



Spouses as Shareholders

The Intersection of Family Law and Corporate Law

Igor Ellyn, QC, CS, FCI Arb. ♦ Evelyn Perez Youssoufian
ELLYN LAW LLP
Business Litigation & Arbitration Lawyers
www.ellynlaw.com



Spouses as Shareholders

- Some spouses are also business partners
- There are often one or more corporations
- Spouse might be a shareholder even if s/he does not work in the business
- Corporation may also have other shareholders including children, other relatives, employees and business associates
- Spouse could be a party to a Unanimous Shareholders Agreement
- Shareholding creates a panoply of rights, restrictions, remedies and obligations
- Spouses may be directors of the corporation and subject to other statutory and common liabilities

Shareholders in closely-held, non-offering corporations

- The points in this presentation deal with private corporations incorporated under the OBCA or CBCA
- Typically the business will have five or fewer shareholders
- Sometimes an employee might have a minority shareholding in the business

Is it Family Law or Corporate Law? Usually, it's both!

- Family Law
 - Family Law Judge
 - Family Law Rules
 - Family Law Act
 - Financial Statement
 - Questioning
 - Disbursements, Costs
 - Impact on NFP
 - Constructive Trust Claim
 - Joint Family Venture
 - Equalization Payment
 - Source of Support
- Corporate Law:
 - OBCA or CBCA
 - Commercial List, usually
 - Rules of Civil Procedure
 - Proceeding by Application or Statement of Claim
 - Cross-exam. or Discovery
 - Self-dealing and Fraud
 - Breach of fiduciary duty
 - Director's duty OBCA s.134
 - Oppression remedy s.248
 - Court-Ordered Meetings
 - Winding-up s.207
 - Mandatory Audit
 - Advance on Legal Fees
 - Termination of Employment

What will happen to the family business going forward? #1

- Will one spouse buy the other's share in the business?
- Will an independent valuation be required?
- Who should do the valuation?
- Can parties agree on valuation parameters?
- Can financing be secured to fund a buyout?
- Other buyout arrangements?
 - Earn out over a period of years
 - Sale to a third party

What will happen to the family business going forward? #2

- If the purchase price is not paid on closing, what security is needed to secure the balance?
- Should the business be put up for sale?
- How will sale affect employment?
- Non-competition and non-solicitation clauses
- Income tax considerations of a sale
- Does the USA provide for "keyman" life insurance which cannot be replaced due to cost or health factors?
- More about valuation later

Corporate issues to consider on marriage breakdown #1

- Structure of the business
 - Partnership of corporations
 - Corporation, Joint Venture
 - Holdco, Opco, other corporations
 - Domestic or international
 - Tax considerations
- Who are the shareholders?
 - Are there other shareholders apart from the spouses?
 - Are there different classes of shares with differing rights?
- Who are the officers and directors?
- What are voting and quorum requirements for meetings of directors and shareholders?
- Who is managing the business?

Corporate issues to consider on marriage breakdown #2

- Is there a Unanimous Shareholders' Agreement?
 - Has the USA been amended?
 - Have circumstances changed since the USA was made?
 - Does it have a buyout or buy-sell ("shotgun") clause?
 - Does it have a mandatory valuation clause?
 - Who does the USA mandate to do the valuation?
 - Is there an arbitration or forum selection clause? (FSC)
 - What kinds of disputes are covered?
 - Is oppression excluded from FSC – *Deluce v. Air Canada*
 - If there is an international element, is there a governing law clause?
 - Appeal rights under the FSC

Corporate issues to consider on marriage breakdown #3

- **How did the Unanimous Shareholders' Agreement (USA) come about?**
 - Who prepared the Agreement? Lawyer? Corp.'s CA?
 - Was there independent legal advice?
 - Was there adequate disclosure?
 - Were the provisions as to shares, management, business plans, etc. implemented?
 - Has anything occurred which affects the operation of the USA: departure or death of a shareholder, restructuring, acquisition of a competitor, children acquiring shares, retirement, sale of the business?
- Has the USA been observed?
- Have the shares been valued? How was the valuation done? Who did the valuation?
- Is there an entire agreement clause?
- Has the USA been replaced or abandoned?

Corporate issues to consider on marriage breakdown #4

- **If there is a buy-out clause under the USA:**
 - Should a buy-sell notice be served?
 - How should the buy-out price be determined?
 - Would an exercise of the buy-sell clause be an oppressive act because the playing field is not level?
 - If a buy-sell notice is received, should negotiations be proposed instead of responding to the notice?
 - Should a different dispute resolution method be proposed?

Corporate issues to consider on marriage breakdown #5

- If there is a dispute resolution clause under the USA:
 - Can the parties agree to a modified dispute resolution process which ties in both the family law and corporate law issues?
 - Should the corporate law issues be left for separate resolution after all other family law matters have been resolved?
 - Are interim payment or preservation arrangements necessary until the corporate situation can be settled or adjudicated? Was there independent legal advice?

