



National Library
of Canada

Bibliothèque nationale
du Canada

Canadian Theses Service

Service des thèses canadiennes

Ottawa, Canada
K1A 0N4

NOTICE

The quality of this microform is heavily dependent upon the quality of the original thesis submitted for microfilming. Every effort has been made to ensure the highest quality of reproduction possible.

If pages are missing, contact the university which granted the degree.

Some pages may have indistinct print especially if the original pages were typed with a poor typewriter ribbon or if the university sent us an inferior photocopy.

Reproduction in full or in part of this microform is governed by the Canadian Copyright Act, R.S.C. 1970, c. C-30, and subsequent amendments.

AVIS

La qualité de cette microforme dépend grandement de la qualité de la thèse soumise au microfilmage. Nous avons tout fait pour assurer une qualité supérieure de reproduction.

S'il manque des pages, veuillez communiquer avec l'université qui a conféré le grade.

La qualité d'impression de certaines pages peut laisser à désirer, surtout si les pages originales ont été dactylographiées à l'aide d'un ruban usé ou si l'université nous a fait parvenir une photocopie de qualité inférieure.

La reproduction, même partielle, de cette microforme est soumise à la Loi canadienne sur le droit d'auteur, SRC 1970, c. C-30, et ses amendements subséquents.

AN ANALYSIS OF THE SHAREHOLDER'S BUY-SELL AGREEMENT
IN THE CANADIAN CLOSE CORPORATION

Marie E. John

Thesis submitted to
the School of Graduate Studies and Research
in partial fulfillment of the requirements
for the LL.M. degree

University of Ottawa



National Library
of Canada

Bibliothèque nationale
du Canada

Canadian Theses Service Service des thèses canadiennes

Ottawa, Canada
K1A 0N4

The author has granted an irrevocable non-exclusive licence allowing the National Library of Canada to reproduce, loan, distribute or sell copies of his/her thesis by any means and in any form or format, making this thesis available to interested persons.

The author retains ownership of the copyright in his/her thesis. Neither the thesis nor substantial extracts from it may be printed or otherwise reproduced without his/her permission.

L'auteur a accordé une licence irrévocable et non exclusive permettant à la Bibliothèque nationale du Canada de reproduire, prêter, distribuer ou vendre des copies de sa thèse de quelque manière et sous quelque forme que ce soit pour mettre des exemplaires de cette thèse à la disposition des personnes intéressées.

L'auteur conserve la propriété du droit d'auteur qui protège sa thèse. Ni la thèse ni des extraits substantiels de celle-ci ne doivent être imprimés ou autrement reproduits sans son autorisation.

ISBN 0-315-62317-9

Canada



UNIVERSITÉ D'OTTAWA
UNIVERSITY OF OTTAWA

ACKNOWLEDGEMENTS

I would like to express my gratitude to my thesis supervisor Dr. Eugene Meehan, of the Faculty of Law, University of Ottawa, without whose knowledge, enthusiasm and patience, this dissertation would not have been possible. I would also like to thank the various other professors both at the Faculty of Law and the Faculty of Administration for their advice and guidance in my work. Also, I would like to thank Mr. Richard Minard for his help in the editing of this dissertation. As well, I would like to thank my friends and family, for their support and encouragement, in particular my friend Keith, whose assistance was invaluable in the preparation of this thesis. Finally I would like to express my appreciation to my mother who continues to be a source of inspiration in my life.

M.E.J.

February, 1990

TABLE OF CONTENTS: SUMMARY

TABLE OF CONTENTS - SUMMARY	i
TABLE OF CONTENTS - DETAILED	ii
TABLE OF CASES	viii
CHAPTER I: INTRODUCTION	1
CHAPTER II: THE BUY-SELL AGREEMENT	10
CHAPTER III: THE VALUATION OF SHARES UNDER THE BUY-SELL AGREEMENT	61
CHAPTER IV: FUNDING THE BUY-SELL AGREEMENT	116
CHAPTER V: INCOME TAX CONSIDERATIONS	162
CHAPTER VI THE LEGALITY AND EFFECTIVENESS OF THE BUY-SELL AGREEMENT	209
CHAPTER VII: REMEDIES	234
CHAPTER VIII: CONCLUSION	264
BIBLIOGRAPHY	267
APPENDICES	

TABLE OF CONTENTS - DETAILED

<u>CHAPTER I:</u>	<u>INTRODUCTION</u>	1
<u>CHAPTER II:</u>	<u>THE BUY-SELL AGREEMENT</u>	
1.	DEFINITION	10
2.	THE CLOSE CORPORATION	11
3.	THE NEED FOR A BUY-SELL AGREEMENT	16
4.	SOME ISSUES FOR CONSIDERATION	21
5.	TYPES OF BUY-SELL PROVISIONS	24
A.	ABSOLUTE RESTRICTIONS AND COMPULSORY PURCHASE PROVISIONS	26
B.	CONSENT PROVISIONS	28
C.	PUT-CALL PROVISIONS	30
I.	"PUT"	30
II.	"CALL"	31
III.	"PUT-CALL" PROVISIONS	32
(A)	THE SHOTGUN	32
(B)	THE RESTRICTED AUCTION	39
D.	THE RIGHT OF FIRST REFUSAL	40
I.	THE "SOFT" RIGHT OF FIRST REFUSAL	41
II.	THE "HARD" RIGHT OF FIRST REFUSAL	42
E.	THE PIGGY BACK	46
F.	COMBINATION BUY-SELL PROVISIONS	47
6.	THE EVENTS WHICH TRIGGER THE BUY-SELL AGREEMENT	48
A.	CESSATION OF EMPLOYMENT	49
B.	MENTAL OR PHYSICAL DISABILITY	49
C.	EVENTS DEFINED IN TERMS OF A CORPORATION'S PERFORMANCE	50
D.	TRANSFERS BY OPERATION OF LAW	51
E.	THE DEATH OF A SHAREHOLDER	59
7.	CONCLUSION	60
<u>CHAPTER III:</u>	<u>THE VALUATION OF SHARES UNDER THE BUY-SELL AGREEMENT</u>	
1.	GENERAL	61

2.	FAIR VALUE VERSUS FAIR MARKET VALUE	64
3.	VALUATION PROCEDURES	68
A.	VALUATION BY AN INDEPENDENT THIRD PARTY OR ARBITRATOR	68
B.	VALUATION AS SET BY THE PARTIES THEMSELVES	70
C.	VALUE AS SET BY THE TAX AUTHORITIES	73
D.	VALUATION BY THE COURTS	76
4.	VALUATION ISSUES	77
A.	THE ISSUE OF CONTROL	77
B.	GOODWILL	80
C.	THE NATURE OF THE BUSINESS	81
D.	TIME OF VALUATION	83
E.	MINORITY DISCOUNTS	85
F.	PREMIUMS FOR CONTROL	92
5.	METHODS OF VALUATION	95
A.	DETERMINATION OF MARKET VALUE	96
B.	FORMULA METHODS	102
I.	CAPITALIZATION OF EARNINGS APPROACH	103
II.	NET ASSET APPROACH	109
(A)	LIQUIDATION VALUE	110
(B)	BOOK VALUE	111
C.	COMBINATION METHODS	114
6.	CONCLUSION	115

CHAPTER IV: FUNDING THE BUY-SELL AGREEMENT.

1.	GENERAL	116
2.	CORPORATE PURCHASE	118
3.	PURCHASE BY SHAREHOLDERS	121
4.	TESTAMENTARY FUNDING - LIFE INSURANCE	122
A.	TYPES OF INSURANCE	127
I.	TERM INSURANCE	128
II.	WHOLE OF LIFE	131
III.	TERM TO 100 INSURANCE	133
IV.	JOINT-LIFE INSURANCE	134
B.	INSURANCE PAYMENT ARRANGEMENTS	135

I.	CRISS-CROSS INSURANCE	136
II.	CORPORATE-OWNED INSURANCE	139
III.	SPLIT-DOLLAR INSURANCE	143
C.	THE UNINSURABLE SHAREHOLDER	147
5.	<u>INTER VIVOS FUNDING</u>	148
A.	A CASH PAYMENT AFTER A SPECIFIED INTERVAL	150
B.	PAYMENT OF THE PURCHASE PRICE IN INSTALLMENTS	151
C.	A SINKING FUND OR SAVINGS SCHEME	154
D.	BANK LOAN	155
E.	MORTGAGE	156
F.	DISABILITY INSURANCE	157
6.	CONCLUSION	161
<u>CHAPTER V: INCOME TAX CONSIDERATIONS</u>		
1.	GENERAL	162
2.	THE ISSUE OF CONTROL	
A.	<u>DE JURE</u> CONTROL	163
B.	THE ARM'S LENGTH RULE	173
C.	CANADIAN-CONTROLLED PRIVATE CORPORATION (CCPC)	178
D.	ASSOCIATED CORPORATIONS	179
3.	THE DEATH OF A SHAREHOLDER	180
4.	FUNDING	
A.	CORPORATE PURCHASE	185
B.	SHAREHOLDER PURCHASE	189
C.	LIFE INSURANCE	192
I.	CRISS-CROSS INSURANCE	192
II.	CORPORATE OWNED INSURANCE	194
III.	SPLIT-DOLLAR INSURANCE	196
IV.	PREMIUMS	199
5.	VALUATION	201
6.	CONCLUSION	208
<u>CHAPTER VI: THE LEGALITY AND EFFECTIVENESS OF THE BUY- SELL AGREEMENT</u>		
1.	GENERAL	209

2.	THE PRESUMPTION OF TRANSFERABILITY	210
3.	THE ATTITUDE OF THE COURTS	211
4.	THE RULE AGAINST PERPETUITIES	216
5.	THE EFFECT OF STATUTE ON THE VALIDITY OF THE AGREEMENT	
A.	THE UNANIMOUS SHAREHOLDER AGREEMENT	219
B.	ENDORSEMENT OF THE SHARE CERTIFICATE	223
C.	CANADA BUSINESS CORPORATIONS ACT SECTION 241(3)(c)	224
6.	INSTRUMENTS IMPOSING THE BUY-SELL AGREEMENT	227
A.	THE GOVERNING STATUTE	228
B.	THE ARTICLES OF INCORPORATION	229
C.	THE UNANIMOUS SHAREHOLDER AGREEMENT	230
7.	CONCLUSION	231
<u>CHAPTER VII: REMEDIES</u>		
1.	DISPUTE AVOIDANCE	233
2.	TRUST AGREEMENT	235
3.	ARBITRATION	236
4.	VOLUNTARY LIQUIDATION OF THE CORPORATION OR TERMINATION OF THE AGREEMENT	239
5.	RESORT TO THE COURTS	241
A.	COMMON LAW AND EQUITY	242
I.	DAMAGES	242
II.	SPECIFIC PERFORMANCE	244
III.	INJUNCTION	246
B.	STATUTORY REMEDIES	247
I.	THE OPPRESSION REMEDY	248
II.	APPLICATION FOR A RESTRAINING OR COMPLIANCE ORDER	253
III.	APPLICATION FOR A WINDING UP	254
IV.	THE RIGHT TO DISSENT	259
V.	THE DERIVATIVE ACTION	260
<u>CHAPTER VIII: CONCLUSION</u>		263

BIBLIOGRAPHY

1. BOOKS	266
2. ARTICLES	268
3. EDITED LECTURES AND ESSAYS	270
4. CONFERENCE MATERIALS	272
5. TABLE OF STATUTES	275
6. INTERPRETATION BULLETINS	275
7. NOTES (no author noted)	277
8. OTHER MATERIALS	277

APPENDICES

APPENDIX I	Buy-Sell Agreement -- Two Shareholders-- Shotgun provision operational during the lifetime of the parties -- Compulsory purchase after the death of either party -- Insurance funding on death -- Valuation fixed in advance.
APPENDIX II	Buy-sell agreement between two parties -- funded by insurance -- right of first refusal -- right to purchase provision -- provision covering incapacity of the shareholder -- includes schedule covering price determination.
APPENDIX III	Buy-sell agreement between two shareholders-- stipulated value -- compulsory purchase after death.
APPENDIX IV	Alternative or additional "shotgun" clause.
APPENDIX V	Alternative or additional "piggy-back" clause. 1. Two shareholders -- Third party offer to A -- Right of B to dispose of an equivalent number of shares to the third party purchaser. 2. Third party offer to A to purchase all of the corporation's shares -- B to purchase or sell his entire shareholding.
APPENDIX VI	Alternative or additional right to purchase clause.
APPENDIX VII	Alternative or additional right of first refusal clause.
APPENDIX VIII	Alternative or additional restricted auction clause.

APPENDIX IX Alternative or Additional valuation clauses.

1. Valuation by an auditor.
2. Valuation by an auditor -- method of determining value.
3. Book value -- capitalization of fixed assets.
4. Value stipulated annually or adjusted.
5. Valuation by an auditor after death-- method of valuing assets.

TABLE OF CASES

- A & B.C. Chewing Gum, Re, [1975] 1 W.L.R. 579.
- A. Zimet Ltd. v. Woodbine Summit Ltd., Re, (1985), 31 B.L.R. 277 (Ont. S.C.).
- Aaron's Ladies Apparel Ltd. v. M.N.R., [1967] C.T.C. 50, 67 D.T.C. 5035 (S.C.C.).
- Aaron's (Prince Albert) Ltd. v. M.N.R., [1966] C.T.C. 330, 66 D.T.C. 5244 (Ex. Ct.); [1967] C.T.C. 50, 67 D.T.C. 5035 (S.C.C.).
- Alberts v. Mountjoy (1977), 2 B.L.R. 178 (Ont. S.C.).
- American Cyanide Ltd. v. Ethicon, [1975] A.C. 396, [1975] All E.R. 504 (H.L.).
- Anderson v. Wittich (1979), 8 B.L.R. 209 (Ont. H.C.).
- Angus v. R. Angus Alta. Ltd. (1988), 58 Alta. L.R. (2d) 76 (C.A.).
- Antoine Guertin Ltee. v. R. (1981), 81 D.T.C. 5268 (F.C.T.D.).
- Arams v. Filliman (1955), 128 N.N. (2d) 284 (N.Y.C.A.).
- Arctic Geophysical Ltd. v. M.N.R., [1967] C.T.C. 571, 68 D.T.C. 5013 (Ex. Ct.).
- Associates Finance Co. Ltd. v. Webber & Dixon, [1972] 4 W.W.R. 130 (B.C.S.C.).
- Attorney General of Alberta v. Royal Trust, [1945] 2 D.L.R. 274, [1945] S.C.R. 267 (S.C.C.).
- B.C. Millwork Products Ltd. v. Overhead Door Sales (Vancouver) Ltd., [1961] 34 W.W.R. 86 (B.C.S.C.).
- Baking of Alberta Ltd. v. R., [1978] C.T.C. 30, 78 D.T.C. 6018 (F.C.T.D.); [1980] C.T.C. 237, 80 D.T.C. 6178 (F.C.A.).
- Beament Estate Re, (1970), 11 D.L.R. (3d) 237, [1970] C.T.C. 193 (S.C.C.); rev'g [1968] C.T.C. 558, 69 D.T.C. 5016 (Ex. Ct.).
- Beauchamp v. Les Contenants Sanitaires C.S. Inc. (1979), 7 B.L.R. 200 (Que. Sup. Ct.).

- Bendix Automotive of Canada Ltd. v. R., [1978] C.T.C. 194, 78 D.T.C. 6137 (F.C.A.); rev'g [1975] C.T.C. 464, 75 D.T.C. 5326 (F.C.T.D.).
- Bernard v. Vallenti (1978), 3 B.L.R. 138 (Ont. H.C.).
- Bird Precision Bellows Ltd., Re, [1984] Ch. 419 (Ch. D.).
- Bondi Better Bananas Ltd., Re, [1951] 3 D.L.R. 522 (Ont. H.C.).
- Borland Trustee v. Steel Bros. & Co., [1901] 1 Ch. 279.
- Boxer v. Norvan Properties Ltd. (1988), 25 B.C.L.R. (2d) 231 (C.A.).
- Brant Investments Ltd. and Keeprite Inc. & Intercity Gas Corporation, Re, (1983), 44 O.R. (2d) 661, 5 D.L.R. (4th) 116 (H.C.).
- Brant Investments Ltd and Keeprite Inc., Re, (1987), 42 D.L.R. (4th) 18 (Ont. H.C.).
- Brigman v. M & J Corp., 352 Mass. 674, 227 NE (2d) 915 (1967).
- Brinacombe v. Dennison, [1953] 4 D.L.R. 827 (B.C.S.C.).
- Bronfman Trust v. R. (1979), 79 D.T.C. 5438 (F.C.T.D.).
- Brunell v. M.N.R., [1977] C.T.C. 2506, 77 D.T.C. 326 (T.R.B.).
- Buckerfield Ltd. v. M.N.R., [1964] C.T.C. 504, 64 D.T.C. 5301, (Ex. Ct.).
- Bugle Press, Re, [1960] 3 W.L.R. 956, [1961] Ch. 270 (C.A.).
- Bury and Bell Gouinlock Ltd., Re, (1985), 12 D.L.R. (4th) 451, (1984), 48 O.R. (2d) 57 (H.C.J.).
- Canadian Long Island Petroleum Ltd. v. Irving Industries (Irving Wire Products Div.) Ltd. (1974), 50 D.L.R. (3d) 265 (S.C.C.).
- Carruthers v. R. (1982), 82 D.T.C. 6009 (F.C.T.D.).
- Carrol v. McArthur (1983), 25 B.L.R. 132 (Ont. Co. Ct.).
- Carter v. Roy M. Lawson Ltd. (1981), 129 D.L.R. (3d) 214, 36 N.B.R. (2d) 353 (N.B.Q.B.).
- Central and Eastern Trust Co. v. Irving Oil Ltd. (1980), 10 B.L.R. 42, (1980), 39 N.S.R. (2d) 541 (S.C.C.).

- Connor et al v. MacCulloch et al (1977), 18 N.S.R. (2d) 404 (S.C.).
- Cote Estate, Re, [1941] 3 D.L.R. 523, 22 C.B.R. 387 (Ont. H.C.).
- Cote-Reco Inc. v. M.N.R. (1980), 80 D.T.C. 1012 (T.R.B.).
- Cucci's Restaurant Ltd. v. Tsang, Re, (1985), 29 B.L.R. 196 (Alta. Q.B.).
- Cyrus Anvil Mining Corp. v. Dickson (1980), 40 B.C.L.R. 180 (S.C.).
- Dean v. Prince, [1954] Ch. 409 (C.A.).
- Daniels and Fielder, Re, (1988), O.R. (2d) 629 (H.C.J.).
- Davidson v. Davidson, [1946] 2 D.L.R. (S.C.C.).
- Diligenti v. RMWD Operations Kellowa Ltd. (No. 2), [1978] 4 B.C.L.R. 134 (B.C.S.C.).
- Direct Lumber Co. Ltd. v. M.N.R. (1981), 81 D.T.C. 627 (T.R.B.).
- Domglas Inc. v. Jarislowsky Fraser and Co. Ltd., Re, [1980] Que. S.C. 925, 13 B.L.R. 135; aff'd (1983), 138 D.L.R. (3d) 21, 22 B.L.R. 121 (C.A.).
- Dunham & Apollo Tours Ltd., Re, (1978), 20 O.R. (2d) 9 (H.C.).
- E.P. Taylor v. M.N.R. (1961), 61 D.T.C. 513 (T.A.B.).
- Ebrahimi v. Westbourne Galleries, [1973] A.C. 360, [1972] W.L.R. 1289, [1972] 2 All E.R. 492, [1973] A.C. 360 (H.L.).
- Economy Carriers Ltd. v. M.N.R. (1984), 84 D.T.C. 1230 (T.C.C.).
- Edmonton Country Club v. Case, [1975] S.C.R. 534.
- Edmund Littler Sr. v. M.N.R., [1976] C.T.C. 379, 76 D.T.C. 6210 (F.C.T.D.); aff'd [1978] C.T.C. 235, 78 D.T.C. 6179 (F.C.A.).
- Eiserman v. Ara Farms Ltd. (1988), 52 D.L.R. (4th) 498, 67 Sask. R. 61, [1988] 5 W.W.R. 97 (C.A.).
- Elder v. Elder [1952] S.C. 49 (Sc. Ct. Sess.).

- Elley v. Positive Government Security Life Association Co.,
[1876] Ex. D. 88, 34 L.T. 190 (C.A.).
- Elsey's Frosted Foods Ltd. v. Mid. White Oak Square Ltd.
(1976), 1 B.L.R. 115 (Ont. H.C.).
- Emerson v. R. (1986), 86 D.T.C. 6184 (F.C.A.); aff'g (1985),
85 D.T.C. 5236 (F.C.T.D.).
- Equitable Acceptance Corporation Ltd. v. M.N.R. (1964), 64
D.T.C. 5045 (Ex. Ct.).
- Estate of Karma May v. M.N.R. (1988), 88 D.T.C. 1189 (T.C.C.).
- Express Cable TV Ltd. v. M.N.R., [1982] C.T.C. 2447, 82 D.T.C.
1431 (T.R.B.).
- Feld v. Glick (1975), 8 O.R. (2d) 7 (H.C.).
- Ferguson v. Imax Systems Corp. (1983), 43 O.R. (2d) 128; 150
D.L.R. (3d) 718 (S.C.C.).
- Fleisher v. Rosenbloom (1988), 53 Man. R. (2d) 247 (Q.B.).
- Fox Johnson & Co. Ltd, Re, [1942] 2 D.L.R. 784 (Ont. H.C.).
- Gandalman Investments Inc., Re, (1985), 52 O.R. 614 (H.C.).
- Gold Coast Selection Trust Ltd. v. Humphrey, [1948] 8 All E.R.
379, [1948] A.C. 459 (H.L.); aff'g in part [1946] 2 All
E.R. 742 (C.A.).
- Goldhar and Quebec Manitou Mines Ltd., Re, (1975), 61 D.L.R.
(3d) 612 (Ont. H.C.).
- Gould Thorp & Easton v. Albert (1958), 26 W.W.R. 274
(B.C.S.C.).
- Gould v. Ablett, [1958] 26 W.W.R. 274 (B.C.S.C.).
- Green Acres Fertilizer Services Ltd. v. R. (1980), 80 D.T.C.
6365 (F.C.A.D.).
- Greenlaugh v. Aderne Cinemas Ltd., [1951] 1 Ch. 286 (C.A.).
- Greenlaugh v. Mallard, [1943] 2 All E.R. 234 (C.A.).
- Guilder News Co. (1963) Ltd. v. M.N.R., [1973] C.T.C. 1
(F.C.A.).
- H. & L. Kushnir v. M.N.R., [1985] 1 C.T.C. 2301 (T.C.C.).

- H.A. Fawcette & Son Ltd. v. R., [1980] C.T.C. 293, 80 D.T.C. 6195 (F.C.A.).
- H.P. Connor v. R., [1978] C.T.C. 669 (F.C.T.D.); aff'd [1979] C.T.C. 365 (F.C.A.).
- Hamer v. National Forest Products Ltd. (1964), 44 D.L.R. (2d) 757 (B.C.S.C.).
- Harvey's Stores Ltd. and Harvey, Re, (1979), 6 B.L.R. 223 (B.C.C.A.).
- Hickman v. Kent, [1915] 1 Ch. 881.
- Hill v. Werner Berman and Spitz, P.A., 197 NJ Super 152, 484 A2d 344 (1984).
- Holt v. I.R.C., [1953] 2 All. E.R. 1499 (Ch. D.).
- Hubley v. Stonehouse Motel et al (1976), 24 N.S.R. (2d) 262 (S.C.).
- I.R.C. v. Clay (1918), 3 K.B. 466 (C.A.).
- I.R.C. v. Crossman [1937] A.C. 26 (H.L.).
- In Matter of Pace Photographers Ltd., 133 App. Div. 2d 829.
- Interfirst Bank of Dallas N.A. v. Risser, 739 SW (2d) 882 (Tex. App. 1987).
- International Iron & Metal Co. Ltd. v. M.N.R, [1972] C.T.C. 242, (1980), 10 B.L.R. 42 (S.C.C.).
- International Mercantile Factors Ltd. v. R. (1990), 90 D.T.C. 6390 (F.C.T.D.).
- Irving Oil Ltd. v. Central & Eastern Trust Co. (1978), 5 B.L.R. 29 (N.S.S.C.).
- Irwin v. D. Coates Enterprises Ltd. (1983), 49 B.C.L.R. 383 (S.C.).
- J.L.R. Holdings Ltd. v. Wiseburg (1977), 2 B.L.R. 250 (Ont. H.C.).
- Jakobson v. Agassiz Enterprises (1988), 49 Man. R. (2d) 270 (Q.B.).
- Jiffy People Sales (1966) Ltd. v. Elaison (1975), 58 D.L.R. (3d) 439, 21 C.P.R. (2d) 209 (B.C.S.C.).

