends on any specific individual and other factors.

An interesting method which guarantees a certain fairness is to proceed in accordance with a so-called "shot gun" (236) or "Russian roulette" (237) clause. First, one of the parties offers to sell his shares to the others at a stated price, and if the offer is not accepted within a certain time, the others must sell their own shares and the first party must buy them at the stated price. It is thought that the offeror, by naming a price at which he must either sell or buy, will adopt a fair and realistic price. This type of provision can be unfair where the offeror has a significant financial advantage over the offerees and can name a price and terms which he knows the offerees are not likely to be able to meet, thus forcing them to sell rather than purchase (238). Its availability is also practically limited to close corporations with two or three shareholders.

5. Buy-Sell Agreements

A buy-sell agreement provides that on the realization of a specific event which makes one shareholder leave the corporation this shareholder shall offer his shares to the remaining shareholders or the corporation, which have an obligation to purchase them. The trigging event can be one

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(236) D.W. Smith, supra note 5, p. 666.

(237) Coates, supra note 4, p. 121.

(238) D.W. Smith, supra note 5, p. 666.

of those mentioned above for the buy-out option or the death of a shareholder (239). The offering procedure and the method to determine the price of the shares are specified in the agreement. In practice, most buy-sell agreements seem to deal with succession on the death of a shareholder. Their special tax and funding problems warrant the following separate treatment.

6. Buy-Sell Agreements for the Case of Death of a Shareholder

A buy-sell agreement for the case of death of a shareholder is an agreement as mentioned above, with the executor of the deceased shareholder being obliged to sell the shares. The advantages of such a buy-sell agreement are obvious - ready cash is provided to the estate to pay the applicable death duties and normal living expenses of the deceased's family. As suggested earlier, it being essential in a close corporation that the membership be selected and restricted, the agreement ensures continuity of the business and harmony among the shareholders. The major problems with these agreements are their tax implications and the funding of them.

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(239) There is some uncertainty as to this point of the definition of the term "buy-sell agreement". Whereas Huberman (supra note 7, p. 19), Coates (supra note 4, p. 104), Hatt, Keevil (supra note 5) and Sohmer (supra note 8, p. 309) use it as if the event were exclusively the death of one of the shareholders, O'Neal (supra note 7, para. 7.10), Bird (supra note 9, p. 80) and D.W. Smith (supra note 5) describe it in the broader sense used here.

a) Tax Implications

As succession duties have been abolished in all provinces except Quebec, the only major tax problem discussed in connection with these buy-sell agreements is the establishment of a "fair market value" of the deceased's shares for tax purposes. There are many other tax implications, influencing such decisions as the choice of the purchaser - corporation or surviving shareholder - or of the funding arrangement (240); but a detailed treatment of these factors in such an intricate field of law is beyond the scope of this work.

ITA s. 70 (5) provides for a deemed realization of non-depreciable capital property, resource properties and land inventory at death for proceeds equal to the "fair market value", and tax must be paid on any accrued gain. A question not clearly decided is whether the "fair market value" of the shares is determined with or without reference to the buy-sell agreement. This can be of considerable importance because the transfer price agreed on is often less than the fair market value (241). The Interpretation Bulletin IT-140R2 of December 29, 1980, stated the view of Revenue Canada that the fair market value for the purpose of s. 70 (5) must be determined without reference to the agreement where the deceased and the surviving party did not deal at arms length. But, as Revenue Canada's statements have no force in law, but merely express an opinion as to how

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(240) See D.W. Smith, supra note 5, pp. 677-81.