Corporate issues to consider on marriage breakdown #6

- Do both spouses work in the business?
- Can the spouses still co-operate?
- Are the salaries reflective of each spouse's work?
- Notice / Severance on leaving employment
- CRA's review of income splitting/undeclared income
- Have dividends been paid? Are any payable?
- Is the failure to pay dividends an act of oppression?
- Does the corporation have redundant assets?
- How will the shares be valued?
- Will other shareholders be affected?
- Are there other relatives or partners in the business?
- Is independent representation required for any other party or for the corporation itself?

Corporate Finance Issues

- Business is primary source of revenue for support
- How will corporate action affect the revenue stream?
- Will attack on corporate activities give rise to:
 - a CRA audit
 - charges under ITA
 - Insolvency
 - Receivership or demand by creditors?
- Will disclosure in family dispute provide fodder for a fraud claim by another partner?
- Is there undisclosed income and how will its disclosure impact on corporate value?
- If spouse is a corporate partner, will a voluntary disclosure to CRA be necessary?
- How will a buyout of one spouse's shares be financed?

Sources of Shareholders' Rights

- Corporate Statutes
 - Business Corporations Acts
 - Securities Acts
 - Extra-Provincial Corporations Act
- Articles of Incorporation
- By-Laws of the Corporation
- Minutes of Directors Meetings
- Minutes of Shareholders' Meetings
- Unanimous Shareholders' Agreements
- Financial Statements of the Corporation(s)

Voting Rights

- Exercisable by a quorum – majority or agreed number: OBCA s. 101(1)
- Election of Board of Directors to manage affairs of the corporation
- Participate in major business decisions affecting the corporation's business
- Subject to limitations in articles of incorporation, by-laws or shareholders' agreement

Access to Information #1

- Records required to be kept under OBCA
 - Articles and by-laws and all amendments
 - Unanimous shareholders' agreements
 - Minutes of meetings
 - Director and shareholder resolutions
 - Register of directors with info as in s.140(1)
 - Securities register with info as in s.141
- Shareholders are entitled to receive a copy of the financial statements which must be placed before the annual meeting of the corporation and other relevant financial information: ss.154(1)(a)(d)

Access to Information #2

- OBCA entitles shares to view corporate records at the office of the corporation
- In a closely-held corporation, failure of managing shareholder to provide easy access and full disclosure may give rise to an adverse inference
- Notices of directors/shareholders' meetings must provide background and supporting information to enable director/shareholder to make a reasoned decision
- When information is deficient, results of meeting may be voided by the Court

Shareholders' Remedies

- Court-ordered Meetings
- Derivative Action
- Oppression Remedy
- Investigations and Audits
- Appraisals
- Winding-Up
- Motion for corporation to pay shareholder's legal fees of an action

Court-ordered Meetings

- Quorum and notice are required for all meetings
- Business conducted and resolutions passed at a meeting:
 - Not properly constituted as to notice or quorum are a nullity
 - Without proper disclosure of materials are voidable
- Director or shareholder may seek to void the results
- OBCA s. 106: Court may order a meeting where “impracticable” to call a meeting
- Court has wide discretion to make orders as to the purpose and structure of the meeting

Oppression Remedy #1

- The most effective and frequently-used shareholder remedy
- Intended to prevent one or more shareholders from operating the corporation in a manner contrary to the reasonable expectation of the shareholders
- “Reasonable expectation” is a question of fact to be determined from the agreements, history, conduct and dealings of the shareholders.
- OBCA/CBCA do not define reasonable expectation.
- Applies to only OBCA/CBCA corporations: *PMSM Inv. Ltd. v. Bureau*, 1995 CanLII 7123 with some exceptions: *Manulife v. AFG Ind.* 2008 CanLII 873 (ON SC). (Of course, there are similar remedies in Corp. Acts in other provinces.)

Oppression Remedy #2

- Court has broad discretion where oppressive conduct exists to remedy oppression by appropriate order, including
 - Setting aside a transaction
 - Amending a shareholder agreement
 - Amending corporate articles or by-laws
 - Directing purchase of shares
 - Directing an auction or other buyout method
 - Winding-up the corporation and directing sale of assets and distribution
 - Appointing a receiver to manage or oversee the business
 - Directing the trial of an issue

Oppression Remedy #3

- What is oppressive conduct?
 - Conduct which is unfairly prejudicial
 - Conduct which unfairly disregards the interests of a shareholder or security holder
 - Conduct which is inconsistent with the *reasonable expectations* of the parties
 - Conduct can be oppressive even if it is legal
 - Conduct can be oppressive even if not done in bad faith

Oppression Remedy #4

- **Examples of oppressive conduct**
 - Failure to disclose financial information
 - Self-dealing, fraud, non-disclosure of related party transactions
 - Payment of director/shareholder personal expenses or debts
 - Unilateral increase in salary or expenses
 - Exposing the business new ventures or risks beyond the ordinary business of the corporation
 - Unilateral or disproportionate dividend payment
 - Unilateral dismissal of a key employee