- Jones v. Lipman, [1962] 1 W.L.R., 1 All E.R. 442 (Ch. D.).
- Kanawha-Roane Land Inc. v. Burford, 359 SE (2d) 618 (W. Va. 1987).
- Keho Hldg. Ltd. v. Noble (1987), 38 D.L.R. (4th) 368, 57 Alta. L.R. (2d) 197, 78 A.R. 131 (C.A.).
- Kelvin Energy Ltd. v. Bahan (1987), 52 Alta. L.R. (2d) 71 (Q.B.).
- Lavigne v. Robern (1984), 28 B.L.R. 77 (Ont. C.A.).
- Leitch Transport Ltd. v. Neonex International Ltd. (1979), 8 B.L.R. 257 (Ont. C.A.).
- Les Investments Mont Soleil Ltd. v. Nat. Drug Ltd., [1982] C.S. 716, 22 B.L.R.139 (Que. S.C.).
- Lo Cicero, Ravin & Ravin v. BACM Industries Ltd., (1988), 49 D.L.R. (4th) 159, [1988] 1 S.C.R. 399, [1988] 4 W.W.R. 671 (S.C.C.); rev'g [1986] 3 W.W.R. 152, (1986), 25 D.L.R. (4th) 269, 38 Man. R. (2d) 134 (C.A.); rev'g 31 Man. R. (2d) 208, 28 D.L.R. 173 (Q.B.).
- Loeb v. Provigo Inc. (1978), 4 B.L.R. 272 (Ont. H.C.).
- Lough v. Canada Natural Resources Ltd., (1983), 45 B.C.L.R. 335 (S.C.)
- Lusita Holdings Ltd. v. R., [1982] C.T.C. 351, 82 D.T.C. 6297 (F.C.T.D.).
- Lyle v. Baynes Manning Ltd., [1957] 21 W.W.R. 43 (B.C.C.A.).
- Lyndall, Re, [1969] 3 All E.R. 984 (C.A.).
- M.C. United Masonry Ltd., Re, (1983), 40 O.R. (2d) 330 (C.A.).
- M.N.R. v. Dworkin Furs Ltd., [1967] C.T.C. 50, 67 D.T.C. 5035 (S.C.C.).
- M.N.R. v. Consolidated Holdings Co. Ltd., [1972] C.T.C. 18, 72 D.T.C. 6007 (S.C.C.).
- M.N.R. v. Estate of T.R. Merit, [1969] C.T.C. 207 (Ex. Ct.).
- M.N.R. v. Fritz Werner Ltd. (1972), 72 D.T.C. 6239 (F.C.T.D.).
- MacMasters & Labombards Chatham Ltd., Re, (1985), 50 O.R. (2d) 775 (H.C.).

- Manning v. Harris Steel Group Inc. (1989), 63 D.L.R. (4th) 125 (B.C.C.A.).
- Manchester Ship Canal Co. v. Manchester Recourse Co., [1901] 2 Ch. 37 (C.A.).
- Mason & Intercity Properties Ltd., Re, (1987), 38 D.L.R. (4th) 681 (Ont. C.A.).
- Mathers v. Mathers (1989), 89 N.S.R. (2d) 358 (N.S.T.D.); aff'd. (1989), 90 N.S.R. (2d) 354 (N.S.S.C.).
- Mason v. M.O.W. Holdings Ltd. (1983), 23 B.L.R. 225 (Man. Q.B.).
- McKay et al v. M.N.R. (1984), 84 D.T.C. 1699 (T.C.C.).
- Medical Building Ltd., Re, [1953] 9 W.W.R. 278 (Sask. Q.B.).
- Meltzer v. Western Paper Box Co., [1978] 1 W.W.R. 451, (1977), 3 B.L.R. 113 (Man. Q.B.).
- Mica Management Centre Inc. v. Lockett (1986), 37 B.L.R. 209, (Ont. H.C.).
- Min. of Finance of British Columbia v. Estate of William Mann, [1972] 5 W.W.R. 23 (B.C.S.C.); aff'd [1973] C.T.C. 561 (B.C.C.A.); aff'd [1974] C.T.C. 222 (S.C.C.).
- Moodie v. W.J. Shepherd Ltd., [1949] 2 All E.R. 1044 (H.L.).
- Motherwell v. Schoof, [1949] 4 D.L.R. 812 (Alta. S.C.).
- Noranda Mines Ltd. v. M.N.R. [1987] 2 C.T.C. 2089, 87 D.T.C. 379 (T.C.C.).
- Noren Investments Ltd. v. Brownie's Franchises Ltd. (1987), 36 B.L.R. 85 (B.C.C.A.).
- North-West Transport v. Beatty, [1877] 12 A.C. 589 (P.C.).
- Northern Canadian Mortgage Co Ltd. & Moore v. Northwood, Re, (1960), 22 D.L.R. (2d) 698 (Man. C.A.).
- Northern Life Assurance Co. and Fawcette, Re, [1932] 1 W.W.R. 44 (Sask. K.B.).
- Oakley v. McDougall (1987), 14 B.C.L.R. (2d) 128 (C.A.).
- Ogilvy, Re, (1966) 58 D.L.R. (2d) 385, [1966] 1 O.R. 755 (H.C.).

- Ontario Jockey Club Ltd. v. McBride, [1927] 4 D.L.R. 30, A.C. 916 (P.C.).
- P. Dontigny Estate v. R., [1974] C.T.C. 532 (F.C.A.).
- Parkes Estate v. M.N.R., [1986] C.T.C. 2262, 86 D.T.C. 1214 (T.C.C.).
- Patmore Re, [1962] 39 W.W.R. 460 (B.C.S.C.).
- Pender Enterprises Ltd. v. M.N.R., [1965] C.T.C. 343 (Ex. Ct.).
- Phillips Electronics Ltd. v. Westinghouse Can. Inc. (1984), 27 B.L.R. 54 (Ont. H.C.).
- Phillips & La Paloma Sweets Ltd., Re, [1921] 51 O.R. 125, [1922] 66 D.L.R. 577 (S.C.).
- Prat v. Hitchcock (1925), 36 B.C.L.R. 142, [1925] 3 D.L.R. 1142 (C.A.).
- Pre-Delco Machine Tool Ltd. (1973), 36 D.L.R. (3d) 50, [1973] 3 O.R. 115 (H.C.).
- R. v. Alroy Industries Ltd. (1976), 76 D.T.C. 6220 (F.C.T.D.).
- R. v. Imperial General Properties Ltd., [1985] 2 S.C.R. 288, (1985), 31 B.L.R. 77, [1985] C.T.C. 299, 85 D.T.C. 5500, (S.C.C.).
- R. v. Mars Finance Inc., [1980] C.T.C. 216 (F.C.T.D.).
- R. v. Mastronardi, [1976] C.T.C. 572 (F.C.T.D.), aff'd [1977] C.T.C. 355 (F.C.A.).
- Rayfield v. Hands, [1960] Ch. 1, [1958] 2 W.L.R. 851 (Ch. D.).
- Ringuet v. Bergeron (1960), 24 D.L.R. (2d) 449, S.C.R. 672 (S.C.C.).
- Roberts v. Letter "T" Estates Ltd., [1961] 3 W.L.R. 176 (P.C.).
- Robinson v. M.N.R., [1987] 1 C.T.C. 2055 (T.C.C.).
- Robinson Brothers (Brewers) Ltd. v. County Durham Assessment Committee, [1938] A.C. 321 (H.L.).
- Rogers v. Agincourt Holdings Ltd. (1977), 1 B.L.R. 102 (Ont. C.A.).

- Rogers v. Bank of Montreal (1985), 30 B.L.R. (B.C.S.C.).
- Rostal Sales Agency Ltd. v. R., [1983] C.T.C. 5, 83 D.T.C. 5036 (F.C.T.D.).
- Rous & Mann Press Ltd. v. M.N.R. (1953), 53 D.T.C. 326 (T.A.B.).
- Rousseau Metal Inc. v. M.N.R. (1979), 79 D.T.C. 467 (T.R.B.).
- Royal Bank of Canada v. Stewart (1979), 8 B.L.R. 77 (B.C.S.C.).
- Sabex Internationale Ltee., Re, (1979), 6 B.L.R. 65 (Que. S.C.).
- Saloman v. Saloman & Co., [1897] A.C. 22, 13 T.L.R. 46 (H.L.).
- Scottish Co-operative Wholesalers Society v. Meyer, [1959] A.C. 324 (H.L.).
- Sharon Golf & County Club Ltd., Re, (1975), 2 C.B.R. 159 (N.S.H.C.).
- Shield Dev. Co. v. Snyder, [1976] 3 W.W.R. 44 (S.C.C.).
- Shoal Harbour Marine Service Ltd., Re, (1956), 20 W.W.R. 312 (B.C.S.C.).
- Short v. Treasury Commissioners, [1948] 1 K.B. 116 (C.A.); aff'd [1948] A.C. 534 (H.L.).
- Smith Fawcette Ltd., Re, [1942] Ch. 304 (C.A.).
- Southside Car Market Ltd. v. R., [1982] C.T.C. 214, 82 D.T.C. 6179 (F.C.T.D.).
- Special Risks Holdings Inc. v. M.N.R., [1986] 1 C.T.C. 201 (F.C.A.).
- Taylor Estate v. M.N.R., [1967] Tax A.B.C. 555, 67 D.T.C. 405, (T.A.B.).
- "The Barn Ltd." and Moldowan Estate, Re, [1962] 41 W.W.R. 444 (B.C.S.C.).
- Toric Optical Ltd. v. R. (1978), 78 D.T.C. 6310 (F.C.T.D.).
- Trans-Prairie Pipelines Ltd. v. M.N.R. (1970), 70 D.T.C. 6351 (Ex. Ct.).

- Trego v. Hunte, [1896] A.C. 7, [1895-9] All E.R. 804 (H.L.).
- Trimac Ltd. v. C-I-L Inc. (1987), 52 Alta. L.R. (2d) 263 (Q.B.); aff'd 52 Alta. L.R. 97 (C.A.).
- Trimac v. C-I-L Inc. (1989), 69 Alta. L.R. 113, [1990] 1 W.W.R. 133 (Alta. Q.B.).
- Utermyer Estate v. Attorney General for British Columbia, [1929] S.C.R. 84 (S.C.C.).
- VCS Holdings Ltd., Re, (1978), 5 B.L.R. 265 (B.C.S.C.).
- Veldova v. Garden House Inn Ltd. (1985), 29 B.L.R. 236 (H.C.).
- Viking Food Products Ltd. v. M.N.R. (1967), 67 D.T.C. 5067 (Ex. Ct.).
- Vineland Quarry and Crushed Stone Ltd. v. M.N.R., [1966] C.T.C. 69, 66 D.T.C. 5092 (Ex. Ct.).
- West Estate v. Minister of Finance for the Province of British Columbia, [1976] C.T.C. 313 (B.C.S.C.).
- Whitehorse Copper Mines Ltd., Re, (1980), 10 B.L.R. 113 (B.C.S.C.).
- Winram v. M.N.R (1972), 27 D.L.R. (3d) 763 (F.C.).
- Yardley Plastics of Canada Ltd. v. M.N.R., [1966] C.T.C. 215, 66 D.T.C. 5183 (Ex. Ct.).
- Yenidge Tobacco Co., Re, [1916] 2 Ch. 426 (C.A.).
- Yorkshire Trust Co. v. Bennet (1986), 46 Alta. L.R. (2d) 346 (Q.B.).

UNREPORTED CASES

- Argo v. Marini (7 July, 1989) Ontario 38419/89 (H.C.).
- Bradshaw Const. v. Bank of Nova Scotia (29 June, 1989) Victoria 2135/84 (B.C.S.C.).
- Charlwood Pac. Corp. v. Samoth Fin. Corp. Ltd. (11 April, 1989) Vancouver C886008 (B.C.S.C.).
- De Mond Jr. and Trading Dev. Co. v. Carlson (16 February, 1988), Vancouver CA007475 (B.C.C.A.).

Hornby v. Nugent (23 June, 1988) Vancouver CL2:017
(B.C.S.C.).

Merrel v. Burguss (29 August, 1988) Vancouver CL2:007
(B.C.S.C.).

Montgomery Agencies Ltd. v. Krischke (10 January, 1989)
Saskatoon 1730/87 (Q.B.).

Morrison v. United Westburne Ltd. & Dumez Invt. Inc. (United
Westburne Ltd.) (18 April, 1988) Ontario RE1926/87
(H.C.).

O'Neil v. Anderson (2 December, 1986) Vancouver CA004391
(B.C.C.A.).

CHAPTER I

INTRODUCTION

Though the buy-sell agreement has long been regarded as an effective tool for administering the share capital of a close corporation in the United States, the concept is fairly new to Canadian corporate law.¹ The importance of this type of agreement has increased considerably in recent years with the introduction of the unanimous shareholder agreement (USA) into several of the business corporations statutes in Canada.²

Under these statutes, a unanimous shareholder agreement may provide for a variety of matters, for example, it may allow shareholders to assume the rights, duties and powers of directors, through the structuring of the management of the corporation,³ and it may also provide for the transfer of the

¹J.F. Kennedy, "Shareholder's Agreements" in Special Lectures of the Law Society of Upper Canada, Recent Developments in Estate Planning and Administration, (Toronto: De Boo Ltd., 1980) 316-320; B.G. Hansen "Corporate Law" in The Legal Education Society of Alberta, ed., Alberta Law for the 80's, (Vancouver: Butterworths, 1978) at 116; D.P. Coates, "Share Transfer and Transmission Restrictions In The Close Corporation" (1968) 3 U.B.C.L. Rev. 96.

²See for example, Canada Business Corporations Act, S.C. 1974-75-76, c.33, s.140, as amended by S.C. 1978-79, c.9, s.146, (hereafter called the C.B.C.A.), Business Corporations Act, 1982, S.O. 1982, c.4, s.108, (hereafter called the O.B.C.A.), Business Corporations Act, S.A. 1981, c.B-15, s.140, (hereafter called the A.B.C.A.);

³This is contrary to the common law rule, whereby the shareholders' agreement is valid only when it affects shareholders in their capacity as shareholders, and any part of the agreement which affects shareholders in their capacity as directors, is invalid even if it is unanimous; Ringuet v. Bergeron (1960), 24 D.L.R. (2d) 449, [1960] S.C.R. 672

corporation's shares.⁴ The provisions of the shareholder agreement dealing with the management of the corporation should be regarded as a separate subject. This subject is not addressed in this dissertation.⁵

This study focuses on those provisions in shareholders' agreements dealing with the transfer of a corporation's shares. These are called buy-sell provisions and through them, the shareholders can control the termination of their relationship as shareholders by mutual agreement.

The parties may enter into a separate buy-sell agreement dealing with buy-sell provisions and related matters such as share valuation and the funding of the agreement.⁶ Once this agreement restricts the powers of directors to manage the corporation, and is signed by all shareholders, it becomes a unanimous shareholder agreement within the provisions of the various Canadian business corporations statutes. It is therefore automatically covered by statute which provides for

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

⁴For a comprehensive listing of the matters which may be dealt with in the unanimous shareholder agreement, see J. Bernstein, Tax Planning for Professionals and Executives, (Don Mills, Ontario: CCH Canadian Ltd., 1983) c.10.

⁵See generally, R.J. Hay & L.A. Smith, "The Unanimous Shareholder Agreement: A New Device For Shareholder Control" (1985) 10 Can. Bus. L.J. 440; J.S. Elder & S.H. Ash "Shareholder Rights, Obligations and Procedures" The New Ontario Business Corporations Act: Responding to the Proclamation, (Toronto: Insight Press, 1984).

⁶S.P.H. Robinson, "Shareholder Agreements: Control and Divorce Provisions" Critical Issues Inside Major Business Agreements, (Toronto: Insight Press, 1984).

the summary enforcement of the rights under the agreement.⁷ However, the buy-sell agreement does not have to be unanimous and it does not have to affect all of the corporation's shares before it can be regarded as an enforceable agreement.

The increasing amount of litigation dealing directly and indirectly with the buy-sell agreement would seem to suggest that this type of agreement is gaining popularity in the corporate world. However, this topic does not appear to have received much coverage in the literature on Canadian corporate law.⁸ Discussion of the buy-sell agreement has generally been confined to journal articles, conference materials, and comprehensive coverage of the tax aspects of the agreement in the tax literature.

This dissertation analyses the buy-sell agreement as an important device for organizing and managing the interests of the shareholders of a corporation. It provides a comprehensive and up to date review of both the legal and financial aspects of the buy-sell agreement and some useful insight into the many considerations involved in drafting such an agreement.

The subject of the buy-sell agreement can be regarded as very wide, with implications for several areas of the law.

⁷See further, infra, Chapters VI and VII.

⁸See for example, F.H. Buckley & M.Q. Connely, Corporations: Principles and Policies, 2d ed., (Toronto: Emond Montgomery Publications Ltd., 1988); E.E. Palmer & B. Welling Canadian Company Law: Cases, Notes and Materials, (Toronto: Butterworths, 1986).

The writer has found it necessary to operate within certain constraints in the interest of presenting a concise and functional dissertation. Whenever relevant, these limitations are noted and the reader is referred to material which covers the area more thoroughly.

As far as possible, Canadian authorities are used in support of the material presented. The Canada Business Corporations Act,⁹ the Ontario Business Corporations Act, 1982,¹⁰ and the Alberta Business Corporations Act¹¹ have been selected to provide examples of relevant statutory provisions. Whenever necessary, authorities from both the United Kingdom and the United States of America are noted.

The buy-sell agreement is discussed in the context of the close corporation, as this type of corporation presents the most suitable format for its operation.¹² This form of agreement is not as effective in the public corporation or even in the larger private corporation because the number of shareholders makes the agreement unwieldy. Additionally, in the case of the public corporation, shares are usually traded on a stock exchange and the need for the buy-sell agreement is

⁹S.C. 14-75-76, c.33, as amended by S.C. 1980-81-82-83 c.115.

¹⁰S.O. 1982, c.4.

¹¹S.A. 1981, c.B-15.

¹²Though the term "close corporation" is of American origin, it has become quite popular among Canadian commentators and shall therefore be used in this text. See further, infra, Chapter II, notes 7-21 and accompanying text.

reduced.¹³

The transactions in the buy-sell agreement are sometimes administered through the use of a holding corporation. In the interest of clarity, references to the holding corporation are minimized. To some extent, the issues discussed in the dissertation involving shareholders and the corporation are relevant to similar transactions involving holding corporations.¹⁴

To simplify the discussion, the buy-sell agreement is presented primarily in the context of the standard two shareholder situation where both parties are active in the business, and contract to dispose of their entire shareholding either voluntarily or on the occurrence of a particular event. However, it must be made clear that the buy-sell agreement between more than two shareholders can and does exist, and the parties can contract to dispose of any percentage of their shareholding at any given time. Also, all the shareholders

¹³Large public corporations, where management control is closely held but share capital is widely held, may present an exception to this rule. See further, E.F. Horsey, "Control and Restrictions on Ownership of Shares" Legal Problems Relating to Shareholders' Agreements (Vancouver: The Continuing Legal Education Society of British Columbia, 1982), 1 at 2.

¹⁴See generally, W.E. Crawford & P.O. Gratis, "Shareholder's Agreements - A Need for Greater Flexibility" (1983) 31 Can. Tax J. 257 at 258-262; J. Bernstein, Shareholder Agreements: A Tax and Legal Guide, (Don Mills, Ontario: CCH Canadian Ltd., 1988); R. Witterick, "Buy-Sell Agreements" Report of the Proceedings of the Fortieth Tax Conference, 1988 Conference Report, (Toronto: Canadian Tax Foundation) 16:1 at 16:18-16:20.

who are signatories to the agreement need not be actively involved in the business.

This dissertation is divided into six chapters exclusive of Chapters I and VIII which comprise the introduction and conclusion respectively. The areas selected for analysis present as detailed a treatment of the various aspects of the buy-sell agreement as is possible in a work of this nature.

Chapter II focuses on the buy-sell agreement itself. A working definition is provided and the importance of the buy-sell agreement in the close corporation is established. Various types of buy-sell provisions including the put-call provisions and the right of first refusal provisions are classified and examined. This discussion does not include pre-emptive (anti-dilution) rights.¹⁵ Chapter II also looks at possible events which may trigger the operation of the buy-sell agreement. These include transfers by operation of law, in particular, transfers resulting from bankruptcy or foreclosure. The issue of possible spousal claims under the Family Law Act¹⁶ resulting from marriage breakdown, is seen as being outside the scope of this dissertation and is therefore not discussed.¹⁷

¹⁵C.B.C.A. s.28(1); O.B.C.A. s.26; A.B.C.A. s.28(1); See also infra, Chapter II, note 97.

¹⁶R.S.O. 1986, c.4, as amended 1986, c.35.

¹⁷Since the introduction of the Family Law Act, the spouse of the shareholder has a potential interest in a business on the separation or on the death of a shareholder unless there is a domestic contract to the contrary. See

Chapter III deals with the valuation of shares under the buy-sell agreement. It begins by reviewing the debate on what constitutes fair value. Relevant valuation issues, including minority discounts and premiums for control are then considered. This dissertation also examines the procedures that can be employed for affecting share valuations and the most important methods of valuation.

Chapter IV discusses both inter vivos and testamentary methods of funding buy-sell agreements. Because life insurance is probably the most effective method of funding testamentary transfers under the buy-sell agreement, the various types of insurance plans available for this purpose are discussed. The most commonly used insurance arrangements and the alternatives for the uninsurable shareholder are also considered. Some methods of funding inter vivos transfers, including bank loans and mortgages are also examined. The merits of the purchase of shares by the shareholders themselves, as opposed to corporate share repurchase are then discussed. The question of funding is important as the buy-sell agreement could be inoperative if the funds needed to ensure its operation are not available.

generally, R. Hull, "The Effect of the New Family Law Act Upon Estates" (1986-87) Can. Fam. L.Q. 1; J. Marmer, "Computation of Net Family Property under the Family Law Act, 1986" (1986-87) Can. Fam. L.Q. 27; W.P. Abo & N.Y. Murrant, "Fair Market Value and Special Purchasers: A Problem Area In Matrimonial Valuations" (1983) 3 Can. Fam. L.Q. 23; E.L. Linkinski, "The Equalizer - The Family Law Act, 1985" Shareholders' Rights and Agreements, (Toronto: Insight Press, 1985).

Chapter V discusses some of the income tax considerations which are relevant to the buy-sell agreement. This aspect of the buy-sell agreement has already received extensive coverage in articles and conference materials by practitioners and tax officials. The treatment of this area is therefore confined to discussion of the impact of tax concepts such as control and association, on the determination of the income tax on the proceeds of the buy-sell agreement.

Some of the effects of income tax law on the valuation of shares under the buy-sell agreement and on the use of life insurance to fund the agreement are also examined. The income tax implications of shareholder purchase and corporate share repurchase are also considered. This treatment excludes discussion of more complex income tax issues, for example, anti-avoidance rules, interest deductibility and the capital dividend account. Illustrations of how the income tax should be calculated are not provided.^{2*}

This dissertation recognizes that the subjects of funding, valuation, and income tax considerations, are each complex enough to merit treatment as individual treatise. However, it is felt that this study would be incomplete without some consideration of these crucial areas.

Chapter VI examines the legality and effectiveness of the buy-sell agreement, while Chapter VII reviews the remedies

^{2*}See further *infra*, Chapter V, note 4 for a list of articles which discuss these issues in detail and also provide illustrations.

which are available for breach of the agreement.