(241) A.R.A. Scace, The Income Tax Law of Canada, 4th ed., 1979, p. 424.

the law should be interpreted (242), the law has to be looked at, and the cases are not at all clear. In Beament Estate v. M.N.R. (243) the Supreme Court favoured the contract price alternative; two English decisions, Attorney General v. Jameson (244) and C.I.R. v. Crossman (245), suggest the contrary. They were argued in the case West v. Minister of Finance for B.C. (246) by the respondent Minister. The court rejected the test developed in the English decisions. D.W. Smith (247) comes to the conclusion that the view of Revenue Canada is too restrictive and that Canadian courts appear to be prepared to follow the buy-sell price in arriving at fair market value.

b) Funding Arrangements

To fulfill the obligations undertaken in the buy-sell agreement, the future purchaser of the deceased's shares, be it the corporation or the surviving shareholders, will need a lot of cash on hand. Detailed funding arrangements are often set up in the agreement, such as whether the purchase price is payable in full and immediately, or only in part and/or over a future period. Possible sources for funds include borrowings by the shareholders or by the corporation, the

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(242) R.J. Reid, Make Your Shareholders' Agreements Less Taxing, 110 CA Mag. 6:44, 45 (1977).

(243) 70 D.T.C. 6130.

(244) [1905] 2 I.R. 218 (C.A.).

(245) [1937] A.C. 26 (H.L.).

(246) [1976] C.T.C. 313 (B.C.S.C.).

(247) Supra note 5, p. 674.

corporation's earnings, shareholders' own resources and insurance.

Insurance plays a predominant role in funding buy-sell agreements. There are essentially three types of insurance in use: the criss-cross, corporate-owned and split-dollar insurance. In criss-cross insurance every shareholder owns a policy on the lives of the other shareholders, pays the premiums and is the policy beneficiary. When a shareholder dies, the other shareholders use the proceeds to fund their purchase under the agreement.

By contrast, in corporate-owned insurance the corporation owns a policy on the life of every shareholder and is beneficiary. This has a considerable practical advantage where there are four or more shareholders in a close corporation. In the case of six shareholders, for example, the corporation can fund the purchase obligation with six insurance policies, that is, with twenty-four less than the shareholders with the traditional criss-cross arrangement. Also, if the shareholders are in an extremely high income tax bracket and the corporation enjoys a small business deduction or other tax benefits, corporate-owned insurance seems to have a financial advantage in reducing the tax on the distribution of the amount required to pay premiums (248). Other substantial advantages of corporate-owned insurance are cash flow savings and mitigation of cost inequalities (249).

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(248) D.W. Smith, <u>supra</u> note 5, p. 683.

(249) Discussed in detail by H.J. Kellough, <u>Corporate Share Repurchase Plans: An Alternative to Shareholders Buy-Sell Arrangements</u>, in: L. Sarna, ed., Corporate Structure, Finance and Operations, 1980, at pp. 370-380.

In split-dollar insurance a policy is taken out on the life of a shareholder which is owned by the corporation. The payment of the premiums is divided up between a shareholder and the corporation: the corporation pays the portion of each annual premium equal to the increase each year in the cash surrender value of the policy, and the shareholder pays the balance of the premium. So the benefit of having the corporation pay the premiums is obtained without the disadvantage of having the policy proceeds added to the taxed fair market value of the deceased's shares.

VII. Conclusion

Share transfer restrictions are essential for close corporations, even after the abolition in most of Canada of the private company concept for corporate law purposes, a concept in which a share transfer restriction was a characteristic ex definitione. The increasing regulation of share transfers and of their restrictions in new corporation statutes is to be welcomed; it contributes to the assurance with which the permitted restrictions can be drafted. The difference between memorandum systems and letters patent and articles of incorporation systems for the extent to which share transfer restrictions are permitted is less important than expected; all over Canada shareholders of close corporations enjoy considerable freedom to adopt transfer restrictions according to their needs. Limits exist only for absolute restrictions. The major problems are probably the drafting ones, of balancing the interests at stake in a workable way.