Oppression Remedy #5

- **More examples of oppressive conduct**
 - Diversion of funds or business to another entity
 - Unilateral changes of corporate structure
 - Binding the corporation to new debt out of the ordinary course of business without notice
 - Operating the business as if the other shareholder does not exist
 - Preferring some shareholders with management fees
 - Paying unfairly high directors' fees
 - Creating a "smokescreen insolvency"
 - See *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69

Oppression Remedy #6

- The oppression remedy is also available to non-shareholders, including
 - officers and directors
 - employees
 - security holders
 - creditors to prevent fraud by shareholders
 - anyone the court considers a “proper person”
- The oppression remedy can also be used to prevent a shareholder from arranging his affairs through a network of corporations where liabilities are incurred in one corporation and assets are in another: *Downtown Eatery (1993) Ltd. v. Ontario*, 2001 CanLII 8538 (ON CA)

Oppression and Arbitration

- Many shareholders' agreements have arbitration clauses.
- There is a strong tendency to defer to a forum selection clause unless there is a clear intention to the contrary.
- Is the oppression remedy available when there is a mandatory arbitration clause in a shareholders' agreement? It depends on the wording.
- *Deluce v. Air Canada* (1992 ONSC): where the majority shareholder was trying to squeeze the minority shareholder out of the business, the Court held that was outside the scope of the arbitration clause and the oppression action was allowed to proceed.

Derivative Action #1

- Powerful remedy to deal with fraud, abuse or breach of fiduciary duty: OBCA s.246
 - “Complainant”, who can be a shareholder, officer, director, employee, creditor or “proper person”
 - Seeks permission from Court to sue or defend a lawsuit in name of corporation
 - Claim can be against another shareholder, director or employee
 - Can be for defence of a lawsuit which management is unwilling to defend

Derivative Action #2

- Derivative action might be required where managing director or majority shareholder is self-dealing or breached fiduciary duty
- Often involves a breach by director of OBCA s.134 – duty to act honestly and in good faith with a view to the best interests of the corporation and exercise reasonable care, diligence and skill
- *Malata Group v. Jung, 2008 ONCA*: “No bright line”: There can be overlap between oppression remedy and derivative action especially where directors in a closely held corp. engage in self-dealing to the detriment of the corporation and other shareholders or creditors.
- Serious breaches of fiduciary duty could give rise to punitive damages of \$125,000 or more: *Capobianco v. Paige 2009 CanLII 29899 (ONSC)*

Derivative Action #3

- Complainant seeks leave to sue or defend in name of the corporation
- Court has to consider:
 - Fairness to complainant
 - Fairness to corporation
 - Who will bear the legal cost
 - Corporation's exposure to legal costs
 - Management of corporation going forward

Derivative Action #4

- Four part test for leave to commence
 - Directors' refusal to prosecute or defend
 - Notice to directors of intention to seek leave
 - Complainant is acting in good faith
 - Court is persuaded that the proceeding is in the interests of the corporation
 - "No bright line" test in *Malata*. If derivative action could also have been an oppression claim, there is no reason to refuse leave.

Other OBCA remedies

- **Investigations, OBCA s.161**
 - Looking for instances of fraud
- **Appraisal Remedy, OBCA, s.188**
 - To require corporation to buy shares of dissenting shareholders where right of dissent to fundamental change exists
- **Winding up, OBCA, s. 207**
 - Just and equitable termination of the corporation where deadlock exists in a corporation which is used as a vehicle for a partnership or where there is animosity which prevents the business from continuing
 - Directions for disposition of assets, payment of liabilities and distribution of surplus among shareholders
- **Payment of shareholder's legal fees s.247(d), 248(4)**
 - Stringent 3-part test: 1) applicant in financial difficulty; 2) financial difficulty arises out of the alleged oppression; and 3) strong prima facie case for oppression: *Molinaro v. U-Buy Discount Foods 2000 CarswellOnt 4656*

More about valuation

- Some USAs contain a valuation clause. The clause might be out of date. Many corporations do not bother to have a valuation done as contemplated. Other factors may make the valuation unfair or irrelevant
- Who is doing the valuation? It should not be the corporate accountant – who may not know how to value
- What agreement can be reached on the parameters of valuation – including valuation date, special factors, normalizing management salary, other factors?
- Are other experts required: real estate appraiser, machinery appraiser, trademark or patent appraiser? What are the special assets of the corporation?
- If a spouse is a minority shareholder, should there be a minority discount? – depends if there is oppression? How much should the minority discount be?

Final Thoughts

- Corporate Law, Fiduciary Duty and Employment Law issues arise in many family cases where spouses are involved in a business.
- These may involve litigation, arbitration and valuation which might have to be separate from other issues in the family law proceeding, especially if other parties are involved in the business.
- We have only scratched the surface to touch on the most common items but
- ... our time is up and you need a coffee break.
- Thank you for your attention.



Igor Ellyn, QC, CS Evelyn Perez Youssoufian