This dissertation is accompanied by appendices containing a selection of buy-sell agreements with clauses for insurance funding and valuation. Additional or alternative buy-sell clauses including shotgun, right of first refusal, piggy-back and right to purchase clauses are also included in the appendices. The aim of the appendices is to provide some practical examples of the matters presented.

CHAPTER II

THE BUY-SELL AGREEMENT

1. DEFINITION

A well constructed buy-sell agreement can serve as an effective tool for managing and enforcing the share transfer restrictions in a close corporation. Such an agreement would include provisions covering the funding of the agreement and the valuation of the shares subject to the agreement. Provisions for the enforcement of the agreement, and remedies for its breach can also be included.²

Defining the buy-sell agreement is not a simple task. Because of the fragmented nature of previous treatment of this subject, definitions of its scope have tended to vary depending on the focus of the particular presentation.² This dissertation seeks to avoid the limited but prevalent definition of a buy-sell agreement as an agreement operating only on the death of a shareholder,³ in favour of a wider

²Re A & B.C. Chewino Gum, [1975] 1 W.L.R. 579.

²See for example, S.P.H. Robinson, "Shareholder Agreements: Control and Divorce Provisions" Critical Issues Inside Major Business Agreements, (Toronto: Insight Press, 1984) at 30-31; and R.J. Hay & L.A. Smith, "The Unanimous Shareholder's Agreement: A New Device In Shareholder Control" (1985), 10 Can. Bus. L.J. 440, where buy-sell agreements are seen as inter se transactions between the shareholders of a corporation.

³F.H. Buckley & M.Q. Connely, Corporations: Principles and Policies, 2d ed. (Toronto: Emond Montgomery Publications Ltd., 1988); D.S.M. Huberman, "Buy and Sell Agreements for the Canadian Close Corporation" (1963) 41 Can. B. Rev. 538; J. Bernstein, "Life Insured Buy-Sell Arrangements" Report of the Proceedings of the Thirty-Sixth Tax Conference, 1984

definition which includes inter vivos transactions.⁴

The buy-sell agreement consists of three elements: (a) a prohibition on the transfer of shares except in accordance with the terms of the agreement; (b) provisions describing circumstances in which a shareholder must sell his or her shares (eg. death or termination of employment) and providing the procedures for such a sale including valuation; and (c) provisions prescribing one or more mechanisms by which shareholders may sell their shares (eg. shotgun or the right of first refusal).

The term "buy-sell agreement" can therefore be defined as any agreement among the shareholders of a close corporation, that governs the circumstances in which transfers of the corporation's shares, by way of sale or purchase, and the mechanisms for such transfers are controlled.

2. THE CLOSE CORPORATION

The peculiar characteristics of the close corporation⁵ present the ideal environment for the effective

Conference Report, (Toronto: Canadian Tax Foundation, 1985) 957 at 957-958.

⁴J.F. Kennedy, "Shareholders' Agreements" in Special Lectures of the Law Society of Upper Canada, Recent Developments in Taxation and Estate Planning and Administration, (Toronto: Richard De Boo Publishers, 1980) 317 at 321.

⁵The terms "closed corporation", "close corporation", and "closely-held corporation", seem to be used interchangeably by different writers, apparently to mean the same thing. At least one writer however sees a clear distinction between each

BUY-SELL AGREEMENT

operation of buy-sell agreements. The nature of this type of corporation is aptly described by Coates in his article where he states that,

"A close corporation is more easily described than defined but essentially it is a private company with two to four shareholders with one or more of the characteristics to be discussed below. Generally all or most of the shareholders work in the business and this integration of ownership and management is essentially what distinguishes the close corporation from other private and public companies. Outside management is rarely used. The affairs of the business are in all likelihood conducted in the same manner as they were before the business was incorporated, that is, without much attention being paid to the proportionate shareholdings of the participants. Often the corporation will provide the sole source of income to the individual shareholders and the capital stock and the shareholder's loans will constitute the bulk of his personal estate. The close corporation must thus be planned and set up very carefully to protect the livelihood and estate of each of the owners."⁶

The close corporation is usually formed to carry on a particular business activity or the business of an individual or a family. This type of corporation has also been referred to as an "incorporated partnership", and to this extent, the relationship is based on trust, loyalty and confidence.⁷

of these terms. See further, F.H. O'Neal & R.B. Thompson, O'Neal's Close Corporations, 3d ed. (Illinois: Callaghan's Company, 1987) c.1.04.

⁶D.P. Coates, "Share Transfer and Transmission Restrictions in the Close Corporation" (1958) 3 U.B.C.L. Rev. 96.

⁷Re. Smith Fawcette Ltd., [1942] Ch. 304 at 306 (C.A.), per Lord Greene M.R.; See generally, G.D. Hornstein, "Judicial Tolerance of the Incorporated Partnership" (1953) 18 Law and Contemporary Problems 435; F. Iacobucci & D.L. Johnston, "The Private or Closely-Held Corporation" in J.S. Zeigel, ed., Studies In Canadian Company Law, (Toronto: Butterworths, 1973) 68 at 72-91.

The close corporation falls under the wider heading of private corporation as formerly provided for in many of the Canadian corporation statutes.⁹ The private corporation is characterized by three features: i) restrictions on the number of shareholders (usually fifty or less, excluding present and former employees)⁹; ii) restrictions on the method of share transfer; and iii) prohibition on invitations to the public to subscribe for the corporation's shares.¹⁰

The distinction between public and private corporations, as formerly provided for under some of the provincial Companies Acts, has been superseded in most of the Canadian business corporations statutes by a more functional approach which utilises terms such as "distribution to the public"¹¹, and "offering corporation".¹²

⁹D. Huberman, supra, note 3 at 539.

⁹See for example, Ontario Securities Act R.S.O. 1980, c.466.

¹⁰H. Sutherland, D.B. Horsey & J.M. Edmiston, Fraser's Handbook On Canadian Company Law, 7th ed. (Toronto: Carswell, 1985) c.3 at 31; See also, R.A. Kingston, Ontario Corporations Manual, (Toronto: Richard De Boo Publishers, 1986) at 6503-6507; H.H. Strikeman & F.P. Elliot, Doing Business In Canada, Vol. 2, (New York: Matthew Bender and Co. Inc., 1988) para.15.04[1].

¹¹See for example, Business Corporations Act, S.A. 1981, c.B-15, (hereafter called the A.B.C.A.), s.1(i), s.3.

¹²These terms are based on the relative requirements of protection of the rights of the minority shareholders of a public corporation and their access to information, as opposed to the requirements of the shareholders of a closely-held corporation. For example, in the case of the public corporation, non-executive directors and mandatory solicitation of proxies. See further, H. Strikeman, supra,

The private corporation is however still provided for in most of the provincial securities statutes.¹³ Many corporations which are intended to be private include the three restrictions noted above in their articles of incorporation to ensure that the corporation qualifies for this status under provincial securities laws. Shares may then be transferred without regard to the registration and prospectus requirements.¹⁴

In most cases where shareholders desire the benefits of incorporation but wish to restrict share transfer, the private corporation is the most suitable form of business.

The position of the shareholders in such a corporation differs greatly from that of their counterparts in a public corporation or even in a partnership. The shareholders in a public corporation can easily and quickly realize their investment through sale on a stock exchange,¹⁵ while partners may have a right to withdraw and cause the dissolution of the

note 10 at para.15.04 (2)-(3); Business Corporations Act (Ontario), 1982, S.O. 1982, c.4, (hereafter called the O.B.C.A.), para.1(1)(27).

¹³For some discussion and the citations of the relevant Canadian statutes, both federal and provincial, which provide for private companies, see H. Sutherland, Fraser's Handbook, supra, note 10 at c.3.

¹⁴H. Strikeman, supra, note 10 at para.15.04(1).

¹⁵R. Elfin, "Suggested Revisions of the Law Pertaining to the Dissolution of Partnerships and Close Corporations" (1987) 25 Am. Bus. L.J. 110.

partnership.¹⁶

These options are often not available to the shareholders of a close corporation because a motion for the dissolution of a corporation is usually governed by statute and often requires a majority vote.¹⁷ Additionally, it has often been found that apart from the remaining shareholders of the corporation, few persons are interested in investing in close corporations, especially if they are not gaining a controlling interest.¹⁸

Given these circumstances, the prudent shareholder would prefer to balance the desire to restrict share transfer with the need to ensure a market for his or her shares, if and when the need for such a market arises. The buy-sell agreement is one way of striking this balance.

¹⁶D.A. Ward, "The Appraisal Remedy" in J.C. McDonald, S. Cole & R.M. Wise, eds., Valuing Shares in a Private Company, (Toronto: Dept. of Continuing Education, The Law Society of Upper Canada, 1986) at F-15; E.F. Horsey, "Control and Restrictions on Ownership of Shares" Legal Problems Relating to Shareholder's Agreements (Vancouver: The Continuing Legal Education Society of British Columbia, 1982) 1 at 2; R. Elfin, supra, note 15 at 111; These provision can be, and typically are varied by the partnership agreement.

¹⁷Canada Business Corporations Act, S.C. 1974-75-76, c.33, (hereafter called the C.B.C.A.) Part XVIII, ss.207-228; O.B.C.A. Part XVI, ss.92-235; A.B.C.A Part 17, ss.200-221; Re Bondi Better Bananas [1951] O.R. 845, [1951] 3 D.L.R. 522, (H.C.J.).

¹⁸Leitch Transport Ltd. v. Neonex International Ltd. (1989), 8 B.L.R. 257 at 299 (Ont. C.A.); M.C. Cullity, R.E. Forbes & C. Brown, Taxation and Estate Planning, (Toronto: Carswell, 1984) at 620; G.J. Vesley, "Some Inter Vivos Aspects of Buy-Sell Agreements" Report of the Proceedings of the Thirty-Sixth Tax Conference (Toronto: Canadian Tax Foundation, 1984) 925 at 926.

3. THE NEED FOR A BUY-SELL AGREEMENT

First and foremost the existence of a buy-sell agreement ensures that shareholders pay or receive a fair price for their interests in the event of any acquisition or disposition of shares.¹⁹

In most cases, all of the shareholders of the corporation work in the business and wish to preserve for themselves the right to select their future associates and to avoid being forced into accepting an unsuitable replacement for a deceased or departing shareholder. They want persons who they find compatible and trustworthy, and who can contribute in some way to the normal running of the business.²⁰ This does not necessarily include heirs of a deceased shareholder, as they may prove to be not as competent as their predecessor.²¹

The shareholders of a close corporation also wish to guard against the possibility of any portion of the corporation's shares passing into the hands of either their competitors, or persons who are not sympathetic to the corporation. Such competitors sometimes seek to purchase shares of a rival corporation in order to obtain access to the corporation's records and trade secrets and also to acquire the voting

¹⁹I.R. Campbell, "Business Valuation Aspects of Shareholder's Agreements" Shareholders Agreements and Disagreements, (Toronto: Canadian Bar Association - Ontario Continuing Legal Education, 1986) at 1.

²⁰E. Horsey, supra, note 16 at 2.

²¹See further, D. Huberman, supra, note 3 at 542; Re Harvey's Stores Ltd. and Harvey (1979), 6 B.L.R. 223 (B.C.C.A.).

rights attached to such shares.²²

The desire to maintain the original power balance which the shareholders themselves set by mutual consent may be another reason for implementing a buy-sell agreement. The existence of such an agreement would prevent any one shareholder from gaining absolute control by unilaterally purchasing the shares of a departing shareholder.²³

The buy-sell agreement should make it difficult for a valued shareholder, who plays an important role in the success of the corporation to abruptly withdraw his services. Given the peculiar characteristics of the close corporation, finding a purchaser with similar talents who is interested in working in the corporation and who can also harmonize with the existing shareholders may not be easy. However, the active shareholder should also have a right to leave the corporation, once adequate notice is given.²⁴ The shareholders' interest in the liquidity of their shareholding should therefore be balanced against their interest in the stability of the corporation.

A majority shareholder may want to retain the option to

²²Ontario Jockey Club v. McBride, [1927] A.C. 917 (P.C.); E. Horsey, supra, note 16 at 2.

²³E. Horsey, ibid., at 2.

²⁴A purchaser interested only in investment is undesirable in close corporations, where profits are usually paid out in salaries, and providing dividends for someone who is not contributing any services may be awkward. Re Daniels and Fielder (1988), 65 O.R. (2d) 629 (H.C.J.).

take control of the corporation by compelling the other shareholders to sell their interest. Shareholders may also want to be in a position to convert their interest on short notice, by selling the shares to the corporation, the remaining shareholders or an outside third party. Alternatively, the corporation and the other shareholders may wish to force the departure of a shareholder who is no longer willing or able to work in the business or who breaches the agreement.²⁵

In the cases of death, incapacity, dismissal or retirement, the agreement may require that the remaining shareholders purchase the shares of the deceased or departing shareholder. This is particularly important in the case of the close corporation where the interest in the corporation is often the most substantial asset that the shareholder possesses. Given the fact that there is usually no ready market for these shares, the buy-sell agreement should provide the means by which the departing shareholder or the estate of a deceased shareholder could realize their investment on relatively short notice. Funding mechanisms have to be carefully arranged if the shareholders are to be able to meet their obligations at the required time.²⁶

²⁵D.R. Brown, "Shareholder Agreements and The Alberta Business Corporations Act" in Alberta Bar Admission Course Material, Corporations, (Edmonton: Legal Education Society Of Alberta, 1981) 147; D.C. Ross, "Shareholder's Agreements" in Law Society of Upper Canada, Bar Admission Course Material, Business Law 1986/87, (Toronto: Carswell, 1986) 206.

²⁶See further infra, Chapter IV.

The buy-sell agreement may also serve as a means of solving disputes among the shareholders.²⁷ The put-call provision is very useful in these cases. This type of provision is usually a mutual agreement between the shareholders which gives each of them the right to initiate the sale of the shares governed by the agreement.²⁸ Because the put-call provision generally forces one shareholder to dispose of his shares in favour of another, it can be a very effective dispute-solving mechanism, especially if there is the possibility of a deadlock between the parties.

The employment of the buy-sell agreement for the settlement of disputes is usually regarded as a last resort and means, in effect, that the dispute has not been settled and the parties no longer wish to work together in the corporation.²⁹ However, this recourse is preferred to an application to the courts for a dissolution or winding up order as permitted under the various business corporations statutes.³⁰ In some cases the mere threat of dissolution is

²⁷P. Finn, "Shareholder Agreements" (1978) *Aus. Bus. L.J.* 97 at 97.

²⁸See further infra, Chapter II, notes 68-93 and accompanying text.

²⁹D. Ross, supra, note 25 at 211.

³⁰See for example, C.B.C.A. ss.207-228; O.B.C.A. ss.190-243; A.B.C.A. ss.200-221. This remedy may not be available to the minority shareholder of the close corporation, as the appropriate resolution may require the approval of at least 50% of all the shareholders at the meeting, see for example, O.B.C.A., s.236; however, relief may be available under the oppression remedy: See further infra, Chapter VII notes 56-76

enough to encourage the parties to settle their differences.²¹

Some of the share transfer restrictions imposed by the buy-sell agreement²² may also ensure compliance with the provisions of the relevant provincial Securities Act.²³ These Acts usually mandate such restrictions if the corporation is to remain a private corporation for the purposes of the Act.²⁴

The similarity of a close corporation to a partnership also encourages shareholders to impose share transfer restrictions in an attempt to maintain the advantages of operating their corporation as a partnership, while enjoying the benefits afforded by incorporation.²⁵

and accompanying text.

²¹R. Elfin, supra, note 15 at 93-122; P.R. Lockyer, "Shareholders' Agreements: Dispute Avoidance and Resolution (Or An Ounce of Prevention is Worth a Pound of Cure!)" Shareholders' Agreements and Disagreements (Toronto: Canadian Bar Association - Ontario Continuing Legal Education, 1986) at 9.

²²See infra, Chapter II, notes 9-10 and accompanying text.

²³See for example, Securities Act R.S.O. 1980, c.466 as amended; Elsey's Frosted Foods Ltd. v. Mid White Oak Square Ltd. (1976), 1 B.L.R. 114 (Ont. H.C.J.).

²⁴See further, H. Sutherland, Fraser's Handbook, supra, note 10 at c.3, for relevant citations.

²⁵W.H. Painter, "Stock Transfer Restrictions: Continuing Uncertainties And A Legislative Proposal" (1960) 6 Vill. L.Rev. 48. The advantages of incorporation over a partnership include the enjoyment of limited liability by the shareholders of the corporation, Salomon v. Salomon & Co., [1897] A.C. 22, 13 T.L.R. 46 (H.L.); as opposed to the personal liability, even after the death of a partner, Partnership Act, R.S.O.

In addition to the many reasons mentioned above, the very existence of a buy-sell agreement may promote the peace of mind and goodwill among shareholders, employees, and creditors which comes from knowing that their jobs and their investment are protected. This would go towards promoting and ensuring the stability and prosperity of the business.³⁶

4. SOME ISSUES FOR CONSIDERATION

When a buy-sell agreement is being drafted, there are several important issues which can ultimately determine its validity and effectiveness.

A primary consideration is that these agreements are usually drawn when the relationship between the parties is most cordial.³⁷ It is therefore up to the drafters to take advantage of the climate of congeniality and cooperation to settle all matters which may be contentious at a later date.³⁸

1980, c.370, ss.10-11.

³⁶D. Huberman, supra, note 3 at 544; P. Finn, supra, note 27 at 104; R. Witterick, "Buy-Sell Agreements" Report of the Proceedings of the Fortieth Tax Conference, 1988 Conference Report, (Toronto: Canadian Tax Foundation) 16:1 at 15:3.

³⁷"The initial capitalization of the company will take place in "honeymoon" period when disagreements will not generally threaten established interests. At this stage, serious problems can be resolved by a simple decision not to proceed with the proposed venture" - R. Hay, supra, note 10 at 452.

³⁸R.B. Blainey, "Shareholder Agreements - Valuation Considerations" Shareholder Rights and Agreements, (Toronto: Insight Press, 1985) at 1.

It is also advised that the buy-sell agreement be executed at the time of incorporation and before the parties have an opportunity to establish their own niche in the corporation which they may be unwilling to relinquish at a later date.³⁹

The effectiveness of the buy-sell agreement often decreases as the number of shareholders increases. This is mainly because many of the provisions contained in the agreement, for example, the put-call options which include offers and counter offers, become more difficult to organise when several parties are involved.⁴⁰

Careful attention should also be paid to the time limit provisions of the agreement. These may be extremely important to the success of the buy-sell agreement, particularly the put-call and first option provisions. Time limits usually range from six to ninety days but the parties may increase or decrease the number of days as the situation warrants.⁴¹ Excessive time limits may however be held invalid.⁴² Where the shareholder dies, the executor is not bound by the time limit stipulated in the agreement, within which the deceased

³⁹P. Finn, supra, note 27 at 104.

⁴⁰This problem can sometimes be countered by grouping two or more shareholders, with similar interests, as a group, and treating them as one shareholder. See further, D. Brown, supra, note 25 at 162.

⁴¹Trimac Ltd. v. C-I-L, Inc., (1987), 52 Alta. L.R. (2d) 263 (Q.B.); aff'd 52 Alta. L.R. 97 (C.A.); Boxer v. Norvan Properties Ltd. (1988), 25 B.C.L.R. (2d) 231 (C.A.).

⁴²Ontario Jockey Club v. McBride, supra, note 22.

shareholder's interest must be transferred. The executor may therefore select, within limits, a time period which he or she considers to be the most appropriate for obtaining the "fair value" of the shares.⁴³

It is important that the buy-sell agreement binds all new shareholders.⁴⁴ Where the buy-sell agreement is contained in a unanimous shareholder agreement, it is protected by statute which provides that the unanimous shareholder agreement binds all transferees except the bona fide purchaser for value without notice.⁴⁵ As an added precaution, the agreement should still provide that it be binding on all transferees. This would ensure that shareholders have notice of the restrictions as shareholders cannot usually be relied on to be aware of incoming corporate legislation. Restrictions should also be referred to on the share certificates. Such a safeguard is even more important where the buy-sell agreement exists as a separate agreement and is not unanimous.

Where one or more of the shareholders are employed in the business the buy-sell agreement should also include a restrictive covenant. This would prevent a departing shareholder from divulging important commercial information about the corporation to outsiders, or from using such

⁴³Roberts v. Letter "T" Estates Ltd., [1961] 3 W.L.R. 176 (P.C.).

⁴⁴D.R. Brown, supra, note 25 at 164-165.

⁴⁵See for example, C.B.C.A. s.146; O.B.C.A. s.108; A.B.C.A. s.140.

information to make a profit to the detriment of the corporation.⁴⁶

The agreement should also provide the definitions of the terms used in the agreement. This, along with careful drafting, may help to mitigate against some of the misunderstandings among the parties which are likely to arise otherwise.⁴⁷

The factors noted above are some of the important reasons why no one standard buy-sell agreement can work for every situation. The buy-sell agreements should be tailor-made to suit the individual needs of the particular corporation and group of shareholders.

5. TYPES OF BUY-SELL PROVISIONS

The main requirement of the buy-sell agreement is that it provide for the controlled disposition of the shareholders' interests. There is no standard form of buy-sell agreement with which parties are forced to comply when they are adopting possible provisions. Each case presents a different set of facts and circumstances which have to be considered when

⁴⁶J.L.R. Holdings Ltd. v. Wiseburg (1977), 2 B.L.R. 250 (Ont. H.C.); Argo v. Marini (7 July, 1989) Ontario 38419/89 (H.C.).

⁴⁷R.M. Wise, "Valuation Aspects of the Shareholder's Buy-Sell Agreement" Report of Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report, (Toronto: Canadian Tax Foundation, 1985) 1013.

drafting.⁴⁸ Accordingly, the scope of the agreement and the mechanics for its operation are limited only by the imagination of the parties to the agreement and that of their advisors.⁴⁹

For these reasons, it would not be feasible to attempt an exhaustive consideration of the various types of buy-sell provisions which parties can include in their agreement. This dissertation will therefore concentrate on discussing the more standard buy-sell provisions. Wherever necessary, these may be modified to reflect the facts of the particular case.

This section begins with a review of the various types of buy-sell provisions which are available.⁵⁰ The different events which may trigger the operation of the buy-sell agreement are considered in the following section.

The different types of buy-sell provisions include:

- a) absolute restrictions and compulsory purchase provisions;
- b) consent provisions;

⁴⁸For example, the number of shareholders, the proportion in which the shares are owned, and the availability of outside third parties who may be potential buyers.

⁴⁹D. Brown, supra, note 25 at 157; D. Coates, supra, note 6 at 96; O'Neal, supra, note 5 at c.7.02.

⁵⁰There are several other types of transfer restrictions which may be included in a buy-sell agreement, but which are not exclusive to the close corporation and hence are outside the scope of this discussion; e.g., restrictions imposed on the transferability of shares to ensure the launching of the corporation on a sound financial basis. See further, O'Neal, supra, note 5 at c.7.05, note 12.

- c) put-call provisions;
- d) first refusal provisions;
- e) the piggy-back; and
- d) combination buy-sell provisions.

A. ABSOLUTE RESTRICTIONS AND COMPULSORY PURCHASE PROVISIONS

Absolute restriction provisions forbid the transfer of shares under any circumstances. Though this type of restriction may be desirable where shareholders wish to retain the expertise or skills of their fellow shareholders, they have been held invalid by the courts.⁵² Absolute restrictions relating to the price of shares have also been held to be invalid.⁵³ Where the absolute restriction is limited in time, its validity may be upheld if the time limit is thought to be reasonable and necessary in the circumstances.⁵⁴

Many of the restrictions which have been upheld were really consent provisions⁵⁴ which were accepted on the ground that the parties to the provisions could join and give

⁵²Shares are prima facie transferable, Ontario Jockey Club v McBride, *supra*, note 22; Associates Finance Co. Ltd. v. Webber & Dixon, [1972] 4 W.W.R. 130 (B.C.S.C.).

⁵³Re. Ogilvy (1966), 58 D.L.R. (2d); [1966] 1 O.R. 755 (H.C.J.).

⁵⁴G. Hornstein, *supra*, note 7 at 447. See also, O'Neal, *supra*, note 5 at c.7.05, note 12, where it is suggested that restrictions limited in time which are imposed to ensure the launching of the corporation on a sound financial basis are valid.

