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When the Family Business Fails

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INTRODUCTION

- Purpose of this paper to explore “the dysfunctional dynamic” that often develops when families pursue a business venture.
- The Canadian Association of Family Enterprise (CAFE)
 - 43% of Manitoba economy and 70% of Canadian economy can be directly linked to the productivity associated with family enterprises;
 - Manitoba - \$25 billion per year

What is a “family business”?

- No universal definition
- Mom and Pop to sophisticated integrated enterprise
- A balance to be struck between the special interests of family members and corporate strategic planning.

THE CORPORATE MODEL

(Hope for the best/Plan for the worst)

- Tax issues
- Limited liability/insurance concerns
- Goal to build safety net(s)

THE “WHAT IF” QUESTIONS

- What if Dad passes away?
- What if Uncle Morley is caught stealing?
- What if Cousin Dave goes bankrupt?
- What if Uncle Fank goes crazy?
- What if Mom and Dad divorce?

WHAT DO THE FOLLOWING CONTRACTS/ AGREEMENTS HAVE IN COMMON?

1. Unanimous Shareholders Agreement
2. Pre-nuptial agreement
3. Post-nuptial agreement
4. Life insurance policies
5. Power of Attorney
6. Will

You are asking the client to “bet” against him or herself

Unanimous Shareholders Agreement

- The business will fail.

Pre-nuptial/post-nuptial agreement

- The marriage will fail.

Life Insurance policy

- I’m going to die. (The insurer is actually betting you will die, but not in the near future.)

Power of Attorney

- Disability is likely.

Will

- You’re not going to live forever.

THE “HOW MUCH” QUESTIONS

- How much will this fancy agreement cost?
- How much will I save if I follow your advice?
 - Nobody wants to dedicate any resources to building a life raft before the ship has even left the dock.

What is a Unanimous Shareholder Agreement (USA)?

- A written agreement among all the shareholders of a corporation that restricts the powers of the directors to manage the business and affairs of the corporation

Why do I need a USA?

- Already have:
 - The Corporations Act
 - Articles of Incorporation
 - General By-Laws of the Company
- Is more paper really necessary?

Two reasons a closely held company needs a USA

- statutory rules need to be supplemented so that there is 'good' corporate governance
- shareholdings are illiquid and liquidity is desired

Corporate Governance Without a USA:

- Shareholders by majority elect the directors
- Directors are the controlling mind of the Corporation. They make all of the decisions, except for certain fundamental ones that require 2/3^{rds} shareholder approval
- Directors control almost all of the information about the Corporation

Corporate Governance Issues:

- Deadlocks – A small board such as 2 directors, who don't agree
- Fiefdom – Majority shareholder or a group of shareholders band together to form a majority which controls the board
- Minority rights – There may be instances where the minority wants a right of approval or a veto
- Corporate finance – Potential roadblocks which might limit the company's access to capital

Deadlocks

- Examples:
 - Separated spouses
 - Crazy Brother
- Potential Solutions:
 - Umpire provision
 - Coin toss
 - Buy Sell Clause

Fiefdom and Minority Rights:

- Examples: A controlling shareholder who:
 - is paying himself too much or reimbursing for questionable expenses
 - is heading into new line of business
 - hired his dimwit son
 - is in breach of corporate law obligations or provisions of the agreement

Fiefdom and Minority Rights (Continued):

- Potential Solutions:
 - Right to minority board appointment
 - Right to supplemental financial information
 - List of 'material transactions' that require minority consent such as: sale, purchase, financing transactions over thresholds, changes in direction of business, non-arms length dealings
 - Annual budget requiring special approval
 - Put / Call rights

Corporate Finance

- Examples: A shareholder
 - won't give her guarantee or postpone her shareholder loan to new bank financing
 - won't participate in the cash call
 - just issued himself more shares because he said the company needs more money. Now I am diluted!

Corporate Finance (Continued)

- Potential Solutions:
 - Hard or soft cash call provisions
 - Pre-emptive rights provision
 - Requirement to give guarantees and subordinate shareholder loans

Illiquid Shares

- There is no secondary market to buy shares in a closely held company
- Articles of Incorporation for closely held companies almost always contain restrictions on transfer requiring director or shareholder approval.

Illiquid Shares

- Example – Death
 - Is my sister-in-law going to be my business partner?
 - Will my sister use the life insurance as working capital
- Solution
 - Buy out provision on death, potentially funded by life insurance

Illiquid Shares (Continued)

- Example – Somebody wants to buy the company buy my brother won't sell
- Potential Solution
 - Outsider offer / drag along / tag along provision
- Example – My brother fired me but won't buy my shares or I had to fire my brother and he won't sell his shares
- Potential Solution
 - Put / Call rights

Some General Observations

- Legalese or legal ease
 - Use a term sheet!
- It's a lot easier to agree upon the rules at the beginning of the game rather than during the game
 - Get your agreement in place at the outset
- Succession Plan
 - Parents' role is to insist on a shareholder agreement as a condition of handing off of business to kids

Some General Observations (Continued)

- Don't let the tax planning distort the corporate commercial terms of the deal
 - Tax planning needs to co-exist with good corporate governance.
- Good corporate governance leads to transparency of dealings between business partners and even if they disagree with one another from time to time, they will be more likely to succeed without family conflict

WHEN THE SAFETY NET FAILS

- *The Corporations Act* (Manitoba)
 - Relief for shareholders, directors, creditors
 - Relief re: corporate deadlock
 - Relief re: alleged misconduct/mismanagement