F. Deadlock Provisions

I. Introduction

Deadlocks often occur in close corporations because fewer parties, often of equal numbers, are opposed to each other. To avoid the serious impact a deadlock can have on the corporation's business, dissolution, although a radical step, very often seems necessary. Statutory help is provided for by the "just and equitable" clause or the oppression remedy; in this context, it is interesting to examine the impact a well-drafted shareholder agreement probably will have on the exercise of the discretion of the courts in case of such a dissolution. Dissolution procedures can also be provided for in a shareholder agreement. A less drastic step than dissolution is arbitration or a buy-out of one of the contending parties, which can be agreed upon in advance.

II. Likelihood and Consequences of a Deadlock in a Close Corporation

Deadlocks and dissension arise frequently in a close corporation. As the shareholders are active in the business, they are in constant contact with each other. Because of this intimacy, once dissatisfaction or distrust has developed, friction is likely to continue to grow. In a public company, it is possible for disputes to be muffled or insularized, by virtue of the high degree of separation of ownership and management. Alternatively, an unhappy shareholder will generally be able to sell his shares at a reasonable price and can thus extricate his investment. For the sale of shares in a close corporation there is rarely, if ever, a ready market, particularly where they represent a minority interest and are subject to share transfer restrictions.

The danger of a management paralysis in a close corporation is increased by the fact that often the shares are equally divided between two shareholders or groups of shareholders. From that, even divisions among the directors' are likely to occur. Further, holders of a minority interest, in an effort to protect themselves, often obtain a veto power over corporate policies and decisions (250).

III. Statutory and Judicial Help for a Deadlocked Close Corporation in Canada

In Canada, corporation statutes allow a dissolution order upon shareholder application to the court on the grounds that it is "just and equitable" to wind the company up (251). This rule derives from English company law (252) and most of the important decisions implementing it have been made by English courts. In interpreting the just and equitable clause, the courts developed the so-called "partnership analogy": in the case of a private company which was in substance a partnership, they applied the same principles as would be applied in a claim for dissolution of

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(250) See _supra_ pp. 46-49.

(251) CBCA, MCA, SBCA, ABCA s. 207 (b) (ii), NBBCA s. 141 (b) (ii); OBCA 1982 s. 206 (1) (b) (iv); NCA s. 138 (e); BCCA s. 295 (3) (a); _Companies Winding-Up Act_, R.S.N.S. 1967, c. 47, s. 4; _Winding-Up Act_, R.S.P.E.I. 1974, c. W-7, s. 22; _Loi sur la liquidation des compagnies_, L.R.Q. 1977, c. L-4, art. 24.

(252) _Companies Act, 1948_, 11 & 12 Geo. 6, c. 38, s. 222 (f).

a partnership (253). A decision which revolutionized the law in this area was Ebrahimi v. Westbourne Galleries Ltd. (254). It broke up the rigid application of the partnership analogy and made way for a more flexible approach to the dissolution of a close corporation. In this decision, it was said that generally, but not exclusively, in the case of a company with partnership characteristics the court has not only to look at the rights and obligations deriving from the corporate constitution, but also has to take into account "underlying obligations and understandings", based on the expectations of the parties at the time of incorporation. These obligations can engage the equitable jurisdiction of the courts by means of the just and equitable rule, which even can void an exercise of legal rights laid down in the corporate constitution. One of the situations in which the "just and

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(253) The first decision discussing it in depth is Re Yenidje Tobacco Co. [1916] 2 Ch. 426; for Canada, see for example Re Winding Up Ordinance and Timbers Ltd. (1917) 35 D.L.R. 431 (Alta. C.A.); Re Bondi Better Bananas Ltd. [1952] 1 D.L.R. 227 (Ont. C.A.); Re Purvis Fisheries Ltd. (1954) 13 W.W.R. (N.S.) 401 (Man. C.A.); Re R.C. Young Ins. Ltd. [1955] 3 D.L.R. 571 (Ont. C.A.); Bonar v. Toth [1957] O.W.N. 268 (C.A.); Re Jowsey Mining Co. (1969) 6 D.L.R. (3d) 97 (Ont. C.A.); Re Dunham and Apollo Tours Ltd. (No. 2) (1978) 86 D.L.R. (3d) 595 (Ont. H.C.); Re Johnson and W.S. Johnson Ltd. (1979) 95 D.L.R. (3d) 495 (Alta. S.C., T.D.).