⁵⁴See *infra*, Chapter II, notes 58 - 67 and accompanying text.

consent to the transfer.⁸⁵ In fact, in all cases where the absolute restrictions could be removed by unanimous consent, they could be characterized as consent restrictions and were accordingly upheld.⁸⁶

In addition to restrictions on transfer, the agreement may also compel parties to purchase the shares of another shareholder under certain circumstances. These can be classified as compulsory purchase provisions. In many shareholder agreements, this type of provision operates in the event of the death of a shareholder, whereupon the remaining shareholders are required to purchase the shares of the deceased shareholder.

The possibility of being able to use life insurance to finance this type of purchase makes the compulsory purchase provision less onerous than the absolute restriction on share

⁸⁵But see, Hill v. Warner Berman and Spitz, P.A., 197 NJ Super 152, 484 A2d 344 (1984), (as cited in O'Neal, supra, note 5 at c.7.06, note 2), the courts here held that a consent restriction, which had no limit as to time, did not provide that consent would not be unreasonably withheld, and did not promote the corporation's welfare, was an absolute restriction and thus invalid.

⁸⁶O'Neal, supra, note 5 at c.7.06, note 2; Coates, supra, note 6 at 101, also submits that such a restriction can always be ensured indirectly by stipulating in the agreement that a certain amount of the shareholder's assets be available to the corporation for a specified period of time. The shareholder would thus be reluctant to sell his shares and leave his original investment tied up in the corporation after he is no longer a member.

transfer. Accordingly, it may be upheld by the courts.¹⁷

B. CONSENT PROVISIONS

Consent restrictions usually stipulate that no transfer of shares is valid unless it has been approved by the directors, the shareholders, or both, or a certain percentage of both or either.¹⁸ The directors authority to refuse the transfer must be clearly stated in the agreement before it is recognized by the courts as a valid restriction.¹⁹ The directors must consider the best interests of the corporation as a whole and not the interest of themselves as directors, when acting on these restrictions.²⁰ There is a presumption that directors voting on share transfers, act honestly and in good faith.²¹

Where a discretion is granted to the directors to refuse their consent to a proposed share transfer they are not bound

¹⁷Hornby v. Nugent (23 June, 1988) Vancouver CL2:017 (B.C.S.C.), where a compulsory buy-out clause in a shareholder's agreement which entitled the shareholder to be bought out by the other shareholders was held to be enforceable; M. Cullity, supra, note 18; R. Witterick, supra, note 36.

¹⁸Coates, supra, note 16 at 102.

¹⁹Mathers v. Mathers (1989), 89 N.S.R. (2d) 358 (N.S.T.D.); aff'd (1989), 90 N.S.R. (2d) 354 (N.S.S.C.).

²⁰E. Horsey, supra, note 16 at 6; Re Smith & Fawcette Ltd., supra, note 7.

²¹Re Bondi Better Bananas, supra, note 17; Re Smith & Fawcette Ltd., ibid.; Re Phillips & La Paloma Sweets Ltd., [1921] O.R. 125; 66 D.L.R. 577 (S.C.).

to state the reasons for their refusal.²² However, such refusal may be overlooked by the courts in the interest of providing a remedy to creditors.²³ Where questions are raised about the conduct of the directors, the onus of proving any impropriety is on the party alleging the breach.²⁴

The consent provision may be in the form of a right of first refusal provision which requires that the selling party first offer to sell his or her shares to the remaining shareholders.²⁵ In such cases, the other shareholders need not give reasons for refusing to purchase these shares even where the provisions of the agreement prevent the selling shareholder from disposing of the shares outside of the corporation.²⁶ However, the court has held that "the parties must act honestly and in the best interest of the corporation, but in so doing, they are not expected to disregard their own

²²Re Phillips & Paloma Sweets Ltd., ibid.; But see, Associates Finance Co. Ltd. v. Webber & Dixon, supra, note 51.

²³Associates Finance Co. Ltd., ibid.; See further infra, Chapter II notes 146-148 and accompanying text.

²⁴Associates Finance Co. Ltd., ibid.; Edmonton Country Club v. Case, [1975] S.C.R. 534 (S.C.C.). But see Re Shoal Harbour Marine Service Ltd., [1956] 20 W.W.R. 312 (B.C.S.C.), where the court found mala fides in the directors decision to withhold consent to a share transfer. See further, D.W. Fox, "Problems of Transferring Shares in Private Companies", (1978) 130 Sol. J. 718.

²⁵See further infra, Chapter II 94-108 notes and accompanying text.

²⁶D. Coates, supra, note 6 at 210.

individual interests".⁷

C. PUT-CALL PROVISIONS

The term "put-call" can be used in two contexts. In the first context the term is divided into two parts: an option to sell (a "put"), and an option to purchase (a "call"). These two parts can stand individually, and when used in this sense, are most useful for dealing with the interest of a minority shareholder in a public corporation.⁸

In its second context, the term "put-call" refers to a mutual agreement between the shareholders.

I. "PUT"

A shareholder whose shares are the subject of a put has the option of selling the shares to the corporation or to a

⁷Greenlaugh v. Arderne Cinemas Ltd., [1951] 1 Ch. 286 (C.A.); But see, Zeigel, J., et al, Cases and Materials on Partnerships and Canadian Business Corporations, 2d ed., (Carswell, 1989) at 687.

⁸The terms "put" and "call" as used here, are to be distinguished from the statutory "put" ("an option transferable by delivery to deliver a specified number of securities within a specified time") or "call" ("an option transferable by delivery to demand delivery of a number of securities at a fixed price within a specified time, but does not include an option or a right to acquire securities of the corporation that granted the option or right to acquire"), defined in C.B.C.A. subsection 2(1)). These terms do not apply to the provinces of Ontario, (O.B.C.A. subsection 23(3)), and British Columbia (B.C.C.A. s. 56), where only fully-paid shares may be issued unless such shares were issued prior to the present day legislation coming into force; See generally, H. Sutherland, Fraser's Handbook, *supra*, note 10 at c.10 at 136-138.

BUY-SELL AGREEMENT

31

majority shareholder under specific circumstances. For example, if the corporation does not meet specified financial targets, a majority shareholder would be granted the right to purchase the shares. Where the corporation is the other party to a put granted a minority shareholder, the put provision may include a put to the majority shareholders as a back-up. This would ensure marketability⁶⁹ in the event that the corporation cannot fulfill its obligation to purchase the shares at the required time under the various business corporations statutes.⁷⁰

II. "CALL"

A call provision, on the other hand, may give the corporation or the remaining shareholders the right to demand that a minority shareholder sell his shares to the corporation or the remaining shareholders under specific circumstances. An example would be where an employee shareholder leaves the corporation to work for a competitor. The corporation would like to be able to prevent such a shareholder from having access to its records and financial information, rights he or she would continue to enjoy as long as they remain a shareholder of the corporation.⁷¹

⁶⁹S. Robinson, supra, note 2 at 31-34.

⁷⁰See for example, C.B.C.A. subsections 34(1) and (2); O.B.C.A. subsections 30(1) and (2); A.B.C.A. subsections 32(1) and (2), which prevent an insolvent corporation from repurchasing its shares.

⁷¹S. Robinson, supra, note 2 at 33.

III. THE "PUT-CALL" PROVISIONS

The put-call provision is usually a mutual agreement between the shareholders which gives each shareholder the right to force either a sale or purchase of their interest in favour of another shareholder. This type of provision is an effective means of solving disputes among the shareholders.

The most common put-call provisions found in shareholder's agreements are:

- (a) the "shotgun" or "russian roulette" provision;⁷²
- and
- (b) the restricted auction.

(A) THE SHOTGUN

In the case of the shotgun, a shareholder (the offeror), offers to sell his or her interest to another shareholder (the offeree), at a specified price and within a specified time. The offeree must then either buy the interest of the offeror at the price specified in the offer or sell his or her interest to the offeror at the same price.⁷³ The fact that the offeree can force the offeror to purchase the interest at the price that the offeror has set is thought to be the

⁷²S. Robinson, *ibid.* at 39, provides a rather colorful description of this type of provision, "The concept behind this provision is brilliant in its simplicity - the corporate variation on the child's stratagem of allowing another to cut the cake provided that he can have his choice of pieces."

⁷³D. Brown, *supra*, note 25 at 160; Trimac Ltd. v. C-I-L, Inc., *supra*, note 40.

guarantee that the offeror will set a fair price in the first instance.⁷⁴

The shotgun usually operates more efficiently where there are only two shareholders with equal shareholdings. It becomes more complex as the number of shareholders increases because the timing of the offers and counter offers and the pricing of the shares may be difficult to organise and determine.⁷⁵ This type of provision is not advisable where the shareholders' interests are not at least roughly equivalent as unequal bargaining power usually puts at least one party at a disadvantage.⁷⁶

The shotgun favours the shareholder who has ready cash to finance the deal, unless a lengthy time limit is built into the agreement which allows the other shareholder enough time to raise the necessary funds.⁷⁷ Where one party's financial resources are limited, the parties could include some

⁷⁴The shotgun provision is sometimes referred to as a "solomon" provision - W. Grover, "Shareholder Agreements" How To Structure Major Business Agreements, (Toronto: Insight Press, 1983) at 7.

⁷⁵M. Cullity, supra, note 18 at 136-137; S. Robinson, supra, note 2 at 39-49; D. Brown, supra, note 25 at 159-161.

⁷⁶D. Brown, supra, note 25 at 161; M.P. Mooney & L.A. Wright, "Buy-Sell Clauses" Shareholders Agreements And Disagreements, (Toronto: The Canadian Bar Association-Ontario Continuing Legal Education, 1986) at 31; R. Witterick, supra, note 36 at 16:38.

⁷⁷M. Mooney, supra, note 76 at 31; A.B. Nixon, "Shareholder's Agreements", in Special Lectures of the Law Society of Upper Canada, Developments in Company Law, (Toronto: Richard De Boo Publishers, 1968) 15 at 46-47.

provision for lengthening the acceptance period to permit the shareholder to secure suitable financial backing.⁷⁸

The shotgun may present substantial risks for all the parties involved. For example, a shareholder who has the necessary funds, and who is aware that another shareholder is in financial difficulty, may be able to use this device to force a colleague out of the corporation by deliberately making an offer which the other shareholder is financially incapable of matching. Also, being aware that the offeree is not in a position to buy the interest, the offeror may offer to sell his or her shares at a value lower than their actual worth, thereby forcing the offeree to sell at an undervalue.⁷⁹

On the other hand, a shareholder who is not a key employee and who is privy to information of which the other shareholder is unaware, may be quite willing to allow himself to be bought out of a corporation which may be about to go under.

The shotgun may work against an offeror who is in need of the revenue that could be generated by the sale of his or her interest, but who may nonetheless be reluctant to initiate such an offer for fear that they may be forced to buy instead of being allowed to sell.⁸⁰ In order to ensure that there is a sale, the offeror may be tempted to offer to sell the shares

⁷⁸M. Mooney, ibid., at 31.

⁷⁹R. Hay, supra, note 2 at 456; R. Witterick, supra, note 36 at 16:38.

⁸⁰D. Brown, supra, note 25 at 160.

for less than their actual worth.

The parties can address the problem of undervaluation by including in their agreement, provision for the valuation of shares by an auditor.⁸¹ The inclusion of such a provision may however prejudice shareholders who are only concerned with realizing their interest and cannot afford to have their offer refused. The parties may also include a base price in the agreement as a guide for future transactions.⁸²

The shotgun is also not suitable for a shareholder who is not active in the business, whether or not he or she has controlling interest. If the clause is exercised, the inactive shareholder may not be in a position to buy the shares and operate the business and the business may not be as valuable without the active shareholder to run it.⁸³

The main advantage of the shotgun is its usefulness as a dispute solving mechanism, if only because it encourages shareholders who are in disagreement to settle their differences rather than resort to the risky remedy of triggering the shotgun.⁸⁴ Where shareholders are in disagreement and are deadlocked, the shotgun can be triggered to force at least one shareholder to dispose of his or her

⁸¹See further infra, Chapter III notes 26-32 and accompanying text.

⁸²M. Mooney, supra, note 70 at 31.

⁸³M. Mooney, ibid.

⁸⁴S. Robinson, supra, note 2 at 40; D. Ross, supra, note 25 at 208; W. Grover, supra, note 74 at 7.

shares in favour of another shareholder in order to settle the deadlock.

The shotgun ensures the liquidity of each shareholder's interest, while allowing for transfers among shareholders only. It also establishes the means of determining the purchase price for the shares and allows shareholders to exclude the intervention of third parties into the transaction. ⁶⁶

Though the shotgun provision is very popular, in the sense that it is often provided for in shareholder agreements, it is rarely used.⁶⁶ This may be because the shotgun is always a gamble based on one shareholder's speculation about another shareholder's finances and possible reactions. For this reason, the shotgun should be more popular with the sophisticated business person who usually has the means to finance the purchase.⁶⁷ In such a case, the shareholders' main concern would be deciding on the right moment to initiate an offer, or whether or not to allow the other party to trigger the agreement.

The facts of the recent case of Trimac Ltd. v. C-I-L

⁶⁶M. Mooney, SUPRA, note 76 at 31; R. Witterick, SUPRA, note 36 at 16:38.

⁶⁷S. Robinson, SUPRA, note 2 at 40; W. Grover, SUPRA, note 74 at 7.

⁶⁸D. Brown, SUPRA, note 25 at 160.

Inc.,** provide a useful illustration of the operation and effectiveness of the shotgun provision. It also gives some intimation of the attitude of the court's towards such arrangements.

This case involved two shareholder corporations, T and C, each having fifty percent interest in another corporation, Tricil Ltd. The parties entered into a shareholder agreement which contained two buy-sell clauses. The first of these, a piggy-back clause,** provided that the selling party give notice of the terms and conditions of any proposed sale of shares to a third party. It also stipulated that the notice be accompanied by "a bona fide offer to purchase from a third party". The second clause was a shotgun clause, which provided the offeree the option of either accepting the third party offer to purchase "unconditionally" or buying the offeror's shares at the price contained in the third party offer "without conditions". The clauses stipulated a ninety day time limit, with the shares passing automatically to the offeror in the case of the shotgun, if the offer was not accepted within the time limit.

T decided to sell its shares in Tricil and agreed to allow another corporation L, to help it obtain C's shares in the same corporation, after which L was to purchase all of

**Trimac Ltd. v. C-I-L. Inc., supra, note 40. See also, B. Sage, "Shotgun To Be Applied Strictly or Not At All", (June 5, 1987), The Lawyer's Weekly 8.

**See infra Chapter II notes 109-111 and accompanying text.

Tricil's shares from T. T announced publicly that it had granted L the right to purchase its shares if C did not buy them, even though T had not yet made any formal offer to C. Two weeks later L offered to buy all of Tricil's shares from the two parties for \$122.5 million. C interpreted this as the initiating of the piggy-back clause by which T was giving notice of "a bona fide offer to purchase from a third party". This interpretation was rejected by T but C still purported to purchase T's shares for \$61.25 million, one half of the amount being offered by L.

T then attempted to initiate the shotgun at the price of \$91 million. The parties then sued each other in different jurisdictions, but C still sought to complete the transaction, claiming to have accepted T's shotgun offer, but insisting on the lower price which it felt it was entitled to pay. T took the position that C's acceptance was not "without conditions" as specified in the shotgun clause.

The courts agreed with T and held that, once the shotgun is initiated, the offeree has only two options. These were to either buy or sell at the price contained in the offer and within the stated time limit. Once the offer expired, the matter was out of the offeree's hands, and it was deemed to have accepted the offer. The words of Virtue J. seem to sum up admirably the effect of the shotgun provision,

"A shotgun is strong medicine, one takes it strictly in accordance with the prescription or not at all"⁹⁰

⁹⁰Ibid., at 271.

The terms of the agreement between the parties in this case constituted a classic put-call arrangement. The shotgun clause was enforced very strictly by the court, which held that the shotgun once initiated could not be overridden by any other buy-sell provision in the agreement.

(B) THE RESTRICTED AUCTION

The restricted auction is a variation of the shotgun clause. As with the shotgun, the shareholder initiating the clause must be willing either to sell all his or her shares in the corporation or buy all the shares of the other shareholders. The price is not fixed in the initial offer but is set by competitive bidding.

The shareholder who wishes to initiate the restricted auction must first give notice to the other shareholders of the date, time and place of the auction. An auctioneer is then selected, and the parties or their representatives must meet on the appointed date to effect the auction. All the corporation's shares are then placed on the auction block and bids are made in an amount which is calculated per bid, per share. The shareholder making the last valid bid is then permitted to purchase all the shares held by the other shareholders for the price per share indicated in his or her bid, and the other shareholders are deemed to have accepted the offer. The purchasing shareholder is then granted a limited time period in which the purchase of the shares must

be completed.*¹

The main advantage of the restricted auction provision, is that it allows for the transfer of shares among the shareholders of the corporation only, and thus prevents the entry of third parties into the business. However, shareholders, especially minority shareholders with limited resources, are often in a dilemma if the restricted auction provision is implemented. On the one hand, they have to be wary of bidding, but at the same time they stand the risk of being bought out at a low price if they do not participate. A possible solution is for the parties to establish a ceiling price based perhaps on the market value of the shares, and above which bidding would not be permitted. This price can then be employed if the price reached through bidding becomes unreasonable.*²

The restricted auction works more effectively if there is only one class of shares and is therefore appropriate for the situation in the close corporation.*³

D. THE RIGHT OF FIRST REFUSAL

The right of first refusal provisions*⁴ are among the most

*¹M. Mooney, supra, note 76 at 35-37.

*²M. Mooney, ibid., at 35.

*³M. Mooney, ibid.

*⁴This is to be distinguished from a pre-emptive right, which is protected by statute, and which grants to existing shareholders a right to purchase a proportion of any new issue

popular buy-sell provisions."²⁵ This type of provision simply provides that if a shareholder is interested in disposing of the whole or a part of his or her interest in the corporation, the other shareholders must be granted the first opportunity to purchase these shares. In this sense, it represents a balance between the need to maintain marketability for the shares, and the desire to restrict the entry of newcomers into the corporation.

There are two types of first refusal provisions, these are:

- i) the "soft right of first refusal; and
- ii) the "hard" right of first refusal.

I. THE "SOFT" RIGHT OF FIRST REFUSAL

This is the most commonly employed first refusal provision."²⁶ The shareholder who wishes to sell (the selling party) is allowed to set a price independent of negotiations

of shares; see for example, C.B.C.A. subsection 28(1); O.B.C.A. subsection 26; A.B.C.A. subsection 28(1). It is suggested that the provisions governing these pre-emptive rights be included in the buy-sell agreement to prevent the dilution of the interest of those minority shareholders who are not in a position to purchase new issues of shares. See further, D. Ross, supra, note 25 at 203; R. Hay, supra, note 2 at 453.

²⁵S. Robinson, supra, note 2 at 15.

²⁶Ibid., at 15-16.

with third parties.⁹⁷ The remaining shareholders are then given the first opportunity to purchase these shares at the stated price and within a specified period of time.⁹⁸

If the shareholders are unwilling or unable to buy these shares, then the selling party may seek an interested arm's length third party who is then permitted to acquire the shares at the same price as offered to the remaining shareholders. If the shareholder can only obtain an offer to purchase from a third party at a lower price, the shares must first be offered to the other shareholders at the lower price. If these shareholders still refuse to purchase the shares, the transaction with the third party can then be completed.⁹⁹ The parties may exclude this latter obligation if they so desire, however it may be wiser for them to retain this clause to avoid exploitation by the seller and the third party.

II. THE "HARD" RIGHT OF FIRST REFUSAL

In this second type of first refusal provision, the selling party must first find a bona fide, arm's length third party who is willing to purchase the shares at a negotiated price. The seller is then required to offer the shares to the remaining shareholders at the same price and on a pro rata

⁹⁷The price may also be set using a formula method or it may be fixed periodically by the parties themselves: See further infra, Chapter III.

⁹⁸A. Nixon, supra, note 77 at 46.

⁹⁹A. Nixon, ibid., at 46.

basis, in accordance with their shareholdings. The remaining shareholders must either purchase at that price or allow the third party to purchase.¹⁰⁰

In cases where the shareholder's whole interest is being offered for sale, the parties may also specify that any party exercising the option to purchase must purchase all of the shares.¹⁰¹ This would be a safeguard against the possibility of a shareholder purchasing just enough shares to gain a majority and leaving the departing shareholder to find a market for the remaining shares. These shares would not be as marketable if they represented only a minority interest in the corporation.¹⁰²

In the cases of both the "hard right" and the "soft right" of first refusal, the third party should agree to be bound by the existing buy-sell agreement.¹⁰³

The difference between these two types of first refusal provisions is the method of determining the price of shares.

¹⁰⁰Trimac v C-I-L, Ltd. [Alta, [1990] 1 W.W.R. 133 (Alta. Q.B.), at 155-163.

¹⁰¹M. Cullity, supra, note 18 at 621.

¹⁰²R. Hay, supra, note 2 at 456, note 77.

¹⁰³Statute now provides that a shareholder is deemed to become party to a USA if they have knowledge of its existence or if a reference to it is noted conspicuously on the share certificate. See for example, C.B.C.A. subsections 49(8), 146(4); O.B.C.A. subsections 56(3), 108(4); A.B.C.A. subsections 45(8), 140(3). The position of the bona fide purchaser for value is not however dealt with in the legislation, and therefore remains unclear. See also infra, Chapter VI, notes 64-66 and accompanying text.

With the soft right, the selling party sets an appropriate price for the shares, and the remaining shareholders are given notice of the shareholder's desire to sell. They are therefore allowed more time in which to make the decision to purchase and to acquire the necessary funds. In the case of the hard right, the price is determined after negotiation with an actual third party purchaser whose presence forces the remaining shareholders to make prompt decisions on whether or not to purchase the shares.

Though the right of first refusal provisions have the advantage of allowing shareholders the final say on who should purchase available shares, there are some disadvantages. First, these provisions are not usually very useful for solving disputes as they leave much room for disagreement among shareholders over the price of the shares. However, the provision of a formula for valuation or some method of periodic valuation, may mitigate against this problem.¹⁰⁴ Also, shareholders may be able to provide that if they cannot agree on a price, the offeror may be permitted to sell to a third party and the remaining shareholders would relinquish the right to ratify the final selling price.

In the case of the soft right of first refusal, where the selling party is allowed to set his or her price without consulting third parties, a self-serving and unrealistic price may result. The remaining shareholder would then be faced

¹⁰⁴See further infra, Chapter III.

with the difficult decision of either paying an unreasonable price, or facing the uncertainty of having to accept an unsuitable new shareholder.

This problem may be circumvented by including a provision which allows the remaining shareholders to refer a questionable price to the corporation auditors or an independent third party for review.¹⁰⁵ Where the auditors determine a lower selling price the shareholder would be obligated to sell at that price, once the remaining shareholders elect to exercise their rights to purchase.¹⁰⁶ However, this exercise is usually time consuming and may result in the loss of a lucrative third party offer.

Another problem which can result from employing the right of first refusal is the fact that it is often difficult to find a third party who is willing to buy into a closed corporation, especially where he or she is not acquiring a majority interest.¹⁰⁷ If the "hard right" of first refusal is being employed and partial purchases are not excluded, the third party purchaser does not even know how many shares he or she would eventually acquire, as the existing shareholders may

¹⁰⁵See infra, Chapter III notes 26-32 and accompanying text.

¹⁰⁶S. Robinson, supra, note 2 at 15.

¹⁰⁷M. Cullity, supra, note 18 at 620; J. Kennedy, supra, note 4 at 317; A. Nixon, supra, note 77 at 46.

be able to exercise their rights to buy some of the shares.¹⁰⁸

E. THE PIGGY-BACK

The piggy-back¹⁰⁹ provision seems to be one way of resolving the problems inherent in the right of first refusal provisions discussed above. Here, the selling party would first obtain a bona fide written offer from an arm's length third party for the purchase at a specified price, of all the corporation's shares which are the subject of the agreement. The remaining shareholders would then be required to either buy the selling party out on the same terms as those set out in the agreement with the third party, or sell their shares to the third party on the same terms.¹¹⁰

The piggy-back is in theory, intended to ensure the availability of a fair market at all times once the selling party can find such a market. It also has the advantage of providing a market for the shares of a minority shareholder who may not want to remain with the corporation once the

¹⁰⁸In fact it has been submitted that the practical effect of this type of provision may be to exclude outside purchasers, as they would be reluctant to make offers, in view of a lengthy period of notice and the knowledge that their offer may only serve as a free valuation for the existing shareholders. See further, M. Mooney, supra, note 76 at 1.