THE OPPRESSION REMEDY

- Section 234 of *The Corporations Act*
 - Section 234(2) reads as follows:

If, upon an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates

- (a) any act or omission of the corporation or any of its affiliates effects a result; or
- (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner; or
- (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner;

that is **oppressive or unfairly prejudicial or that unfairly disregards the interests** of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of. [emphasis added]

- **What is oppressive conduct?**

- Harsh or wrongful, e.g. directors of the corporation do not give access to financial information or produce financial statements (mandated s. 149 of *The Corporations Act*)

- Duties of a director

- s. 117 of *The Corporations Act*

A director must ensure that he acts in good faith and honestly with a view to the best interests of the corporation and further exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

- The interests of the corporation come first.
- The directors, even in a closely held family corporation, must follow the provisions of *The Corporations Act*, the Regulations thereto, the articles and by-laws of the corporation and any unanimous shareholders agreement.

BUT DAD WANTED ME IN CONTROL

- Often family corporations reflect family dynamics.
- The courts, while recognizing that family members may have different expectations and be involved to different degrees with respect to the family business, they they are unlikely to permit informality to override legal responsibility.

C v. C

- recent Manitoba Court of Appeal decision
- father left family business to five sons equally
- over the course of a number of years, one of the sons began to run the corporation to the exclusion of his brothers
- dominant son did not provide full financial disclosure
- dominant son argued dad would be surprised if family sought to rely on legal or corporate technicalities in their business dealings

C v. C continued

- court rejected this argument
- notwithstanding rejection of argument, court examined at length
 - what is unfairly prejudicial?
 - what conduct unfairly disregards the interests of a shareholder?
 - what is a shareholders' reasonable expectation in the context of corporate governance?

- **Unfairly Prejudicial**

- Looks at the EFFECT of conduct that is “Was the result of the conduct unfair to the shareholder?”

- **Unfairly Disregards**

- Looks at whether the PROCESS was unfair
 - E.g. the holder of 60% of the common voting shares does not give notice to the 40% holders of a meeting
 - The rationale is it doesn't matter whether the minority is present or not because they will be outvoted in any event

- The failure to give notice is wrongful and unfair not because it will necessarily change the outcome, but it dismisses the shareholder's or director's stake in the corporation and takes away the individual's right to express his or her views re the company's actions and/or exchange of ideas and/or consult with other directors/shareholders.

REASONABLE EXPECTATIONS

- “The state of a man’s mind as to the future – intentions and expectations is a question of fact. In determining that fact there is no error in looking at prior statements and drawing an inference based on the respective weight of all of the individual pieces of evidence. It is a pure question of fact what the shareholders’ intentions and expectations were at the material time is a pure question of fact as to whether they are reasonable.”

Question...

- what if the shareholders have never received notice in the context of a closely held family corporation?
- does that make their expectations unreasonable when they challenge the fact that they have not received notice of a meeting?

In C v. C...

- the Court of Appeal has framed the problem as follows:
In other words, personal considerations are relevant if they are part of the compact among shareholders. These personal considerations certainly involve the background and dealings in the family corporation how shareholders came to own shares (for example, purchase vs. a will). The compact among shareholders can change over time. It is not static.
- are the courts sending a mixed message?
- No. Expectations must be reasonable.
- The courts are unlikely to ever hold an expectation to be reasonable that is in direct conflict with the provisions of *The Corporations Act*, i.e. the production of financial records is mandated.

- The need for transparency with respect to financial matters, the calling of meetings and the sharing of information will override any family dynamic that the parties may either tolerate or for that matter, embrace.
- In *C v. C* the father left the company to his five sons equally.

THE REMEDY/REMEDIES

- Sweeping powers to correct any misconduct
- Sweeping powers to correct any deadlock
- Wind up or dissolution
- Court mandated buy out
- Deadlock
 - shotgun clause
 - sealed envelope bid
 - third party valuation re fair market value

- Recent Manitoba Court of Queen's Bench decision
 - *S v. WN & S* case
 - Court posed the question “Should one of the two groups of equal shareholders be forced to divest its interest in the company?”
 - the court concluded that “a once harmonious family business wherein the partnership of two groups of equal shareholders operate on the basis of mutual trust is now anything but harmonious and in fact the relationship is now based on mistrust and suspicion.”
 - the court found that one group was primarily responsible for creating the disharmony and ordered the sale of its interest in the family enterprise to the group the court deemed to be “innocent” in the circumstances.

- The Manitoba court was asked to review a rationale in an earlier Ontario decision called *Animal House Investments Inc.*
- In that case, the judge did not order a buy out primarily because the shareholders in the *Animal House* case were not 50/50 and the familial animosities and disagreements did not descend to allegations of misconduct.

HOW MUCH IS THIS GOING TO COST ME?

- The dispute in the *C v. C* case
 - 19 days of trial plus Court of Appeal appearance
 - the “how much” question
 - a lot
- Unanimous Shareholders Agreement creative option
 - mediation
 - arbitration
- *S v. WS & N* file
 - court rejected proposal that an independent third party director be appointed to break the deadlock
- Experts, accounting fees, business valuations
 - USA could provide for formula re calculation of fair market value and eliminate the need for extensive third party expert involvement

CONCLUSION

- Court process is unlikely to lead to a compromise or resolution that will satisfy family members in conflict.
- Court process likely only to add insult (an expensive one at that) to injury as family relationships deteriorate and acrimony rules the day.