(254) [1972] 2 All E.R. 492 (H.L.), followed in Canada in Diligenti v. RWMD Operations Kelowna Ltd. (1976) 1 B.C.L.R. 36 (S.C.), and Re Rogers and Agincourt Holdings Ltd. (1976) 74 D.L.R. (3d) 152 (Ont. C.A.).

equitable" provision frequently was invoked was deadlock (255).

Out of the "just and equitable rule" the legislators developed the oppression remedy with its broad range of possibilities for the courts to interfere with the internal management of a corporation (256). As the range of situations where it can apply has been greatly enlarged by newer Canadian statutes, it can even cover situations of internal disagreement short of deadlock (257).

A question which comes up in this context for the drafting of shareholder agreements is what impact the existence of a detailed shareholder agreement might have on the finding of an "underlying obligation" as in the Ebrahimi and Diligenti cases and how it thus could influence the holding of a court in a dissolution or oppression case. The criteria for determining such an obligation can be the expectations underlying the formation of an incorporated partnership, for example that the affairs of the corporation will be managed so as to reflect mutual confidence by the members in each other; that all members will have *prima facie* some managerial responsibility; that, given the existence of profits, these will be distributed in the form of salaries rather than dividends (258). Whether these

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(255) See D.S.M. Huberman, Winding-Up of Business Corporations, in: J.S. Ziegel, ed., Studies in Canadian Company Law, vol. 2, 1973, pp. 298-304, and the cases cited there.

(256) See *supra* pp. 13-15.

(257) Compare CBCA s. 234 (2).

(258) D.D. Prentice, Winding Up on the Just and Equitable Ground: The Partnership Analogy, 89 L.Q. Rev. 107, 121, 122 (1973).

expectations existed at the time of incorporation must be decided on a case by case basis, and evidence can take various forms. A detailed and carefully considered shareholder agreement will be most valuable proof of the parties' motives for forming the corporation and their concepts of the future, and will as such probably exclude the assumption of underlying expectations besides it (259).

Whereas, by the aforementioned statutory provisions and their interpretation by the courts, a sufficient protection against deadlock seems to be guaranteed, it is by no means the fastest and least expensive way to deal with the problem. The parties may also want to avoid the attendant publicity of a court proceeding. They can, however, make use of the possibility of including dissolution provisions in a shareholder agreement.

IV. Voluntary Dissolution

In a shareholder agreement, shareholders can agree to cause the corporation to be dissolved voluntarily (260).

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(259) See B. Slutsky, Company Law - Minority Rights - Oppression Remedy - Diligenti v. RWMD Operations Kelowna Ltd., 11 U.B.C. L. Rev. 326 (1977), at p. 331, note 37: "In practical terms, one virtually inevitable consequence of Westbourne Galleries....will be the appearance of more detailed and carefully considered shareholder agreements in closely-held corporations.".

(260) Iacobucci and Johnston, supra note 3, p. 118.

Under the CBCA-modelled statutes a unanimous shareholder agreement can entitle a shareholder to demand dissolution after the occurrence of a specified event (261).

The value of dissolution as a means of solving intracorporate disputes is uncertain. Although a rather drastic remedy, it has nevertheless been supported by legal writers. Carlos Israels referred to "the sacred cow of corporate existence" as being the main roadblock in the way of reasonable solutions for deadlock problems (262); and it is arguable that deadlock in a close corporation is in most cases irremovable because of personal differences among the members.