¹⁰⁹The term "piggy-back", is also used to refer to a clause used under American securities law when dealing with the registration of issued unregistered securities. See further, W. Grover, supra, note 74 at 8.

¹¹⁰D. Brown, supra, note 25 at 161-162; S. Robinson, supra, note 2 at 28-29; Trimac Ltd v. C-I-L., supra, note 40.

majority interest changes hands, but who may have trouble disposing of a relatively small interest.

The guarantee of a fair price seems to be based on the fact that the third party may not want to make an offer to buy at an undervalue for fear that the remaining shareholders may take advantage of the opportunity to purchase the same shares cheaply thereby defeating the wishes of the third party.

There is however, nothing to prevent the selling party from negotiating a higher price with the third party. This might prevent the existing shareholders from buying the shares while allowing the outside third party to purchase. Such a scheme may be detrimental to the remaining shareholders, who, even though they are receiving a higher price for their shares, would be forced to relinquish their interest in the corporation. However, this arrangement would benefit both of the negotiating parties.

F. COMBINATION BUY-SELL PROVISIONS

The various types of buy-sell provisions discussed above can also be combined for greater flexibility.¹¹¹ For example, the parties may include a combination right of first refusal/dissolution provision, such that if the original offer is not accepted, the offeror would be empowered to force the liquidation of the corporation.¹¹²

¹¹¹M. Mooney, supra, note 76 at 17.

¹¹²O'Neal, supra, note 5, c.7.05 at 14-15.

The buy-sell agreement may also include more than one buy-sell provision. The parties would then be able to select the most appropriate clause to suit the facts of the particular situation. To guard against concurrent operation of more than one buy-sell clause, the parties may specify that only one buy-sell clause may be initiated within a stated period of time.²²³ The court has also held that once a particular buy-sell clause is initiated, it cannot be superseded by any other buy-sell clause in the agreement.²²⁴

5. THE EVENTS WHICH TRIGGER THE BUY-SELL AGREEMENT

The buy-sell agreement, including the put-call provisions, may be initiated at any time. However, the agreement may also provide that the buy-sell provisions may be contingent upon the occurrence of a specific event. The most common events which may trigger the operation of the buy-sell agreement include:

- a) cessation of employment;
- b) mental or physical disability;
- c) events defined in terms of the corporation's performance;
- d) transfers by operation of law; and
- e) the death of a shareholder.

²²³ Trimac Ltd. v. C-I-L, Inc., *supra*, note 40.

²²⁴ Ibid.

A. CESSATION OF EMPLOYMENT

Where the share transfer is triggered by an event such as dismissal or retirement, the buy-sell agreement could include clauses compelling the departing shareholder to sell his shares to the remaining shareholders or the corporation. This requirement should be coupled with an obligation on the remaining shareholders to purchase the shares. The price or the method of determining such a price should also be specified in the agreement.¹¹⁵

A restrictive covenant prohibiting the departing shareholder from using knowledge and information obtained directly through his association with the corporation should also be included.¹¹⁶

B. MENTAL OR PHYSICAL DISABILITY

Where one of the shareholders becomes physically or mentally disabled for an extended period of time, it is necessary for the other shareholders to be able to continue the business without being impeded by this disability. The buy-sell agreement could therefore provide for the sale of the disabled shareholder's shares under these circumstances. The price or the method of determining such a price should be specified in the agreement.¹¹⁷

¹¹⁵See further, infra, Chapter III.

¹¹⁶Elsey's Frosted Foods, supra, note 33; Argo v. Marini (7 July, 1989) Ontario 34819/89 (H.C.).

¹¹⁷See further infra, Chapter III.

It is important that the buy-sell agreement defines disability, in particular, mental disability. Where the shareholder is subject to an order under the Mental Incompetency Act,¹¹⁹ mental disability is clearly established. In other cases, the agreement may provide for a panel of medical practitioners to make such a determination if the parties consider it necessary.¹²⁰

Physical disability may be defined in terms of the shareholder's inability to carry out normal responsibilities in relation to the corporation.¹²⁰

C. EVENTS DEFINED IN TERMS OF A CORPORATION'S PERFORMANCE

Parties may also provide for the buy-sell agreement to become operational if the corporation is managed in a manner inconsistent with that provided for in the agreement. The agreement may stipulate that the remaining shareholders either sell their interest to the defaulting party or to a third party, or that the corporation or the remaining shareholders purchase the interest of the shareholder who is in default.

This type of provision would protect the interest of a minority shareholder who is interested in investing in the business, but who is afraid that he or she may not be allowed

¹¹⁹R.S.O. 1980, c.264; See also, Mental Health Act S.A. 1985, c.M-13.

¹²⁰J. Kennedy, supra, note 4 at 323; See also infra, Chapter IV notes 128-142 and accompanying text.

¹²⁰J. Kennedy, ibid..

an adequate input into its operation.¹²²¹

D. TRANSFERS BY OPERATION OF LAW

There are occasions when the shares of a corporation may pass by operation of law to an outside third party independent of the actions or desires of the shareholders. This may occur where a shareholder is declared bankrupt, and a trustee in bankruptcy becomes seized of the shares, or where shares which have been deposited for security are foreclosed upon. Shares may also become subject to a judgment or a court order, or they may be distributed to a spouse upon marital dissolution.¹²²²

These non-voluntary transfers by operation of law are sometimes called transmissions and can be distinguished from voluntary transfers by way of sale.¹²²³ The courts have from time to time recognized this distinction,¹²²⁴ but there are also cases in which the courts have failed to do so.¹²²⁵

Many of the Canadian business corporations statutes also

¹²²¹S. Robinson, supra, note 2 at 10.

¹²²²R. Hay, supra, note 2 at 458.

¹²²³See generally, D. Coates, supra, note 6 at 98-109.

¹²²⁴Moodie v. W.J. Shepherd Ltd., [1949] 2 All. E.R. 1044 (H.L.); Carter v. Roy M. Lawson Ltd. (1981), 129 D.L.R. (3d) 214, (1981), 36 N.B.R. (2d) 353 (Q.B); Re Phillips & La Paloma Sweets Ltd. (1951), supra, note 61; Re Fox Johnson & Co. Ltd., [1942] 2 D.L.R. 784 (Ont. H.C.).

¹²²⁵Re Smith & Fawcette Ltd., supra, note 7; Re "The Barn Ltd." and Moldowan Estate, [1962] 41 W.W.R. 444 (B.C.S.C.).

provide that the term "transfer" includes transmission by operation of law.¹²⁶ This would seem to suggest that the distinction is no longer valid. Nevertheless, some commentators feel that in the interest of clarity the agreement should make note of the possible distinction between a transfer and a transmission.¹²⁷

Shareholders may include a clause in their agreement which provides that where the shares are transferred by operation of law, it is imperative for outside third parties receiving the corporation's shares, to offer to sell these shares to the corporation or the existing shareholders. The existing shareholders would then have an option or an obligation to purchase these shares.

The decision on whether such a clause should be worded as an option or as an obligation is determined by how seriously the shareholders view the need to restrict the ownership of the corporation's shares. The duties of the parties should be clearly defined in these cases as the courts have held that an option in an agreement cannot be construed as an obligation.¹²⁸

The question of whether effective drafting of the buy-sell

¹²⁶See for example, C.B.C.A. subsection 48(2); O.B.C.A. para.53(1)(v); A.B.C.A. para.44(2)(o).

¹²⁷See for example, D. Coates, supra, note 6 at 108.

¹²⁸Eiserman v. Ara Farms Ltd. (1988), 52 D.L.R. (4th) 498, 67 Sask. R. 61, [1988] 5 W.W.R. 97 (C.A.); Lyle v. Bayne Manning Ltd., [1957] 21 W.W.R. 43 (B.C.C.A.).

agreement can prevent transfers by operation of law has been raised. The answer to this query is linked to two considerations. These are, whether the shares in question can be seized by a sheriff or a trustee in bankruptcy, and whether the sheriff or the person taking from the sheriff, or the trustee in bankruptcy, is bound by the restrictions in the buy-sell agreement.¹²⁹

It is interesting to note the development of this issue. The Execution Act (Ontario)¹³⁰ provided in subsection 14(1), that all stock in a corporation, having "transferable" shares shall be deemed to be personal property, and is liable to bona fide creditors for debts. As such, it may be attached, seized, and sold under writs of execution in like manner as other personal property.

The question of whether or not the shares of a close corporation can be seized under the Execution Act seems to depend on the meaning of the word "transferable" in the Act. This was considered in the case of Re Phillips & La Paloma Sweets Ltd.¹³¹ Middleton J. stated,

"That statute (Execution Act) provides only for the seizure and sale of "transferable shares". That, I think does not include shares which can be transferred only with the consent of the directors, but applies only to shares which the debtor can freely transfer."¹³²

¹²⁹D. Coates, supra, note 6 at 109.

¹³⁰R.S.O. 1980 c.146 as amended.

¹³¹Supra, note 61.

¹³²Ibid., O.R. at 127-128.

He concluded that it was doubtful that the shares which had been seized were in fact legally subject to seizure.¹³³

The Execution Act of Ontario was subsequently amended to provide that if shares of a private corporation were seized, the sheriff must first offer these shares to the other shareholders and if no reasonable offer is forthcoming, the shares would then be offered to the general public.¹³⁴

The amendments in the Act were considered in the case of Associates Finance Co. Ltd. v. Webber & Dixon.¹³⁵ Anderson J. examined the existing case law and held, supporting the conclusion reached by the sub-committee of the Canadian Bar Association on the subject that,

" "Execution" does not mean "seizure" but "seizure and sale". The present practice of the sheriff seizing shares in private companies and holding them in his custody is not correct. His duty is to seize and sell, in accordance with the articles of association, save those articles which absolutely prohibit transfers at the discretion of the directors, by which he is not bound."¹³⁶

This holding has been followed in other decisions.¹³⁷

This position is supported by the Bankruptcy Act,¹³⁸ which excludes from the property divisible amongst creditors of a

¹³³Ibid..

¹³⁴Execution Act (Ontario), s.15.

¹³⁵Supra, note 51.

¹³⁶Ibid., at 146.

¹³⁷See Yorkshire Trust Co. v. Bennett (1986), 47 Alta. L.R. (2d) 346 (Q.B.); Gould v. Ablett, [1958] 26 W.W.R. 274 (B.C.S.C.); Re Patmore, [1962] 39 W.W.R. 460 (B.C.S.C.).

¹³⁸R.S.C. 1980, c.B3, s.1.

bankrupt, any property that as against the bankrupt is exempt from seizure under the laws of the province within which the property is situate, and within which the bankrupt resides.¹³⁹ In such cases, the only recourse would be for the court to pierce the corporate veil on some basis.¹⁴⁰

The next question is whether or not a sheriff, trustee in bankruptcy, or any other person receiving the shares is bound by the provisions of a buy-sell agreement. The Canada Business Corporations Act provides that a transferee of shares which are subject to any restrictive provisions are bound by these restrictions once gaining knowledge of them, or they are conspicuously noted on the share certificate.¹⁴¹

In the case of Borland Trustee v. Steel Bros. & Co.,¹⁴² a trustee in bankruptcy was held to be bound by the buy-sell agreement which was contingent on the bankruptcy of the

¹³⁹S.67; D. Coates, supra, note 6 at 112; The common law remedy of a charging order may also be available to subject the shares of a shareholder of a close corporation to seizure. This remedy would not be affected by the possible considerations associated with the bankruptcy provisions, Prat v. Hitchcock (1925), 36 B.C.L.R. 142, [1925] 3 D.L.R. 1142 (C.A.); B.C. Millwork Products Ltd. v. Overhead Door Sales (Vancouver) Ltd. (1961), 34 W.W.R. 86 (B.C.S.C.); Gould, Thorp and Easton v. Albert (1958), 26 W.W.R. 274 (B.C.S.C.).

¹⁴⁰Re Bugle Press, [1960] 3 W.L.R. 956, [1961] Ch. 270 (C.A.); Jones v. Lipman, [1962] 1 W.L.R. 832, 1 All E.R. 442 (Ch. D.).

¹⁴¹Subsections 49(8), 146(4) and s.60; O.B.C.A. subsections 56(3), 108(4) and s.69; A.B.C.A. subsections 45(8), 140(3) and s.56; See further infra, Chapter VI, notes 64-66 and accompanying text.

¹⁴²[1901] 1 Ch. 279; Re Fox Johnson & Co. Ltd., [1942] 2 D.L.R. 784 (Ont. S.C.).

shareholder. Also, in the La Paloma case, where the corporation's charter contained a consent restriction, the court indicated that the purchaser of shares purchased from a sheriff, could not compel the corporation to register the transfer, but could appoint a receiver to receive any dividends which might be declared and paid.²⁴³ In the case of Yorkshire Trust Co. v. Bennet,²⁴⁴ the court held that the shares in question could be sold but that the sheriff must comply with the procedures contained in the articles of amalgamation which obliged him to offer the shares to the other shareholders prior to selling them elsewhere.

The reasoning of the courts in these cases suggested that the execution creditor had no greater right than the execution debtor, and therefore the sheriff's sale could only give the purchaser the right and title of the debtor.²⁴⁵

In the Associates Finance Co. Ltd. case, Anderson J. went further in declaring that,

" . . . the modern trend of our jurisprudence is, where possible, to prevent the use of restrictive corporate devices which have the effect of defeating the rights of creditors. The right to remain a "closed" corporation is a privilege granted by the Legislature, subject to a condition imposed by the same Legislature that the shares held by a judgment debtor may be seized and sold in execution proceedings and that the purchaser of the shares has the right to become a registered shareholder".²⁴⁶

²⁴³La Paloma, supra, note 61 at 128.

²⁴⁴Supra, note 137 at 349.

²⁴⁵La Paloma, supra, note 61 at 127; Yorkshire, ibid., at 356; Davidson v. Davidson, [1946] 2 D.L.R. 289 (S.C.C.).

²⁴⁶Supra, note 51 at 147.

He concluded that a judgment debtor would not be entitled to evade his creditors by using his powers as director of the corporation to refuse to register the transfer.¹⁴⁷

It is therefore clear that the shares of a close corporation are available for seizure and sale, subject to the buy-sell agreement. In some cases, the court may even be prepared to disregard restrictions in the agreement in order to protect the interest of judgment creditors.¹⁴⁸

In light of the above discussion, it seems clear that provisions in a buy-sell agreement which bind all transferees are not absolute and the courts may disregard these provisions in some instances.

Some additional provisions may be included in the agreement to protect the interest of the remaining shareholders. For example, to ensure that the corporation's shares are not subject to seizure in the event of bankruptcy, or other transmission event, a restriction may be placed on the amount of shares that the shareholder could pledge, or the size of the undertaking that could be secured using these shares.¹⁴⁹

In some cases, the transfer may be made by a shareholder who is experiencing financial difficulties, and with the

¹⁴⁷Ibid., at 146-147.

¹⁴⁸Ibid.

¹⁴⁹R. Hay, supra, note 2 at 45; Also see generally, D. Coates, supra, note 6 at 108-112.

intention of minimising the exposure of his assets to his creditors by leaving himself unable to satisfy their claims. Such a transaction may be void as a fraudulent conveyance,¹⁵⁰ and as such may be set aside by the courts.¹⁵¹

Alternatively, the shareholder may choose to give one or more of his creditors a preference over his other creditors. Such a transaction may be void as a fraudulent preference.¹⁵²

The persons interested in establishing that there has been a fraudulent preference or conveyance, must bring an action for a declaration that the particular conveyance is void as against them. The finding of fraudulent intent will usually turn on whether or not consideration was given. Where there is no consideration or inadequate consideration, then there is a presumption of fraudulent intent. However, if there is good or adequate consideration, the fraudulent intent would have to be established.¹⁵³

In those cases where a conveyance is declared to be invalid as against creditors, and where the property has been

¹⁵⁰The Fraudulent Conveyances Act, R.S.O. 1970, c. 182, s.2.

¹⁵¹Fraudulent Preferences Act, s.3.

¹⁵²The Assignments and Preferences Act, R.S.O. 1970, c.34, s.3.

¹⁵³Jack Walker & Harvey J. Ash, Debtor - Creditor Relations: Cases and Materials, (Toronto: Butterworths, 1978) at 5.3. See also, Meehan, Eugene & Vaarton, Peter, Creditors Remedies in Alberta, (Calgary: Carswell Co. Ltd., 1987); Robert W. Kerr, "Fraudulent Conveyances and Unjust Preferences", in M.A. Springman & E. Gertner, eds., Debtor-Creditor Law: Practice and Doctrine, (Toronto: Butterworths, 1978).

disposed of by the transferee, the proceeds of disposition may be seized by the creditors.¹⁵⁴

In the case of the shareholders of a close corporation where a buy-sell agreement is in place, the issue of fraudulent conveyances or preferences becomes relevant where one of the voluntary buy-sell provisions is utilised by a shareholder to defeat the claims of his or her creditors. The transferee shareholders should therefore be aware that the shares in question can be seized by the creditors in satisfaction of the debt. In such a case, the rules for transfers by operation of law discussed above would apply.

E. THE DEATH OF A SHAREHOLDER

The shareholders of the corporation would like to ensure that their beneficiaries would have a right to require the corporation or the remaining shareholders to purchase their interest in the event of death. The surviving shareholders, on the other hand, often do not want to be forced to accept the deceased shareholder's heirs as fellow shareholders.¹⁵⁵

Most of the buy-sell provisions discussed above can be used to secure the desires of both parties. In all cases, with the exception of the shotgun and restricted auction provisions, some provision for determining the price of shares

¹⁵⁴The Assignments and Preferences Act, s.12(1).

¹⁵⁵Re Harvey's Stores Ltd. and Harvey, (1979), 6 B.L.R. 223 (B.C.C.A.).

is also necessary. Problems may arise if the surviving shareholders are unable to fund the purchase at the required time. A suitable arrangement for guaranteeing the availability of such funds at the required time is therefore necessary.¹⁵⁶

7. CONCLUSION

This chapter has defined the buy-sell agreement and its usefulness in the administration of share transfer in the close corporation. The various types of provisions which are available have also been examined.

Because of the variety of possible provisions and the many issues which may affect their operation, the lawyer or drafter must be insightful and selective in the interest of securing the buy-sell provisions which are most effective for protecting the interest of their clients.

¹⁵⁶See further infra, Chapter IV.

CHAPTER III

THE VALUATION OF SHARES UNDER THE BUY-SELL AGREEMENT

1. GENERAL

In most commercial transactions a price has to be negotiated which will be acceptable to both the vendor and the purchaser. The sale of the shares of the close corporation is no exception, however in this case the price may be influenced by a large number of factors. Specific provisions are therefore required to ensure that an equitable price is computed.

Where the buy-sell agreement contains a shotgun, restricted auction, or right of first refusal provision, a procedure and method for determining the price of shares is automatically provided. In these cases a valuation clause may be used to set a lower or higher ceiling for the value of the shares at the time the buy-sell provision is enforced. The other types of buy-sell clauses discussed in the previous chapter, require that the agreement provide a pre-determined price and/or procedure and method of determining the price of the shares covered by it.²

The provisions dealing with the share valuation issues are very important to the success of the buy-sell agreement and are even thought by some writers to be the most important

²The price and method of valuation must be clearly stated in the agreement, as vague and uncertain valuation arrangements may be a threat to the validity of the agreement. Brinacombe v. Dennison (1953), 4 D.L.R. 827 (B.C.S.C).

provisions in the agreement.²

The clauses governing the valuation of shares should be carefully formulated at the beginning of the corporate relationship along with all other provisions of the buy-sell agreement.³

The valuation clauses should state clearly when the valuation would take place.⁴ Standardized technical terms should also be used as often different terms are used to mean the same thing, when in fact they may have different meanings.⁵

²M.C. Cullity, R.E. Forbes & C.A. Brown, Taxation and Estate Planning, (Toronto: Carswell, 1984) at 117; D.W. Smith, "Buy-Sell Agreements" Report of the Proceedings of the Thirty-First Tax Conference, 1979 Conference Report, (Toronto: Canadian Tax Foundation, 1980) 665 at 666.

³In fact this course is recommended. See further, F.H. O'Neal, & R.B. Thompson, O'Neal's Close Corporations, (Illinois: Callaghan's Company, 1987) c.7.29 at 136. This recommendation must however be weighed against the fact that valuation involves some measure of "conjecture and prediction" and can be influenced by many factors which may not yet have developed in the early stages of the business. Also, the transfer and the corresponding need for a valuation may not arise until many years after the clauses have been inserted in the agreement. The answer to this problem would be for the valuation clause to be reviewed from time to time in light of the changing financial conditions.

⁴Brinacombe v. Dennison, *supra*, note 1. Here, a valuation "at a price or consideration to be agreed upon" was held to be unenforceable as it was merely an agreement to make an agreement.

⁵An example of this is the use of the term "book value" to mean "adjusted book value". In the case of Carrol v. McArthur (1983), 25 B.L.R. 132 (Ont. H.C.), the term "book value" was accepted as being synonymous with "adjusted book value". Also see generally, R.M. Wise, "Valuation Aspects of the Shareholder's Buy-Sell Agreement" Report of Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report,

The term "value" has been described as an illusive and subjective concept".* This may be because no one standard valuation clause can be made to work for every situation as each business operation has its own unique characteristics. Valuation clauses should therefore be tailored to suit the facts of the particular situation which they are intended to fit.⁷

The essence of share valuation is the principle that the shareholder is entitled to receive the fair value of his or her shares. The value of a share can be defined as the present value of the future cash flow of the corporation. The question of what fairly constitutes such value has been the focus of much discussion by both the courts and academics.

The next section of this chapter looks more closely at the question of what constitutes the fair value of a share. This is followed by some discussion of the important valuation issues, the procedures used for conducting share valuations and examination of the four major methods of valuation.

(Toronto: Canadian Tax Foundation, 1985) 1013 at 1016-1017.

*S. Cole, A. Friedman & L. Brent, "Valuation Concepts and Terminology" in J.C. McDonald, S. Cole, & R.M. Wise, eds., Valuing Shares In a Private Company, (Toronto: Department of Education, The Law Society of Upper Canada, 1986) J1 at J1.

⁷D.W. Fox, "Compulsory Purchase of Shares in a Private Company - Some Recent Cases" (1987) *The Journal of Bus. Law* 276 at 282.

2. FAIR VALUE VERSUS FAIR MARKET VALUE

The question of fair value has been discussed extensively by the courts¹⁰ in relation to the determination of the value of the shares of dissenting shareholders in public corporations in accordance with the provision of the various business corporations statutes.¹¹ The principles established in some of these cases, can provide useful guidelines in the establishment of the value of shares under the buy-sell agreement.

There are several different valuation terms which can lead to different valuation conclusions.¹² Accordingly, drafters of valuation provisions must appreciate the consequences of the terms they select. The most commonly used valuation terms are "fair value" and "fair market value". Both of these terms

¹⁰See for example, LoCicero, Ravin and Ravin v. BACM Indus. Ltd., [1986] 3 W.W.R. 153 (Ma. C.A.); Douglas Inc. v. Jarislowsky, Fraser & Co. Ltd. et al., [1980] Que. S.C. 925, 13 B.L.R. 135; aff'd (1983), 138 D.L.R. (3d) 521, 22 B.L.R. 12 (Que. C.A.); Re VCS Holdings Ltd., [1985] 5 W.W.R. 559 (B.C.S.C.); Cyrus Anvil Mining Corp. v. Dickson (1982), 40 B.C.L.R. 180 (S.C.).

¹¹See for example, Canada Business Corporations Act, S.C. 1974-75-76, c.33, as amended by S.C. 1978-79, c.9 (hereafter called the C.B.C.A.) s.190; Business Corporations Act 1982, S.O. 1982, c.4 (hereafter called the O.B.C.A.), s.184; Business Corporations Act, S.A. 1981, c.B-15 (hereafter called the A.B.C.A.) s.184; Income Tax (Canada) Act, S.C. 1970-71-72, c.63, as amended - "fair market value".

¹²See further, R.M. Wise, "Valuation and The Income Tax Act" (1981) 29 Can. Tax J. 626 at 627; S. Cole, supra, note 6 at J8, for listings of some of these valuation terms.

have been incorporated into Canadian legislation,¹¹ but no definitions have been provided.¹² These terms are also used synonymously by some writers.¹³

The courts have attempted to provide working definitions of these terms. The most popular definition of "fair market value" is that adopted by McIntyre J. in the case of Min. of Finance of British Columbia v. Estate of William Mann,¹⁴

" 'fair market value' is the highest price available estimated in terms of money which a willing seller may obtain for the property in an open and unrestricted market from a willing knowledgeable purchaser acting at arm's length."¹⁵

This definition was quoted with approval by Greenburg J. in the case of Re Douglas Inc. v. Jarislowsky & Co. Ltd, et al.¹⁶ The learned trial judge however concluded that "fair value" meant something different and apart from "fair market

¹¹See for example, C.B.C.A. s.190 (3) - "fair value"; O.B.C.A. s.184 (3) - "fair value"; A.B.C.A. s.184 (3) - "fair value"; Income Tax (Canada) Act, S.C. 1970-71-72, c.63, as amended - "fair market value".

¹²R. Wise, supra, note 10 at 627.

¹³G. Ovens, D.I. Beach & C.T. Grant, Business and Securities Valuation (Toronto: Methuen Publications, 1972) at 6.

¹⁴[1972] 5 W.W.R. 23 (B.C.S.C.); aff'd [1973] C.T.C. 56 (B.C.C.A.); aff'd (1974) C.T.C. 222 (S.C.C.).

¹⁵[1972] W.W.R. 23 (B.C.S.C.), at 27; I.R. Campbell, Canada Valuation Service, (Toronto: Richard De Boo Publishers, 1988) at 4-19.

¹⁶Supra, note 8; See further, A.P. Gauthier, "The Appraisal Remedy" in J.C. McDonald, S. Cole, & R.M. Wise, eds., Valuing Shares In a Private Company, (Toronto: Department of Education, The Law Society of Upper Canada, 1986) F1-F13 for commentary on this case.

value". His reasoning suggested that Parliament, by excluding the word "market" from its provision for "fair value" in the Canadian business corporations statutes, had conveyed upon the courts "the equitable jurisdiction and obligation to fix a value which is fair, just and equitable, having regard to all the circumstances."¹⁷

This interpretation is disputed by at least one writer who submits that the phrase "fair value" in the Domglas case should have been interpreted in the context of its legislative and judicial history.¹⁸ Nonetheless, this interpretation was adopted and expanded in the case of LoCicero, Ravin and Ravin v. BACM Indus. Ltd.,¹⁹ which held that "fair value" was to be defined as value to the owner²⁰ and not market value.²¹ This decision was subsequently overturned by the Supreme Court of Canada, but the court made no reference to the above

¹⁷Domglas, ibid, at 965. See also, D.A. Ward, "The Appraisal Remedy" in J.C. McDonald, S. Cole, & R.M. Wise, eds., Valuing Shares In a Private Company, (Toronto: Department of Education, The Law Society of Upper Canada, 1986) at F22; I.R. Campbell, "Fair Market Value and the Notional Market" in J.C. McDonald, S. Cole, & R.M. Wise, eds., Valuing Shares In a Private Company, (Toronto: Department of Education, The Law Society of Upper Canada, 1986).

¹⁸V. Krishna, "Determining the "Fair Value" of Corporate Shares" (1987-1988) 13 Can. B.L.J. 132 at 139-147.

¹⁹Supra, note 8.

²⁰That is, the value of the property to the owner himself. See further, J.C. Bonbright, Valuation of Property (Virginia: The Mitchie Company, 1965) Vol.1 at 66-97; I. Campbell, supra, note 15 at 4-14 - 4-17.

²¹Supra, note 8, per O'Sullivan J.A., D.L.R. at 279.

principles.²² These principles were challenged in Manning v. Harris Steel Group Inc.,²³ where Anderson J. stated,

"The "fair value" is to be determined for all owners and not with respect to the circumstances of individual owners. Thus, in this sense, at least, "fair value" is not "value to the owner".²⁴

The trend of the authorities on this issue would seem to suggest that there are no conclusive rules as to what constitutes the fair value of shares. Parties therefore are not confined to using fair market value or even fair value as defined above. They can select the most appropriate method and procedure for conducting the valuation from a variety of available options.²⁵

The above comments are useful but not conclusive in determining the fair value of shares in the close corporation. While issues such as value to the owner are usually more relevant to the valuation of shares in the public corporation, other issues including the provisions of the buy-sell agreement, goodwill and the question of control, become important considerations when the shares being valued are those of a close corporation.

Some of these valuation issues are examined more closely

²²(1988), 49 D.L.R. (4th) 159, [1988] 1 S.C.R. 399, [1988] 4 W.W.R. 67 (S.C.C.).

²³(1989), 63 D.L.R. (4th) 125 (B.C.C.A.).

²⁴Ibid., at 126.

²⁵See further, infra, Chapter III, notes 26-46 and 100-173 and accompanying text.

later on in this chapter under the heading "Valuation Issues". The next section of this chapter looks at the procedures available for effecting valuations under the buy-sell agreement. The most important methods of valuation are also discussed later in this chapter.

3. VALUATION PROCEDURES

The parties to a buy-sell agreement should select the procedure for conducting the valuation. This should be inserted into the agreement at its inception, so as to prevent possible disputes at a later date. There are at least four available valuation procedures. These are:

- a) valuation by an independent third party or arbitrator;
- b) valuation as set by the parties themselves;
- c) valuation by the tax authorities; and
- d) valuation by the courts.

A. VALUATION BY AN INDEPENDENT THIRD PARTY OR ARBITRATOR

The agreement may provide for the appointment of a valuator or an arbitrator to value the shares when a valuation is required. Such an arbitrator or valuator may also be appointed to value shares on an annual basis.^{2*}

The valuation may be conducted by a panel made up of

^{2*}Montgomery Agencies Ltd. v. Krischke, (10 January, 1989) Saskatchewan 1730/87 (Q.B.).

arbitrators or valuers chosen by both parties (possibly each side choosing one representative, who would in turn choose a third representative). In this case, the majority decision of the arbitrators typically governs.

A sole arbitrator or valuator may also be employed to conduct the valuation, his or her findings would then be binding on all the parties.

The major disadvantage in employing an arbitrator or an independent third party to conduct the valuation, is the cost in both time and money. There may also be some delay in completing the share transfer while parties wait for the valuation to be finalized.²⁷

Some of these difficulties could be avoided if certain guidelines are observed. The parties should stipulate whether or not they want matters such as the issues of minority discounts and premiums for control to be dealt with in the arbitration.²⁸ The financial material which will be used in the valuation should be specified in the agreement. The agreement should also state whether or not such financial material should be audited as well as the name of the auditor

²⁷R. Blainey, "Shareholders' Agreements - Valuation Considerations" Shareholder Rights and Agreements, (Toronto: Insight Press, 1985) at 18.

²⁸See further infra, Chapter III notes 70-99 and accompanying text.

to be consulted.²⁹

The agreement should include a clause ensuring the cooperation of all the parties who are privy to the agreement and corporation's employees whose input may be necessary for the successful completion of the valuation. Valuers and arbitrators should also be allowed access to the relevant corporate information.³⁰

On the whole, this method of valuation is thought to be ineffective mainly because it achieves no more than what the parties themselves could have achieved under a properly planned agreement.³¹ Also, where the agreement provides for a buy-out clause, the parties may be bound by such a clause and have no resort to arbitration.³²

B. VALUATION AS SET BY THE PARTIES THEMSELVES

In this instance, the shareholders themselves conduct the valuation. This can be done in either of two ways. The parties could incorporate a valuation figure into the agreement by which they would agree to be bound (fixed valuation). Alternatively, they could meet periodically,

²⁹This will usually be the company auditor, but it has been suggested that the information should still be provided in the interest of completeness, R. Blainey, *supra*, note 27.

³⁰R. Blainey, *ibid.*, at 7-19.

³¹*Brinacombe v Dennison*, *supra*, note 1.

³²*Merrel v. Burquess*, (29 August, 1988) Vancouver CL2:007 (B.C.S.C.).

VALUATION

71

annually or perhaps more frequently, to calculate the value of the shares. The agreed valuation figure would then be incorporated into the agreement with the understanding that the most recent valuation recorded at the applicable time would prevail (periodic valuation).

With the fixed valuation method, the parties would initially calculate an amount which represents the total value of the business. This figure would then be incorporated into the agreement and thereafter, the parties would be bound by it.

This method of valuation may be acceptable in the short term, because the value of the shareholding often reflects the actual contributions to the corporate capital made by the individuals at the start of the business.³³ It may however become outdated after a few years and may have little or no relation to the current value of the business. Such a development could have serious repercussions for the parties under the Income Tax (Canada) Act.³⁴

The periodic valuation on the other hand, is thought to be the most acceptable method of valuation for many reasons.³⁵ The owners of the business are intimately involved with the

³³O'Neal, supra, note 3 c.7.31.

³⁴S.C. 1970-71-72, c.63 as amended; See further infra, Chapter IV.

³⁵D.P. Coates, "Share Transfer and Transmission Restrictions in the Close Corporation" (1968) 3 U.B.C.L. Rev. 96 at 121.

business and as such can gauge its future potential based on their knowledge of its past performances. They are also in the best position to value the goodwill and other intangibles of the business.

This method has the advantage of guaranteeing that there would likely be no dissatisfaction over the price in the agreement, as all the parties would have agreed to the recorded price. It is also more economical as the parties forego the additional expense of employing an outside arbitrator.

The price of the shares would also be pre-determined and the shareholders could plan their estates knowing the exact value of their shareholdings.

Problems may result if the parties, having provided for such a valuation in their agreement, fail to meet on a periodic basis to compute or re-evaluate the price of the shares.³⁶ Another problem may arise if the parties, having met as planned, cannot agree on a new value for the shares. One solution to these problems may be for the agreement to provide for an alternative valuation procedure, for example,

³⁶In two recent American decisions, In Matter of Pace Photographers Ltd., 133 App. Div. 2d 829, 520 NYS2d 202 (1987), and Kanawha-Roane Lands Inc. v. Burford, 359 SE2d 618 (W. Va. 1987), (cited by O'Neal, supra, note 3 at c.7.31, note 2), the courts held that fixed prices in the buy-sell agreement were enforceable as being "freely and voluntarily" entered into by the parties, despite some disparity between the buy-sell agreement and the current value of the shares.

the arbitration method.³⁷

Another problem is the possibility that one or more of the shareholders may be tempted to delay triggering a buy-sell agreement until after a new value has been calculated, so as to obtain the best price. The problem may be avoided by a provision that the valuation should be undertaken whenever the shares are to be sold.

Periodic or agreed valuations have been criticised on the grounds that they may bring regularly to the surface, old disagreements and conflicts among the shareholders. This may however be seen as an advantage because it is an opportunity for shareholders to meet regularly to discuss and resolve issues. Unresolved issues could lead to disharmony among the parties or even worse, they could become major issues if one shareholder leaves, dies, or is dismissed.³⁸

C. VALUE AS SET BY THE TAX AUTHORITIES

The agreement may simply provide that the value of the shares shall be the value as determined by Revenue Canada at the relevant time.³⁹ Alternatively, the agreement may provide

³⁷O'Neal, supra, note 3 at c.7.31; O'Neil v. Anderson et al., (2 December, 1986), Vancouver NO CA004391, (B.C.C.A). Here, the courts held that, having accepted the agreed valuation before receiving knowledge of its sum, a shareholder was held to be bound by such a price to the exclusion of the arbitration method for which he could have opted.

³⁸R. Blainey, supra, note 27 at 11.

³⁹E.g., for the purpose of determining the amount of estate duty on the death of a shareholder.

a valuation, but state that this may be amended to conform with the valuation set by the tax authorities. This is known as a price adjustment clause.

One difficulty with this valuation procedure is that the valuations are usually subject to long delays before being finally determined by the tax authorities. Where a shareholder has died, such delays could hinder prompt execution of the sale and purchase of the shares and could also result in the loss of valuable tax advantages which the share transfer restrictions might otherwise provide.⁴⁰

This type of valuation clause was examined in the case of Guilder News Co. (1963) Ltd. v. M.N.R.⁴¹ Here, the appellant corporation sold some of its shares to its shareholders at a price substantially lower than fair market value. The agreement stipulated the price of the shares. It also contained a price adjustment clause which stated that the contractual price should be equal to the fair market value and provided that should the Minister of National Revenue determine at any time that the fair market value was different from the agreed price, the latter should be adjusted to conform.

This clause was disregarded by the court as being a sham

⁴⁰D.S.M. Huberman, "Buy and Sell Agreements", (1963) 31 Can. B. Rev. 538 at 569; D. Coates, supra, note 35 at 119, note 106; Interpretation Bulletin IT -140R2, "Price Adjustment Clauses", Dec. 29, 1980, para.5; See also infra, Chapter V.

⁴¹[1973] C.T.C. 1 (F.C.A.).

on the ground that the parties had made no attempt to sell the property at fair market value. The court therefore ruled that the agreement was inherently defective, and that the defect could not be cured by a price adjustment clause.

The Guilder decision has raised concern as to the legitimacy of the use of price adjustment clauses. Revenue Canada has since provided that this decision should be restricted only to those situations where parties do not place reasonable value upon the assets which are the subject matter of the sale. Price adjustment clauses will therefore be acceptable in situations where the parties displayed a bona fide intention to transfer the property at fair market value, and the determination was arrived at in a fair and reasonable manner.⁴²

Revenue Canada has provided further that, in order to be effective, the price adjustment clause must leave the final determination of fair market value to Revenue Canada. The Revenue Canada valuation is binding on all parties to the

⁴²Interpretation Bulletin IT-169, "Price Adjustment Clauses", August 6, 1974, para.1; American authorities have established three additional conditions. These are: (i) that the price must either be fixed or determinable by a formula, (ii) that the estate is obliged to sell the interest at a fixed price, and (iii) that the obligation to sell at the agreed price must be binding on the owner during his lifetime and on his estate after his death. See further, R.R. Budd, and K.F. Somerville, "The Impact of Buy-Sell Agreements" (1984-86) 7-8 Family Advocate 18; I.R. Campbell, "The Concept of Fair Market Value" in Special Lectures of the Law Society of Upper Canada. Recent Developments in Estate Planning and Administration (Toronto: Richard De Boo Publishers, 1980) 297 at 312.

agreement which contains the clause. The parties are obliged to accept Revenue Canada's position without question and amend their agreement accordingly.⁴³

D. VALUATION BY THE COURTS

In the event of a dispute over the valuation provisions in the agreement, the shareholders have resort to the courts to challenge such provisions.

The courts are often called upon to value the shares of public corporations in connection with application for the oppression remedy and the exercise of the right to dissent in the various business corporations statutes.⁴⁴ In the case of the small private corporation, this alternative may be both expensive and time consuming. Resort to the courts for the purpose of conducting valuations is therefore reserved for those cases where the parties cannot settle the valuation dispute among themselves, and there is no provision for the appointment of an arbitrator.

Parties could attempt to avoid court proceedings by providing in the agreement that the valuation arrived at in the manner prescribed in the agreement is binding on all

⁴³Interpretation Bulletin IT-169.

⁴⁴See for example, C.B.C.A. s.241 and subsections 190 (12)-(16); O.B.C.A. s.247 and subsections 184 (13)-(17); A.B.C.A. s.234 and subsections 184 (6)-(10); See also *infra*, Chapter VII notes 56-76, 103-110 and accompanying text.

parties.⁴³ However the courts may overturn such a provision under the oppression remedy.⁴⁴

The principles established by the courts in previous cases, may also assist the parties in arriving at a value that is acceptable to all the parties.

1. VALUATION ISSUES

Several related issues can influence the value of shares. The factors which may have some bearing on the valuation of shares include:

- a) the issue of control;
- b) the amount of goodwill generated by the business;
- c) the nature of the business;
- d) the time of the valuation;
- e) minority discounts; and
- f) premiums for control.

A. THE ISSUE OF CONTROL

The buy-sell agreement may affect the manner in which a close corporation is controlled. This is mainly the result of the special rights and restrictions which result from such an

⁴³Mica Management Centre Inc. v. Lockett (1986), 37 B.L.R. 209 (Ont. H.C.).

⁴⁴Re Bury & Bell Gouinlock Ltd. (1985), 12 D.L.R. (4th) 451, (1984), 48 O.R. (2d) 57 (H.C.J.); See also infra, Chapter VII notes 56-76 and accompanying text.

agreement, for example, the option to acquire shares on the occurrence of a particular event. The issue of control may also affect other issues including the voting rights of the shareholders.

The question of whether the issue of control should really affect the value of shares still seems to be open.⁴⁷ In the leading case in this area, Min. of Finance of British Columbia v. Estate of William Mann,⁴⁸ the issue of control was held not to affect the value of shares. The facts of the case were that the deceased, Mr. Mann, owned ten Class B voting shares by which he controlled the corporation while his children owned nine hundred and ninety Class A shares which had no voting rights. In valuing the deceased's shares, the assessor of succession duties took into account the fact that the Class B shareholder would be able to use his voting power to ensure that he received a salary or a management fee for his services. Accordingly, the shares were valued at \$81,000. The executors on the other hand, valued the shares on the proportionate net worth of the corporation with no allowances for the fact that all the voting power was attached to the Class B shares. They therefore valued the shares at \$1,495. The trial judge accepted the executors valuation which was

⁴⁷R.E. Levine, "Income Tax Implications Of Shareholders' Agreements" Legal Problems Relating To Shareholders Agreements, (Vancouver: The Continuing Legal Education Society Of British Columbia, 1982).

⁴⁸Supra, note 14.

VALUATION

79

based on expert evidence that the market value of shares of companies of that kind tended to stabilize at break-up value.

At least one writer suggests that this case may not apply in every context.⁴⁹ The case of Winram v. Minister Of National Revenue,⁵⁰ where the opposite result was achieved, seems to support this position. Here, the deceased owned nine of the ten class A voting shares while his wife owned the remaining class A share and all nine hundred class B non-voting shares. In valuing the nine class A shares, the Minister took account of the fact that the deceased could have transferred his shares without his wife's consent and all the corporation's surplus could then have been paid by way of dividends to the transferee. Accordingly, the Minister's valuation of the shares was one hundred times more than the valuation of the executors. This reasoning and valuation were accepted by the court.

The issue of control as raised by the buy-sell agreement will also determine for the purposes of Sec.70(5) of the Income Tax (Canada) Act, whether or not parties to the transaction were dealing at arm's length at the time of the agreement. This fact is of importance in determining whether or not shares under a buy-sell agreement will be valued according to the agreement or given their fair market value for the purposes of the Act. This issue will be discussed

⁴⁹R. Levine, supra, note 47 at 9.

⁵⁰(1972), 27 D.L.R. (3d) 763 (F.C.T.D.).

further in Chapter V of this dissertation under the heading "Valuation".

The issue of control can also affect the size of the minority discount or premium for control (if any) to be applied to a shareholding. This will be discussed later in this section under the headings "Minority Discounts" and "Premiums for Control".⁵¹

B. GOODWILL

Goodwill is an important asset which may influence the value of a closely held business. In some cases, the quantum of goodwill may even determine the choice of method used to value the business.⁵² Goodwill may be calculated as the difference between the fair value of the whole business and its tangible asset backing,⁵³ and may fluctuate widely depending on a number of factors.⁵⁴

Goodwill may come in many forms when regarded as a factor

⁵¹See infra, Chapter III notes 70-99 and accompanying text.

⁵²G. Ovens, "Methods of Valuation for Privately Owned Businesses and Closely Held Companies" (1958) Can. B. Rev. 57 at 72.

⁵³S. Cole, supra, note 6 at J3.

⁵⁴"Goodwill and other intangible values [including location, know-how, patents, copyrights, trademarks and advertising, contracts, and licenses] may be likened to quicksilver which can be held in the hands but easily slips through the fingers . . . In each and nearly every situation, goodwill and intangible values are questions of fact and there is a burden of proof upon those who make calculations as to their value." - G. Ovens, supra, note 13 at 132-145.

of valuation, it may either flow from a product or it may be the result of a particular location. This type of goodwill is referred to as commercial goodwill and can be sold or transferred as a commodity.⁵⁵

Goodwill may also flow from good relationships between owners or employees of a business and their clients. This is called personal goodwill and may not be as easy to market as commercial goodwill.⁵⁶ Personal goodwill may diminish or disappear if any of the individuals on whom it is dependent become ill, die, or for some other reason are unable to maintain the relationship with their clients.⁵⁷

Goodwill can be seen as representing an important asset of a close corporation and must be taken into consideration regardless of which method of share valuation the parties employ.⁵⁸

C. THE NATURE OF THE BUSINESS

The nature of the business usually determines its ability to generate future cash flow.

The nature of the business must be defined in terms of the

⁵⁵S. Cole, ibid., at J9; G. Ovens, supra, note 52 at 72.

⁵⁶J.L.R. Holdings v. Wiseburg (1977), 2 B.L.R. 250 (Ont. S.C.); Alberts v. Mountjoy (1977), 2 B.L.R. 178 (Ont. S.C.); Jiffy People Sales (1966) Ltd. v. Elaison (1975), 58 D.L.R. (3d) 439, 21 C.P.R. (2d) 209 (B.C.S.C.); Trego v. Hunte [1896] A.C. 7, [1895-9] All.E.R. 804 (H.L.).

⁵⁷G. Ovens, supra, note 52 at 72.

⁵⁸Brinacombe v. Dennison, supra, note 1.

VALUATION

82

corporation's essential characteristics and the environment of the industry in which it operates. As such, it may be influenced by any number of factors. These include, the products manufactured or the services provided by the business, the market for the products or services, and the existing or future competition.⁸⁹ The prospects of the industry, including new technology, government regulations affecting the industry, and threats to the industry (e.g. product substitution, and shortage of raw materials) are also significant.⁹⁰ These factors will assist in determining the risk factors in the business being valued.⁹¹

Some valuation methods seem to be more suitable for valuing certain types of businesses, for example, the net asset approach may be more appropriate for valuing real estate businesses and construction companies because the assets of such a corporation tend to be substantial. Manufacturing and service companies on the other hand, may be better served by a capitalization of earnings approach. This may be because in such a corporation there tends to be more emphasis on the ability of the corporation to earn income rather than on the

⁸⁹G. Ovens, supra, note 13 at 59; R. Blainey, supra, note 27 at 4.

⁹⁰R. Blainey, supra, note 27 at 4.

⁹¹H.M.S. Fraser & G.C. Francis, "Problems Areas In Valuing Closely-Held Companies" in J.C. McDonald, S. Cole, & R.M. Wise, eds., Valuing Shares In a Private Company, (Toronto: Department of Education, The Law Society of Upper Canada, 1986) E5-E7.

assets which the corporation possesses.⁶²

The age and reputation of the business are also factors in determining its nature.

The basis of the valuation for any given corporation may not always be the same, for example while a book value approach may be more appropriate at the start of the business when an earnings capability has not yet been established, an earnings related approach may be more suitable as the business develops.⁶³

D. TIME OF VALUATION

An important consideration when valuing shares is that the value has to be determined as at a specific date.⁶⁴ In the case of income tax valuations, the Income Tax (Canada) Act requires that the valuation be determined at a specific point in time.⁶⁵ The timing of the valuation is important for establishing an accurate price for shares as the nature of a business may change from day to day due to both internal and external factors, and the shortest time frame may make a

⁶²R. Blainey, supra, note 27 at 5.

⁶³R. Blainey, ibid., at 4.

⁶⁴This fact is of particular significance to the public corporation especially when valuing the interest of minority shareholder, particularly in a compulsory purchase situation. See further, D. Fox, supra, note 7 at 280-281.

⁶⁵See further, R. Wise, supra, note 10 at 634, for a table detailing the relevant point in time for computing valuations for income tax purposes, for certain inter vivos and testamentary transactions.

material difference to the final outcome of the valuation.

Internal factors may include changes in management, acquisitions or services. The value of a business may also be affected by external factors such as the development of new competition or changes in the economy and government policy or changes in legislation. The date of valuation should therefore be as close as possible to the date of sale of the shares.