Still, there can be no doubt that dissolution is a painful, expensive and uncertain solution which affects not only shareholders, but also employees, creditors and perhaps the general community. In most cases, it brings with it the loss of the value of a going concern, leaving only the dead assets to be realized. Easy dissolution also gives a minority shareholder a means to exert pressure on the majority and, on the other hand, invites the majority to squeeze the minority out in dissolving the corporation and transferring the business and the assets to another corporation.

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(261) CBCA, MCA, SBCA, ABCA s. 207 (1) (b) (1); NBBCA s. 141 (1) (b) (i); OBCA 1982 s. 206 (1) (b) (i).

(262) C. Israels, <u>The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution</u>, 19 U. Chi. L. Rev. 778 (1952).

Alternatives to a voluntary dissolution provision in a shareholder agreement as a means to solve a deadlock are arbitration clauses and buy-out provisions.

V. Arbitration Clauses

Arbitration has distinct advantages over litigation as a method of settling disputes that paralyse close corporations. It is quicker and often less expensive. Confidential matters can be safeguarded. Arbitration decisions are often more workable than court judgments. Businessmen familiar with the corporation or similar businesses can be chosen as arbitrators. Naturally, they have a better understanding of the problems that arise in the business than does the average judge (263). Arbitration usually does not create the same degree of bitterness between the contracting parties as litigation (264).

There is little point in discussing the position of arbitration at common law or the validity of agreements to arbitrate "future disputes", matters which are still of considerable importance in the U.S. (265), since all Canadian jurisdictions have arbitration statutes (266).

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(263) O'Neal, supra note 7, para. 9.11.

(264) Donner, supra note 21, p. 17.

(265) O'Neal, supra note 7, para. 9.14.

(266) Arbitration Act, R.S.A. 1980, c. A-43; Arbitration Act, R.S.B.C. 1979, c. 18; Arbitration Act, R.S.M. 1970, c. A 120; Arbitration Act, R.S.N.B. 1973, c. A-10, as am. by S.N.B. 1979, c. 41; Arbitration Act, R.S.N.S. 1967, c. 12, as am. by S.N.S. 1969, c. 23, 1981, c. 13; Arbitration Act, R.S.O. 1980, c. 25; Arbitration Act, R.S.P.E.I. 1974, c. A-14; Arbitration Act, R.S.S. 1978, c. A-24; Code de procédure civile, L.R.Q. 1977, C-25, hereinafter cited as CPC, arts. 940-951; Judicature Act, R.S.N. 1970, c. 187, ss. 178-197, as am. by S.N. 1974, No. 57, s. 34.

Problems concerning validity can arise if the exercise of powers and duties conferred by statute on directors is left to arbitration (267). Today these difficulties can be avoided in most jurisdictions by making the shareholder agreements containing such provisions unanimous (268). Arbitration clauses must be in writing to come within the Arbitration Acts (269).

One important merit of arbitration is not the final remedy it provides for breaking a deadlock; rather the existence of this clause and the ultimate irrevocable solution by arbitration will force a compromise between the parties (270).

VI. Buy-Out Provisions to Resolve Disputes

Buy-out provisions, as described above (271), can provide a very effective mechanism for resolving fundamental disagreements among the shareholders. They give a dissenting party a way out of the business without destroying it. Often, however, the parties are unable to agree on which of

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(267) Motherwell v. Schoof, supra note 67, p. 818.

(268) See CBCA, MCA, SBCA s. 140 (2); ABCA s. 140 (1); NBBCA s. 99 (2); OBCA 1982 s. 108 (2); LCQ art. 123.91.

(269) Erbach v. Bender (1910) 14 W.L.R. 720 (Sask. Dist. Ct.); Re Simpson and Halford (1913) 11 D.L.R. 410 (Man. K.B.); CPC art. 941. See also F. Russell, The Law of Arbitration, 19th. ed. by A. Walton, 1979, p. 48.

(270) Apple, supra note 42, p. 52.