Because the valuation must be done at a specific point in time, the use of hindsight evidence to determine value is usually held to be non-admissible.⁶⁶ Hindsight may be acceptable if certain conditions apply. These are: i) that projections, budgets, or forecasts actually existed at the valuation date; ii) that it was the corporation's practice to prepare such forecasts; and iii) that a prospective or hypothetical purchaser would probably have taken account of such forecasts when forming an opinion as to the price/value of the shares.⁶⁷ Hindsight may also be permissible to determine whether a projection made at a time in the past was reasonable.⁶⁸

⁶⁶Baking of Alberta Ltd. v. R., [1978] C.T.C. 30, 78 D.T.C. 6018 (F.C.T.D.); aff'd [1980] C.T.C. 237, 80 D.T.C. 6178 (F.C.A.); Brunell v. M.N.R., [1977] C.T.C. 326, 77 D.T.C. 2506; V. Krishna, supra, note 18 at 137-138; R. Wise, ibid., at 636.

⁶⁷R. Wise, ibid.

⁶⁸Douglas Inc. v. Jarislowsky, Fraser & Co. Ltd. et al, supra, note 8; Diligenti v. RMWD Operations Kellowa Ltd. (No 2), [1977] 4 B.C.L.R. 134 (B.C.S.C.); Carruthers v. R.

Hindsight is to be distinguished from similar fact evidence, whereby valuation predictions are based on comparable sales. This type of evidence is usually admissible.⁶⁹ The shorter the time period between the comparable sale and the date of the valuation, the more probative the similar fact evidence will be.⁷⁰

The parties may also consider selecting a time period over which the valuation would be calculated.

E. MINORITY DISCOUNTS

Where the shares which are to be valued represent only a minority interest in the corporation, the question of whether or not a minority discount should be applied to the final value must be considered.

The issue of minority discounts is relevant to take-over bids and compulsory buy-outs or squeeze-outs in the public corporation.⁷¹ In such cases, the shares are usually traded on the stock exchange and are automatically subject to a discount because the stock exchange is a market for such minority interests.⁷² However, the court does not hesitate

(1982), 82 D.T.C. 6009 (F.C.T.D.).

⁶⁹Edmund Littler v. M.N.R., [1978] C.T.C. 235, 78 D.T.C. 6179 (F.C.A.); aff'g [1976] C.T.C. 379, 76 D.T.C. 6210 (F.C.T.D.).

⁷⁰V. Krishna, supra, note 18 at 138.

⁷¹See for example, C.B.C.A. ss.199 and 241; O.B.C.A. Part XV ss.186-189 and 247; A.B.C.A. Part 16, ss.187-199 and 234.

⁷²V. Krishna, supra, note 18 at 166.

to award a premium or impose a discount whenever it feels that either of these is warranted.⁷³

Minority discounts may also be relevant to share valuations under a buy-sell agreement. The application of a minority discount in calculating the value of shares may be provided for in the buy-sell agreement. Where no such provision is made, the question of whether or not a discount should be applied in such cases is a matter of law. The rate of such a discount is however, a matter of fact to be determined only after an examination of all the relevant issues. This was reiterated in the case of In re Bird Precision Bellows Ltd.,⁷⁴ where an application was being made for an order that the petitioner's shares be purchased by the respondents at their fair value. Nourse J. stated,

" . . . I must start by rejecting [the] submission that the question of any discount is a question of valuation to be decided on the evidence of the valuers. It will be evident that I regard it as a matter of law to be decided by the courts. If as a matter of law, it is a case where there ought to be a discount, then I would agree that the amount of the discount is a matter of valuation."⁷⁵

The process for determining the minority discount involves two stages, the valuing of the corporate entity in its

⁷³In Domglas Inc. v. Jarislowky, Fraser & Co. Ltd. et al, supra, note 8 at 16, the court, in determining the fair value of shares, held that the "squeezing-out" of a minority dissenting shareholder in this case, was similar enough to an expropriation to warrant a 20% premium for control, rather than a minority discount; Re Brant Investments Ltd. & Keeprite Inc. (1987), 42 D.L.R. (4th) 18 (Ont. H.C.).

⁷⁴[1984] Ch. 419.

⁷⁵Ibid., at 435-436.

entirety (ie. the en bloc fair market value), and an examination of the particular shareholding to determine how much discount (if any) should be subtracted from the value so determined.⁷⁶

The need for a minority discount may be the result of certain limitations in the shareholding itself. Some of the more significant limitations can be listed as follows:

- the size of the shareholding;
- the ability of the shareholder to influence the control of affairs of the corporation;
- whether the interest entitles the shareholder to a say in the timing and distribution of dividend payments;
- the existence of a buy-sell agreement restricting share transfer;
- inability of the minority shareholders to elect themselves to the board of directors, and thus be able to influence corporation policy and operations;
- illiquidity of the shareholding,
- the interest of a minority shareholder in a close corporation may not be as well protected as those of the minority shareholder in a public corporation as the management personnel of the close corporation are usually active in the everyday running of the

⁷⁶p. Gampel, "Valuing the Interest in Closely-Held Company: A Complex Task" (June 1987) The National at 32.

business and are probably majority shareholders themselves. As such, shareholders' interests may not be as well pursued as those of minority shareholders of a public corporation where directors have a greater accountability and fiduciary responsibility to a vast number of shareholders.⁷⁷

The size of the minority discount can be influenced by a number of factors. In many instances the factors mentioned above, which contribute to determining whether or not there is need for a minority discount, can also affect the quantum of such a discount. Other factors include:

- the marketability of shares where the buy-sell agreement does not provide for the immediate sale of shares of a minority shareholder to remaining shareholders;⁷⁸
- where there are restrictions on the rights of the minority shareholder to transfer shares freely.

The three most important factors which may influence both the existence and quantum of the minority discount are, the issue of control, the lack of marketability and the restriction factor.⁷⁹

The issue of control can play an important role in

⁷⁷Ibid.

⁷⁸P. Gampel, ibid.

⁷⁹P.W. Moore, "Valuation Revisited" (Feb. 1987) *Trusts and Estates*, 40.

determining the imposition and amount of a minority discount.⁸⁰ Consequently, if a minority interest is substantial enough to effectively block a special resolution pursuant to the Canada Business Corporations Act,⁸¹ then it may not command as large a discount as a minority shareholding that can have little or no effect on the major decisions of the corporation.

Where the shares are being sold to remaining shareholders, especially if they are already majority shareholders, the justification for the minority discount may not apply. The reason for this may be that these shares are not being sold on the open market and in purchasing them, the purchaser does not become a majority shareholder, he or she merely consolidates an existing position in the corporation.⁸²

There is some question as to whether or not a minority discount would normally apply in cases of family or group control where the interest being sold is that of a minority

⁸⁰See also infra, Chapter III, notes 44-48 and accompanying text.

⁸¹" "Special resolution" means a resolution passed by a majority of not less than two thirds of the votes cast by the shareholders who voted in respect of that resolution or signed by all the shareholders entitled to vote on the resolution."- C.B.C.A. subsection 2(1). See also, O.B.C.A. subsection 1(44); A.B.C.A. subsection 1(y).

⁸²Domglas Inc. v. Jarislowsky, Fraser & Co. Ltd. et al., supra, note 8 at 942; Diligenti v. RWMD Operations Ltd. et al., supra, note 68; Taylor Estate v. M.N.R. (1967), 67 D.T.C. 405, [1967] Tax A.B.C. 555 (T.A.B.).

shareholder outside of this group."³ While some writers feel that this is possible once certain conditions are satisfied,⁴ the question still seems open for debate.⁵ The relevant factors in such a determination include a finding of whether all the parties forming the control block are amicable and have demonstrated that they acted in concert in respect to the decision-making aspects of the corporation (eg. by voting together at annual shareholders meetings), and whether there are restrictions on the right to sell or vote shares that form part of the control block.⁶

Lack of marketability is also a very important factor in determining the size of a minority discount. This type of discount generally applies in everyday commercial transactions where certain commodities which do not have a fixed and ready market, are often offered at a discount to make them more attractive to prospective buyers. Such a discount may also be necessary in the sale of the shares of a close corporation as these would be affected by the same kinds of limitations.

³S.251(5)(a) of the Income Tax (Canada) Act provides that where a related group is in a position to control a corporation, that group shall be deemed to control the corporation.

⁴P. Gampel, supra, note 76.

⁵See further, A.L. Feld, "The Implications Of Minority Interest and Stock Restrictions In Valuing Closely Held Shares" 122 U. Pa. L. Rev. 934 at 936; W.D. Goodman, "The Effect of a Shareholders' Agreement on the Valuation of Shares of a Closely-Held Corporation" (1976) 24 Can. Tax J. 193 at 207-214.

⁶A. Feld, ibid.; W. Goodman, ibid.; P. Gampel, supra, note 76.

Nonetheless, the courts have held that lack of marketability should not be taken into account when valuing the shares under the oppression remedy.⁸⁷

Restrictions on the right to transfer shares freely may also lead to a corresponding decrease in the value of the shares. Though most buy-sell agreements intentionally create such restrictions, these may not affect the price of the shares where the agreement provides a pre-determined price or method of determining such a price. However, where the remaining shareholders are granted an option to purchase shares, the minority discount may be necessary to attract outsiders if the shareholders choose not to exercise their option to purchase the shares.⁸⁸

The courts have taken the liberty from time to time to forbid discounts where it was felt that such a discount would prejudice the minority shareholders right to the fair market value of their shares.⁸⁹ The question of minority discounts in these cases would depend, to some extent, on the nature of the event that gives rise to the valuation and the facts of

⁸⁷Daniels v. Fielder (1988), O.R. (2d) 629 (H.C.J.); Lough v. Canada Natural Resources Ltd. (1983), 45 B.C.L.R. 335 (S.C.); See also infra, Chapter VII, notes 56-76 and accompanying text.

⁸⁸Domglas Inc. v. Jarislowsky, Fraser & Co. Ltd. et al., supra, note 8 at 940-942.

⁸⁹See for example, Re Mason and Intercity Properties Ltd. (1987), 38 D.L.R. (4th) 681, (Ont. C.A.); Diligenti v. RWMD Operations Kelowa Ltd. et al. (No 2), supra, note 68.

the particular case."⁰

F. PREMIUMS FOR CONTROL

The corresponding question of whether a premium for control is justified when a party's shareholding represents a controlling block,¹ has often been raised.² The possession of control usually bestows certain rights on the shareholder who holds it and the term "premium for control" implies the payment of an amount solely because of these rights.³

The rights bestowed on a shareholder by control usually include:

- the power to elect and remove the board of directors and thus indirectly govern the affairs of the

⁰Re Mason Intercity Properties, ibid., where it was held that a minority discount would only be justified if the conduct of the applicant was of such grave character that she deserved to be excluded from the company. The discount was accordingly disallowed; But see Eiserman v. Ara Farms, [1985] 5 W.W.R. 97 (Sask. C.A.), where a minority discount was disallowed because the plaintiff had forced the sale of his own shares; Irwin v. D. Coates Enterprises Ltd. (1983), B.C.L.R. 383 (S.C.).

¹This can be described as the power to vote more than 50% of the shares in a corporation.

²Gold Selection Trust Ltd. v. Humphrey, [1948] 2 All E.R. 379 (H.L.); aff'g in part [1946] 2 All E.R. 742 (C.A.); Short v. Treasury Commissioners, [1948] 1 K.B. 116 (C.A.).

³See generally, I. Campbell, supra, note 15 at paras.7-34 - 7-39; However some commentators reject the notion that either the control premium or the minority discount should be used in valuing the shares in a close corporation. See for example, Thomas Hall, "Comment: Valuing Closely Held Stock: Control Premiums and Minority Discounts" (1982) 31 Emory L. Rev. 139.

- corporation;
- the right to sell control of the corporation;
 - power to have oneself appointed an officer of the corporation and thus receive remuneration and other emoluments in excess of what would normally be paid for management services;
 - the right to determine the timing and amount of dividends to be distributed.²⁴

The suggestion that a premium should be paid for the above powers does not appear to be a very popular one.²⁵ The main criticism stems from the fact that such a premium could and would be at the expense of the price payable for the interest of the minority.²⁶ The tradition of the courts has leaned towards not recognising any premium for control where a hypothetical purchaser might be able to abuse the power acquired through payment of the control premium, to the detriment of the minority shareholders.²⁷ Nonetheless, the courts have recognised the award of a premium price over what may have been considered fair market value, where the ownership would have entitled the hypothetical purchaser to deprive the other shares of the assets of the corporation.

²⁴I. Campbell, ibid., at paras.7-34 - 7-35; See further, T. Hall, supra, note 93 at 147.

²⁵T. Hall, ibid.

²⁶Re Estate of Mann, supra, note 14.

²⁷I. Campbell, supra, note 15 at 7-34A; Re Estate of Mann, ibid.; See further, T. Hall, supra, note 93 at 139.

Here however, the action was taken within the terms and conditions of the relevant agreement.**

The matter of premiums for control was discussed in the British case of Dean v. Prince**. Here the corporation's articles provided for the shares of a deceased shareholder to be purchased by the directors of the corporation at fair market value as determined by the corporation's auditor. The majority shareholder died and a dispute arose between the widower and the surviving directors as to the value of the shares. The ability of the auditor was not called into question, and the main issue before the court was whether the block should have been valued at a premium to reflect that they carried majority voting power.

At the time of the valuation, the company was incurring losses, and based on this fact, the auditor decided against valuing its assets as those of a going concern.

The court seemed to relate the ability to control to the valuing of the business as a going concern, rather than to the valuing of the business at break-up value. It therefore upheld the auditors valuation and indicated clearly that it does not follow, simply because a block of shares constitutes a majority, that it had to be valued at a premium.

**Winram Est., *supra*, note 50.

**[1954] Ch. 409.

5. METHODS OF VALUATION

The number of methods by which the value of a corporation's shares may be calculated were limited to four by Greenburg J. in the case of Re Douglas Inc. v. Jarislowsky Fraser & Co Ltd. et al.¹⁰⁰ In his words,

"Generally accepted and recognized valuation principles and theories have postulated four approaches to the valuation of corporate shares. They are:

- a) The quoted market price on the stock exchange - the market value approach.
- b) The valuation of the net assets of the company at fair market value - the assets approach.
- c) The capitalization of maintainable earnings - the earnings investment approach.
- d) Some combination of the preceding three methods."¹⁰¹

The very nature of the close corporation as a rule however precludes the existence of a ready market for its shares and the potential purchasers of such shares are usually the remaining shareholders of the close corporation. These four methods may be employed by the parties to determine value whenever a dispute arises as to the value of shares. Regardless of which method of valuation the parties select, their real goal is usually to attempt to approximate as far as possible, the market value of the shares.¹⁰²

In the close corporation, where there is often only one

¹⁰⁰Supra, note 8.

¹⁰¹[1980] Que. S.C. 925 at 950.

¹⁰²D. Coates, supra, note 35 at 118.

class of shares, the value of a share would be a fraction of the value of the business as a whole. Consequently, the value of shares in such a corporation must be related to the value of the business in its entirety. Each party's interest should therefore be determined as an proportionate interest in the fair market value of all the issued shares en bloc, subject to minority discounts or premiums for control as applicable.¹⁰³

No method of valuation would be equally applicable to every type of business as each business would have its own unique characteristics. The selected valuation method must take account of all the factors in the interest of producing the most accurate valuation possible.

A. DETERMINATION OF MARKET VALUE

The expression "market value" can be used in two contexts. It can refer to either the "market value approach" or the "determination of market value". The market value approach refers to the use of prices quoted on a stock exchange reflecting actual transactions of purchase and sale between arm's length parties, or the price of similar types of businesses whose stocks are actively traded in the open

¹⁰³P. Gampel, supra, note 76; I.R. Campbell, "Business Valuation Aspects of the Shareholder's Agreements" Shareholders Agreements and Disagreements, (Toronto: Canadian Bar Association - Ontario Continuing Legal Education, 1986) at 3.

market.¹⁰⁴ This is the approach referred to by Greenburg J. in the Domglas case. It is used for valuing the shares of public corporations and is therefore not pertinent to the present discussion.¹⁰⁵

The market value approach is to be distinguished from the determination of market value approach.¹⁰⁶ This approach is more appropriate for valuing the shares of a close corporation where there is no free and open market for the transfer of shares.¹⁰⁷

Even though a value determination is necessary, there need be no contemplation of an actual open market transaction. Therefore possible open market purchasers are not necessarily identifiable.¹⁰⁸ This method provides for the value of shares to be determined by the price and terms of a hypothetical market situation in which a bona fide third party purchaser¹⁰⁹

¹⁰⁴P. Gampel, ibid.; Re Whitehorse Copper Mines Ltd. (1980), 10 B.L.R. 113 (B.C.S.C.).

¹⁰⁵See generally, D. Ward, supra, note 17 at F1.

¹⁰⁶Re Brant Investments Ltd. and Keeprite Inc., supra, note 73 per Anderson J. at 53; I. Campbell, supra, note 7.

¹⁰⁷C. Rohrllich, Organising Corporate and Other Business Enterprises, (New York: Matthew Bender's Co. Inc., 1987) at 2A.08[3]; Re Brant Investments Ltd., ibid., at 73.

¹⁰⁸I. Campbell, supra, note 15 at para.4-20A.

¹⁰⁹In the American case of Interfirst Bank of Dallas N.A. v. Risser 739 SW 2d 882, (Tex. App. 1987), cited by O'Neal, c.7.32, note 1, the court held that sales between family members are generally not relied upon in establishing fair market value of stock of a closely held corporation, nor are sales involving insiders, such as officers, directors and employees.

acting at arm's length offers to buy the shares.¹¹⁰

This concept was outlined by Estey J. in the case of Attorney General of Alberta v. Royal Trust¹¹¹

"It is not suggested that the Commissioner has overlooked any factor that ought properly to have been taken into account in determining the value of the property. He had to determine the market value and when, as in this case, no market value exists, it is the task of the Commissioner, so far as he can, to construct a normal market - a market which is not disturbed by factors similar to either boom or depression, and where vendors ready but not too anxious to sell, meet with purchasers ready and able to purchase, and this case is no exception."¹¹²

The concept presupposes a notional market characterized by a perfect buyer and a perfect seller through which the fair market value of the shares can be clearly established.¹¹³

In such a market the parties are assumed to be dealing at arm's length, and to be of equal negotiating ability and similar financial strength. The requirement of readiness without anxiety is stressed because it is felt that anxiety could influence the price of the shares in the same manner as could a reluctant buyer or seller.¹¹⁴

¹¹⁰O'Neal, supra, note 5 at c.7.33, classifies this method of valuation with some of the voluntary buy-sell clauses discussed earlier in this text e.g., the shotgun and restricted auction. See further infra, Chapter II notes 72-93 and accompanying text.

¹¹¹[1945] 2 D.L.R. 274 (S.C.C.).

¹¹²Ibid., at 291, quoted with approval by McIntyre J. in Re Estate of Mann, supra, note 14.

¹¹³See generally, I. Campbell, supra, note 17.

¹¹⁴G. Ovens, supra, note 13 at 22-23; I. Campbell, supra, note 15 at para.4-20A - D.

Transactions are thus assumed not to have been forced, but rather, to have been conducted in a prudent manner and to have achieved the highest price available minus any restrictions on sale.¹¹⁵ To this end, this market has been distinguished from an "open market"¹¹⁶ where transactions are constantly consummated between parties of different negotiating ability and different financial strength, and may or may not be concluded at the highest price.¹¹⁷ Therefore, an assumption that an open market transaction is prima facie evidence of fair market value may be an inaccurate one.¹¹⁸

This concept of the notional market raises the question of the extent of knowledge which should be imputed by the courts to the "ready purchaser". The issue was addressed in the case of Re Lyndall.¹¹⁹ The court here held that knowledge affecting the value of shares which would be imputed to the

¹¹⁵I. Campbell, ibid., at para.4-20D - 4-21.

¹¹⁶The courts have on occasion failed to make a similar distinction, and have in fact, used these terms interchangeably. See for example, H.P. Connor v R., [1978] C.T.C 669; aff'd [1979] C.T.C 365, (Fed. Ct.), per Mahoney J: "When one comes to value the shares of a private company, the open and unrestricted market must be assumed. That notional market ought not to be limited to the other shareholders; it should be assumed that strangers would be willing to take a position in the company at the right price and that the other shareholders would be willing to have him or meet his price." (emphasis added).

¹¹⁷For example if A, acting at arm's length from B, sold his shares to B; See further, I. Campbell, supra, note 15 at para.4-20A - 4-22.

¹¹⁸I. Campbell, supra, note 17 at D4.

¹¹⁹[1969] 3 All E.R. 984 (C.A.).

parties in a hypothetical sale, was possession of the information which a willing vendor would normally require before he was prepared to sell and a willing purchaser would normally require before he was willing to purchase. The reasoning behind this decision seemed to suggest that in normal commercial transactions a prudent purchaser would inform himself as fully as possible about the relevant facts of the prospective transaction. A similar assumption could be made about the vendor, though the purchaser may be better informed than the vendor in relation to his ability to utilize the business to be purchased.¹²⁰

The criticisms of this method of valuation have surrounded the concept of the notional market. The idea of a market with the required features is thought to be difficult to construct unless one is in possession of all the relevant information which would normally be considered by both parties to the transaction prior to its completion.¹²¹

There is also some question as to whether or not the concept of the notional market makes adequate provision for purchasers with special motives. This type of purchaser is common in the reality of the open market and in fact, is often prepared to pay a higher price than a purchaser without a

¹²⁰I. Campbell, ibid, note 15 at para.4-20C.

¹²¹ibid., at para.4-20D.

comparable interest.¹²²²

If the term "open market" is accepted as implying "a market from which no potential purchaser is excluded",¹²²³ then it should follow that where special interest purchaser considerations exist these should be considered when the fair market value is being determined.¹²²⁴

As a practical matter, it may be difficult to identify special interest purchasers and to quantify the prices they might pay for an interest in the particular business being valued. However, where such special interest purchasers can be identified, the fair market value or fair value of the shares of the business, becomes the price which the special interest purchaser might be willing to pay to obtain the shares.¹²²⁵

The determination of the market value may involve some degree of conjecture and speculation which may vary from court to court. There can therefore be no fixed rules for dealing with the many issues which this method of valuation may raise. The following observation made by Widgery L.J. in Re

¹²²²I. Campbell, supra, note 17 at D5; R. Wise, supra, note 10 at 629.

¹²²³Re Lyndall, [1969] 3 All E.R. 984 (C.A.), per Harmon L.J. at 990; Holt v. I.R.C., [1953] 2 All E.R. 1499 (Ch. D.); Utermyer Estate v. A.G. for British Columbia, [1929] S.C.R. 84 (S.C.C.); I.R.C. v. Clay, [1914] 3 K.B. 466 (C.A.).

¹²²⁴Robinson Brothers (Brewers) Ltd. v. County Durham Assessment, [1938] A.C. 321 (H.L.); Edmund Littler Sr. v. M.N.R. supra, note 66.

¹²²⁵I. Campbell, supra, note 17 at D5.

Lyndall,¹²⁶ may however, be a useful guide:

"It is desirable, in my opinion, that when the court is constructing the conditions under which the hypothetical sale is deemed to take place it should build on a foundation of reality, so far as this is possible, but it is even more important that it should not defeat the intention of the section by an undue concern for reality in what is essentially a hypothetical situation."¹²⁷

This hypothetical market situation has sometimes been applied to cases where there are in fact restrictions on the sale of shares. In such cases the purchaser may take account of such restrictions when arriving at the market value.¹²⁸

B. FORMULA METHODS

When employing a formula method of valuation, the agreement provides a mathematical formula by which the value of the corporation and its shares can be calculated.

The main disadvantage in using formula methods of valuation is that formulas are usually fixed, and therefore cannot take account of possible changes in the business. The particular formula method provided in the agreement may become unsuitable five or ten years later.¹²⁹

¹²⁶Supra, note 119.

¹²⁷Ibid., at 992.