(271) Supra, pp. 75-79.

them should sell out and for what price. Then, the installation of a "shot-gun" clause can be helpful, which solves both questions one at a time (272). In case nobody wants to initiate the process, provision can be made in the agreement for either party to request the drawing of lots to determine which of them shall make the first offer (273).

VII. Conclusion

Canada's corporation statutes, particularly those based on the CBCA, provide for efficient remedies in case of deadlock. A well-drafted shareholder agreement can be of some help to a court in determining the conditions and details of its interventon. If the opposed parties want to stay out of court, they can agree on dissolution procedures or arbitration, both facilitated in most Canadian corporation statutes by the admission of unanimous shareholder agreements. A further way out of a deadlock are agreed-upon buy-out provisions, especially in form of so called "shot gun" clauses.

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(272) See *supra* p. 78.

(273) Huberman, *supra* note 7, p. 21.

G. Conclusion and Proposal

Canadian corporate legislation was created with the publicly-held corporation in mind. Close corporations are forced to adapt this structure to their needs as best they can. An important means of achieving this are shareholder agreements. This work examined, in a selective manner, characteristic types of provisions found in shareholder agreements: those for influencing management, veto and voting clauses and those for restricting share transfers and for solving deadlocks.

Prior to the introduction of unanimous shareholder agreements, almost unsurmountable difficulties arose for shareholders in their attempt to influence management by means of a shareholder agreement. The courts rated the duty of directors to serve in the best interests of the corporation to be more important than the freedom of shareholders to decide on corporate matters. This seems to be hardly justifiable under close corporation circumstances. Since its introduction into Canadian corporation law, the unanimous shareholder agreement has provided a very useful planning tool for close corporations. It is likely to be available in practice only to corporations with a very limited number of shareholders. A drawback is that some features of the unanimous shareholder agreement concept lack clarity. For example, these questions remain open for discussion: how valid are the agreements in the case of an innocent shareholder becoming a member?; or to what degree is a shareholder personally liable when he participates only by way of supervision in management? While unanimous shareholder agreements make it possible to strip the directors of all their powers, they do not enable the shareholders to abolish the board altogether.

Veto agreements, although legal under most circumstances, suffer from practical disadvantages, whereas voting agreements are very useful planning tools for the exercise of shareholder rights in the general meeting. They can be enforced by voting trusts, whereas an irrevocable proxy is most likely to be invalid under Canadian law.

The wave of corporate law reform in Canada initiated by the CBCA 1975 brought a better regulation of share transfers and their restrictions. A wide variety of them is available for inclusion in shareholder agreements, which can be fitted to the needs of each close corporation.

Concerning the solution of deadlocks in close corporations, Canada's corporation statutes offer the "just and equitable" dissolution remedy and the oppression remedy, both wide in scope. Their application will certainly be influenced by a well-drafted shareholder agreement that explains the expectations of the parties at the time of incorporation. If the contentious parties want to stay out of court, there exists the possibility of adopting a unanimous shareholder agreement for arbitration or dissolution. A less than unanimous agreement on arbitration runs the danger of being considered invalid because it violates the rule that the directors' discretion may not be fettered.

Shareholder agreements are indispensable for close corporations in Canada; the only serious legal limitation they encounter is when they fetter the directors' discretion. In most, <u>i.e.</u> the articles of incorporation jurisdictions, this problem can now be overcome by unanimous shareholder agreements. By stipulating that shareholder agreements interfering with management have to be unanimous, deviations from the statutory structural model of a corporation are limited to small closely-held corporations. The only real deficiency of the unanimous shareholder agreement concept is the possibility of a board existing without any power, kept as a formality. This should be corrected by way of legislative amendment, as should the unclear provisions already discussed dealing with the admission of an innocent shareholder and with shareholder liability. Beyond that, Canadian corporation law shows itself to be responsive to the needs of close corporations, at least so far as concerns the legality of shareholder agreements.

A disadvantage of relying on shareholder agreements for effecting the necessary changes in a close corporation lies in the fact that their drafting will inevitably involve a lawyer being hired to deal with the matters already discussed; this represents an added expense and delay to incorporation. Although incorporators will at the same time receive good counselling on the dangers of setting up a business in corporate form, it might be a better solution to adapt the rules set by the state even more to the needs of the average corporation, that is, a close corporation (274). Corporation law should not only give the freedom to agree upon different structures as laid out therein, but should provide a model structure for close corporations. This model structure could take a form similar to the model articles provided for by Table A of English-modelled memorandum statutes (275).

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(274) See <u>supra</u> p. 1.

(275) See, for a similar proposal for a "model charter and bylaws", Iacobucci and Johnston, <u>supra</u> note 4, pp. 132, 133, and Iacobucci, Pilkington, Prichard, <u>supra</u> note 4, p. 79.

However, to avoid the disadvantages of the corporate constitution pointed out earlier (276), such a model structure should have the form of a contractual agreement, with the same amendment procedures (unanimous agreement without public disclosure of the results) as this. The contents of this set of rules should correspond to the specific needs of close corporations. For example, in the areas treated by this thesis, it would mean that all members would be entitled to take part in the management, or at least have a right of intervention; that share transfers would be subject to the directors' consent; and that certain arbitration procedures would be followed in case of deadlock. Widely-held, public offering corporations, would, of course, find this model unworkable for them, and not employ it (277). The rules of current law for the protection of creditors and investors in larger, public offering corporations would continue to apply regardless of the corporation's internal structure, as at present.

The proposal of a model agreement for close

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(276) See <u>supra</u> pp. 10, 11.

(277) In this context, the question arises whether this model agreement should automatically apply in the absence of another agreement which excludes or modifies it. Without making a final statement on this, it appears to the author from the argument made in the thesis that, as the bulk of corporations are close corporations, the model agreement should apply unless otherwise provided. That way, widely-held corporations would have to opt out of it; this seems fair, because they are more likely to be able to afford the legal advice the drafting of a measure-made agreement requires. However, the opting-out procedure should be made relatively easy, for example by a respective question on the incorporation forms.

corporations is necessarily incomplete; within the scope of this work it was only possible to show that the statutory model has to be altered considerably by the shareholders to fit close corporation needs. Another solution would be to create a separate statute for close corporations, as has been done in some continental European countries (278). This option has already been the object of lively discussion among American and English authors (279); and it would probably serve as well the same purposes as the solution indicated here. However, such a separate statute would require a much broader analysis (280) than was here possible. A statute

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(278) See, for example, the German Gesetz betreffend Gesellschaften mit beschraenkter Haftung of April 20, 1892, translated by M.C. Oliver, The Private Company in Germany, 1976, and the French statute which provides for the Société à responsabilité limitée, the Loi sur les sociétés commerciales of July 24, 1966, arts. 34-69, and the Décret sur les sociétés commerciales of March 23, 1967, arts. 20-53, both translated by J.H. Crabb, French Business Enterprises: Basic Legislative Texts, 1979.

(279) Compare, for example, for England Gower, supra note 4, pp. 388-396; T. Hadden, Company Law and Capitalism, 2nd. ed., 1977, pp. 222-230; W.J. Sandars, Small Businesses - Suggestions for Simplified Forms of Incorporation, [1979] J. Bus. L. 14, 18-22; and the considerable literature in the U.S., where several jurisdictions adopted special close corporation provisions or statutes, O'Neal, supra note 7, paras. 1.13-1.14 c.

(280) For example, one that takes account of the special interests of creditors under close corporation circumstances: see P. Halpern, M. Trebilcock, S. Turnbull, An Economic Analysis of Limited Liability in Corporation Law, 30 U. Toronto L. J. 117 (1980).

with a set of model rules for close corporations, as suggested here, would require the least change of the law itself and would serve businessmen better than the present regulation provided for in Canada.

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