¹²⁸I.R.C. v. Crossman, [1937] A.C. 26 (H.L.); But see, Beament Estate v M.N.R. (1970), 11 D.L.R. (2d) 237, [1970 C.T.C. 193 (S.C.C.); rev'g [1968] C.T.C. 588, 69 D.T.C. 5016 (Ex. Ct.). Here the court held that the proper value could not exceed the amount that could be obtained for the shares on a winding up as provided for in the shareholder agreement. See generally, I. Campbell, supra, note 42 at 298-300.

¹²⁹I. Campbell, ibid., at 310.

The definition of terms is very important in formula valuations. In many instances of litigation in this area, the uncertainty created by the language used in the formula, is the major reason for the parties having to resort to the courts.¹³⁰

There are basically two variations of the formula based valuation method. These are:

- i) the capitalization of earnings approach; and
- ii) the net asset approach.

I. CAPITALIZATION OF EARNINGS APPROACH

The capitalization of earnings method of valuation may be approached using either the future earnings of the corporation or the realized earnings of the corporation.¹³¹

The use of future earnings of the corporation to calculate the capitalization of earnings rate is really a prophesy of the corporation's future earnings.¹³² This approach is apparently preferred by persons calculating the shares of going concerns, on the reasoning that the worth of a corporation can usually be determined by its ability to

¹³⁰See R. Blainey, supra, note 27 at 13-15, for the description of such a case.

¹³¹For discussion of special variations of the capitalization of earnings valuation technique, see H.J. Haynsworth, "Valuation of Business Interests" (1982) 33 Mercer L. Rev. 457 at 478-480.

¹³²J. Bonbright, supra, note 20 at 249-253.

generate an appropriate rate of return on investment.¹³³

This method of valuation involves the computing of two figures, the net maintainable earnings, and an appropriate earnings multiplier.¹³⁴ In calculating the net maintainable earnings, several factors may be considered. These include, the actual earnings for the last fiscal year before the event triggering the valuation, the earnings for a twelve-month period ending immediately at the time of the event precipitating valuation, and the projected earnings for the fiscal year in which the event occurred.¹³⁵ The testimony of expert witnesses is relied on in arriving at these figures.

This future earnings approach may ensure a more accurate valuation because the alternative method, the determination of the capitalization rate using realized earnings, has no appraisal significance except as an index of future earning power.¹³⁶ The future earnings method is also much easier to administer.

This method seems only to be preferred for the valuation of new enterprises, where realized earnings figures are unavailable. This may be because future earnings are often difficult to estimate directly.

¹³³J. Bonbright, ibid.; Douglas, supra, note 8; D. Ward, supra, note 17 at F25.

¹³⁴G. Fraser, supra, note 61 at E4-E5; D. Ward, ibid., at F25.

¹³⁵D. Ward, ibid.; Douglas, supra, note 8 at 221.

¹³⁶J. Bonbright, supra, note 20 at 263.

Another problem with this method of valuation is the discrepancies in the testimonies of the expert witnesses.¹³⁷ This problem often arises in litigation and the courts are inclined to exclude conflicting testimony from the record.¹³⁸

Where realized earnings are being used to calculate the capitalization of earnings rate, the profitability (i.e. cash flow of the corporation projected over the long range), and the cost of capital (i.e. the required rate of return) are noted over a period of time. These amounts may be adjusted to make allowances for extraordinary non-recurring profits or losses made in any year in order to portray a more accurate reflection of underlying profitability.¹³⁹

The final figures are then combined with the actual cash

¹³⁷See further, V. Krishna, supra, note 18 at 164-165; and D. Ward, supra, note 17 at F27-F28, for comments on expert testimony; See also, Les Investments Mont Soleil Ltd. v. Nat. Drug Ltd., [1982] C.S. 716, 22 B.L.R. 139 (Que. S.C.), where the court noted that while expert opinions should be used to assist the courts, it is not obliged to follow them.

¹³⁸Morrison v. United Westburne Ltd. and Dumez Invt. I. Inc. (United Westburne Ltd. (15 April, 1988) No. RE1926/87, where the court showed a preference for a capitalized earnings approach based on "maintainable earnings" (i.e. the level of earnings which the corporation could reasonably be expected to maintain over a period of time). A similar approach provided by an expert witness but based on "future earnings" was therefore rejected; Connor v. R. (1978), 78 D.T.C. 6497; aff'd (1979), 79 D.T.C. 5256 (F.C.).

¹³⁹Profits or losses made during the initial years of the business may not be a true indication of the real earning capacity of the business. It has even been suggested that any valuation based on these earlier figures may not be valid; See further, D. Coates, supra, note 35 at 120; H. Fraser, supra, note 61 at E4-E5.

flow to reflect any decrease in the value of the business.¹⁴⁰ This exercise is best taken over a period of years, whereby the recurring and non-recurring profits can be excluded or included accordingly.¹⁴¹

The above calculations are then subject to further adjustment based on other significant factors such as individual executive salaries. The salary factor is particularly important in a small private corporation, where most of the corporation's profits may be paid out in the form of executive salaries.¹⁴² Valuers therefore have to consider matters such as replacement salaries if the need for these may arise as a result of the departure of a shareholder.¹⁴³

In some cases, the executive salaries may have been disproportionately high, in which case replacement salaries may result in increased profits being reflected. On the other hand, where executive salaries were low an increase may be needed to attract management personnel with similar

¹⁴⁰It has been further suggested that instructions setting out a future method of calculating depreciation be included in any such formula. See further, D. Coates, ibid., at 119-120.

¹⁴¹Every business is said to have a cycle, extending over a period of years, in which it records profit and loss patterns. Such cycles also take into account both internal and external influencing factors of the particular business. See further, G. Ovens, supra, note 52 at 66.

¹⁴²D. Huberman, supra, note 40 at 569; D. Coates, supra, note 35 at 119, note 106.

¹⁴³G. Ovens, supra, note 52 at 66-67.

qualifications. A decrease in profits may therefore be reflected.¹⁴⁴

The quantum of these salaries may also affect the timing of the valuation, that is, whether or not they should be taken into account in computing the corporation's annual income.¹⁴⁵ This is significant in the close corporation where most of the profits are taken out in the form of executive salaries and accordingly the corporation's books may not reflect the true earning power of the business.¹⁴⁶

The average profit arrived at after the above adjustments and calculations have been made is then multiplied by an earnings multiple. The earnings multiplier is a function of the existing rates of return of different types of investments and the "quality" of the anticipated level of future earnings.¹⁴⁷ This multiple is selected after a review of salient factors relating to the business including economic conditions, interest rates, inflation and transactions in ownership positions of reasonably comparable corporations. The resulting figures are supposed to reflect the value of a corporation according to its ability to generate profit.¹⁴⁸

The main advantage of the capitalization of earnings

¹⁴⁴Ibid..

¹⁴⁵D. Coates, supra, note 35 at 119.

¹⁴⁶D. Huberman, supra, note 40 at 569.

¹⁴⁷D. Ward, supra, note 17 at F25-F26.

¹⁴⁸H. Fraser, supra, note 61 at E8.

method of valuation, regardless of whether the future or realised earnings approach is being used, seems to be that, because it considers the capitalization rate, this method manages to account for intangible assets such as goodwill.¹⁴⁹ Many criticisms can however be levelled against it.¹⁵⁰

In the first instance, parties employing this method may find some difficulty in defining the term "earnings". Providing a suitable definition raises questions such as when the valuation should be computed, i.e. before or after salaries and or taxes.

Secondly, even though this method manages to take account of goodwill and other intangible assets,¹⁵¹ it does not allow for extraordinary events, for example, where the future earning capacity of the business is affected over the short term by the loss of intangibles, such as goodwill where a valued shareholder/employee leaves the business.

Thirdly, this method may be unreliable as it places much dependence on a multiplier which is based substantially on a calculation of the earnings of similar types of businesses. Given that the valuation of shares is essentially a prophesy as to the future, it may be unwise to attach too much weight to the price/earnings ratio of similar companies in a similar

¹⁴⁹D. Coates, supra, note 35 at 119.

¹⁵⁰See generally, O'Neal, supra, note 3 at c.7.33.

¹⁵¹See infra, Chapter III 52-58 notes and accompanying text.

type of business.¹⁵² These prices tend to fluctuate and may be unreliable as part of a formula for determining the value of the shares of a close corporation at any point in time.

Also, earnings calculations are usually based on generally accepted accounting principles (GAAP), and different corporations in the industry may use different accounting practices, all of which may be generally acceptable. This may present some discrepancies as the earnings per share of two identical corporations with identical gross revenues and expenses may be expressed quite differently, even though they each conform to the GAAP.¹⁵³

This method may also involve the appointment of a professional appraiser to undertake the analysis necessary to secure the correct capitalization rate. This may result in further expenditure and possible delays which may make this method of valuation even less attractive to the shareholders of a close corporation.

II. NET ASSET APPROACH

In contrast to the capitalization of earnings approach, the net asset approach to valuation is more appropriate if the value of the business based on earnings is less than the net value of its assets on a liquidation.¹⁵⁴ The net asset

¹⁵²H.O. Spindler & D.Y. Timbrell, Canadian Estate Planning (Ottawa: CCH Canadian Ltd., 1966) at 15.

¹⁵³V. Krishna, supra, note 18 at 149.

¹⁵⁴D. Ward, supra, note 17 at F25.

approach to valuation may be either:

- a) the liquidation value of a business; or
- b) the book value of a business.¹⁵⁵

(A) LIQUIDATION VALUE

In the case of the liquidation value, the assets of the corporation are valued as if the corporation were liquidated. This form of valuation assumes that the sale is conducted under orderly circumstances, and not as a result of fire sale conditions.

The final valuation is the amount realizable after expenditures such as the commissions on disposal, income taxes, legal and accounting fees, severance pay and shut-down costs are deducted. The liquidation value amounts to the adjusted equity value less the cost of liquidation.¹⁵⁶

This method has been criticised on the basis that it is derived from the assumption that the enterprise is not a going concern. It therefore fails to take adequate account of the individual aspects of the business. Accordingly, the business is not valued as a whole component with operational assets so it may be found to be worth less than its actual value.¹⁵⁷

This method of valuation may be appropriate in cases where the corporation is insolvent, operating at a loss or has

¹⁵⁵R. Blainey, supra, note 27 at 3.

¹⁵⁶S. Cole, supra, note 6 at J3.

¹⁵⁷V. Krishna, supra, note 18 at 155.

redundant assets.¹⁵⁸ Where the business is being valued as a going concern, liquidation value may also be used to provide supplementary assistance in the assessment of risk. The risk factor may have some indirect influence on the value of a going concern.¹⁵⁹

(B) BOOK VALUE

The book value of the corporation is the value appearing in the corporation's financial statement. Therefore, the net value per share is determined by an aggregation of the historical cost of the corporation's assets, less corporate liabilities and accumulated depreciation of assets. The resulting figure (called the shareholder's equity) is then divided by the number of the corporation's participating shares.¹⁶⁰

This method of valuation is probably the most frequently used. Its attraction seems to lie in the apparent simplicity of its calculation. However, the inadequacies inherent in this method of valuation may outweigh its advantages.¹⁶¹

In the first instance, the book value approach is based on the historical record of the value of the assets of the

¹⁵⁸Ibid.

¹⁵⁹S. Cole, supra, note 6 J2-J3.

¹⁶⁰ For a comprehensive checklist of factors to be taken into account when calculating book value see generally, G. Ovens, supra, note 52 at 67-70.

¹⁶¹D. Huberman, supra, note 40 at 568.

corporation. In most cases these may be nominal amounts relative to the true value of the business.¹⁶²

Additionally, book value does not take account of the earnings potential of the business or of intangible assets such as patents and in some cases, the value of goodwill.¹⁶³ These intangible assets could be a very valuable aspect of a corporation's worth.

This method has also been criticised as being unreliable if fixed assets of some age are involved. Market appreciation over the costs of such assets is rarely reflected in this type of valuation even though in periods of rising costs, replacement costs may be considerably higher than the original cost of the assets. This is particularly true of the valuation of land. Also, machinery and equipment which may have been written off on the corporation's books may still be valuable and may even be sold for a substantial sum.¹⁶⁴ By the same token, a fall in prices might cause assets to be valued at prices in excess of their actual value.¹⁶⁵

¹⁶²D. Coates, supra, note 35 at 119.

¹⁶³D. Huberman, supra, note 40 at 568; But see G. Ovens, supra, note 52 at 67, where reference is made to "goodwill at its book value", which usually represents goodwill which the corporation may have on its balance sheets, typically as a result of acquiring a business, but which would seldom represent the total goodwill of the business; See also, O'Neal, supra, note 5 at c.7.33, for a description of the ARM34 formula which can also be used to calculate the value of goodwill.

¹⁶⁴O'Neal, supra, note 3 at c.7.30.

¹⁶⁵C. Rohrllich, supra, note 107 at para.2A.08[1].

A further consideration may be that management has a great deal of control over the value of assets to be recorded on the books and may be able to manipulate book value to the detriment of the minority shareholder.¹⁶⁶

Notwithstanding the above considerations, book value may be acceptable where the corporation's assets are very liquid and turn over frequently.

Parties employing the book value method should consider the following factors. First, the agreement should provide for the date at which book value would be determined (possibly the date of the corporation's last financial statement if this is computed annually, or alternatively, the date at which the event triggering the valuation occurred). In the latter case, if this date is far removed from the date of the financial statement, then the agreement should also provide for some form of adjustment of the book value, in which case the nature and extent of these adjustments should be clearly set out in the agreement.¹⁶⁷

Secondly, the agreement should stipulate whether intangibles such as goodwill should be treated as asset items and if so, how their value should be computed. In some instances, goodwill may be discounted because the loss of the withdrawing shareholder may considerably reduce both the goodwill and the earning capacity of the business.¹⁶⁸

¹⁶⁶O'Neal, supra, note 3 at c.7.30.

¹⁶⁷Ibid.

¹⁶⁸Ibid.

C. COMBINATION METHODS

As noted earlier, the aim of any valuation arrangement should be to approximate as far as possible the actual market value of the shares regardless of whether or not such a value exists. In some cases, therefore, it may be found that a combination of two or more methods may best suit a particular situation¹⁶⁹ or alternatively, different methods may be appropriate for the same business, but at different points in time.¹⁷⁰

The question of whether or not a combination method is the most appropriate would depend on the facts and circumstances of each case. This point was noted in the case of Domglas v. Jarislowsky, Fraser & Co.¹⁷¹

"The combined approach to share valuation gives regard to the principle that such valuation is not based as much on a priori concepts as it is on empirical evidence."¹⁷²

This approach has been recognised and applied by the courts in the interest of determining the accurate valuation

¹⁶⁹See O'Neal, ibid., at c.7.36, for some interesting examples of possible combination methods which can be used for share valuation.

¹⁷⁰Arams v Filliman (1955), 128 N.N.(2d) 284 (N.Y.C.A.). Here valuation on an inter vivos transfer was by arbitration but on death the valuation was calculated at book value.

¹⁷¹Supra, note 8.

¹⁷²Ibid., per Greenburg J. at 955.

for shares.¹⁷³

8. CONCLUSION

Share valuation is an important aspect of the buy-sell agreement. This will ultimately determine whether or not the parties to the agreement will receive an acceptable reimbursement for their investment.

Parties attempting to conduct a share valuation have to take account of several factors, including the valuation issues, particularly questions of minority discounts and premiums for control. An appropriate valuation procedure and method of calculating the valuation should also be selected. Each of these factors will play an important role in ensuring a fair and realistic value for the corporation's shares.

¹⁷³Jakobson et al. v Agassiz Ent. (1980) Ltd. (1988), 49 Man. R. (2d) 270 (Q.B.). Here a combination of two methods (the capitalization of earnings method and the net asset method) was found to be the most appropriate for valuing the shares of a business that had expanded considerably a year before the amalgamation proceedings which triggered the valuation.

CHAPTER IV

FUNDING THE BUY-SELL AGREEMENT

1. GENERAL

An important aspect in the operation of the buy-sell agreement is the provision of some mechanism for financing the purchase of the shares covered by the agreement. This is particularly significant where the agreement is operative on a specific event, for example, death or disability and the remaining shareholders are obliged to produce the cash over a short period of time to fund the purchase of the shares.¹ Funding provisions may also be necessary to facilitate the operation of the shotgun and restricted auction provisions.²

In some cases wealthy shareholders may have liquid assets available to them at the required time. In other cases, the shares may be the only valuable asset that the shareholder possesses and, in the absence of adequate arrangements for financing the buy-sell agreement, there is the possibility that the agreement may not operate to serve the interests of the parties at the relevant time.³

Funding provisions should always be arranged in advance,

¹H.J. Kellough & R.B. Zien, "Corporate Share Repurchase Plans: An Alternative to Shareholders' Buy-Sell Agreements" (1977) 25 Can. Tax J. 475.

²See infra Chapter II, notes 72-93 and accompanying text.

³D.P. Coates, "Share Transfer and Transmission Restrictions In The Close Corporation" (1968) 3 U.B.C.L. Rev. 96 at 122; M.C. Cullity, R.E. Forbes, and C. Brown, Taxation and Estate Planning, (Toronto: Carswell, 1984) at 625.

and should be included in the buy-sell agreement from its inception.⁴ The shareholders should also decide whether the purchase price should be paid in full immediately or whether all or part of the price should be payable over a period of time. Where the price is to be paid in full immediately, the parties should also determine in advance the source of the funds, that is to say, whether the funds would be generated through borrowings, their own resources, the corporation, or from insurance.

On the other hand, if it is to be paid over a period of time, the parties should determine the length of the period, the amount and type of security which would be acceptable, the applicable interest rate, and the sources of these future payments.⁵

The sources and methods of funding can be divided into two categories, testamentary funding and inter vivos funding.

Life insurance is the most effective means of funding the buy-sell agreement in the event of the death of a shareholder. This chapter therefore discusses the types of insurance available for funding the buy-sell agreement, and the insurance arrangements which the parties can implement. The more successful methods of inter vivos funding of share

⁴D.S.M. Huberman, "Buy and Sell Agreements for the Canadian Close Corporation" (1963) Can. B. Rev. 538 at 549.

⁵D.W. Smith, "Buy-Sell Agreements", Report Of The Proceedings Of The Thirty-First Tax Conference, 1970 Conference Report, (Toronto: Canadian Tax Foundation, 1980) 665 at 681.

transfers are also discussed.

There are three distinct groups of potential purchasers for the shares covered by the buy-sell agreement. These are: outside third parties, the remaining shareholders, and the corporation itself. Where the operation of the buy-sell agreement involves the purchase of shares by an outsider, it is usually not incumbent on the shareholders who are party to the agreement to provide for the financing of such a purchase. When the buy-sell agreement is being prepared, the shareholders usually have no knowledge of the identity or financial standing of the future purchasers.

Funding arrangements can therefore only be made for purchases by the shareholders who are themselves party to the buy-sell agreement and purchases by the corporation itself.

2. CORPORATE PURCHASE

The common law position on corporate share repurchase was clearly established in the case of Trevor v. Whitworth.^{*} This case held that it was illegal for a corporation to purchase its own issued shares. The principle underlying this position, was the belief that the corporation's capital was a fund for the carrying on of the corporation's business and the payment of creditors, and that the purchase of its own shares

^{*}[1887] 12 A.C. 409 (H.L.)

would involve a misapplication and reduction of that fund.⁷

This common law position held good in the Canadian courts for several years.⁸ It has since been abrogated by legislation in several provinces, which now makes it legal for a corporation to purchase its own shares subject to certain safeguards.⁹ It is therefore now possible to include the corporation itself as a purchaser in the buy-sell agreement.¹⁰

Where the corporation is included as a purchaser, the main source of acquiring the funds is through the use of corporate-owned life insurance. The corporation would own insurance on the lives of the shareholders, with the corporation or the other shareholders as beneficiaries. When a shareholder dies, the proceeds from the insurance policy would be used to

⁷H. Sutherland, D.B. Horsey, & J.M. Edmiston, Fraser's Handbook On Canadian Company Law, 7th ed. (Toronto: Carswell, 1985) at 198.

⁸E.g., In re Medical Building Ltd., [1953] 9 W.W.R. 278 (Sask. Q.B.); Re Northern Canadian Mortgage Co. Ltd. and Moore v. Northwood (1960), 22 D.L.R. (2d) 698 (Man. C.A.); Hamer v. National Forest Products Ltd. (1964), 44 D.L.R. (2d) 757 (B.C.S.C.).

⁹See for example, Canada Business Corporations Act, S.C. 1974-75-76, c.33, as amended by S.C. 1985, c. C-44, as amended, (hereinafter called the C.B.C.A.) ss.30-38; Business Corporations Act 1982, S.O. 1982, c.4, (hereinafter called the O.B.C.A.) ss.29-36; Business Corporations Act, S.A. 1981, c.B-15, (hereinafter called the A.B.C.A.) ss.32-39; Angus v. R. Angus Alberta Ltd. (1988), 58 Alta. L.R. (2d) 76 (C.A.).

¹⁰See generally, L. Getz, "Some Aspects of Corporate Share Repurchase" (1974) U.B.C.L. Rev. 9, for some discussion of the history and development of the law relating to corporate share repurchase in Canada.

purchase the shares from the deceased's estate.¹¹

One of the advantages of corporate share repurchase is that the surviving shareholders' percentage interest in the corporation would increase pro rata as a result of the corporate repurchase of the shares of the deceased shareholder for cancellation.¹²

There are some disadvantages to having the corporation as the purchaser. The most significant of these disadvantages is that most Canadian corporate legislation prohibits the corporation from purchasing its own shares if it is insolvent or if the purchase would result in it becoming insolvent.¹³

The corporation may also implement schemes to assist shareholder purchase. These are discussed below under the heading "Purchase by Shareholders".

¹¹See further infra, Chapter IV notes 74-85 and accompanying text, for discussion on corporate owned-life insurance. See also infra, Chapter V, notes 89-108 and accompanying text for some discussion of the tax implications of corporate share repurchase.

¹²J. Bernstein, Shareholder Agreements: A Tax and Legal Guide, (Don Mills, Ontario: CCH Canadian Ltd., 1988) at para. 418; See also infra, Chapter IV notes 74-85 and accompanying text.

¹³"-A corporation may not make any payment to purchase or otherwise acquire shares issued by it if there are reasonable grounds for believing that

- (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
- (b) the realizable value if the corporation's assets would after the payment be less than the aggregate of its liabilities and stated capital of all classes."-C.B.C.A. subsection 34(2).

See also, O.B.C.A subsection 30(2); A.B.C.A. subsection 32(2).

3. PURCHASE BY SHAREHOLDERS

Life insurance may provide the most effective means of financing the purchase of the deceased shareholder's interest by the remaining shareholders.

The corporation may also retain a percentage of its profits which it could then pay to shareholders in the form of dividends so that they may repurchase shares at the relevant time.¹⁴

It may also be possible for the corporation to minimize its value prior to such a buy-out by annually distributing after-tax profits to shareholders in the form of dividends and bonuses.¹⁵ The minimized value would be reflected in an overall lower price for the corporation's shares.

Additionally, where a shareholder owns shares through a holding corporation, the corporation's business earnings may be distributed on a regular basis through the holding corporation without the corporation being subject to Part IV tax¹⁶ on dividends paid by the operating corporation.¹⁷

¹⁴J. Bernstein, Tax Planning for Professionals and Executives, (Don Mills, Ontario: CCH Canadian Ltd. 1983), at 135, para.1028.

¹⁵J.F. Kennedy, "Shareholders' Agreements" in Special Lectures of the Law Society Of Upper Canada, Recent Developments in Estate Planning and Administration, (Toronto: Richard De Boo Publishers, 1980) 316 at 326; D. Smith, supra, note 5 at 681; J. Bernstein, ibid., at 135, para.1028.

¹⁶I.e special tax on certain amounts of dividend income levied by the Act and added to the corporation's refundable dividend tax on hand. In effect the tax becomes fully refundable to the corporation if and when it in turn pays a taxable dividend to its shareholders. See further, G.M.

4. TESTAMENTARY FUNDING - LIFE INSURANCE

Where the option or obligation to purchase results from the death of a shareholder, the parties can use life insurance to fund the purchase price. This method of funding ensures the availability of sufficient cash at the relevant time.¹⁸

The use of life insurance for this purpose is probably the most successful means of funding the buy-sell agreement.¹⁹ Its main advantage is that the cash is readily available for the completion of the transactions under the buy-sell agreement.²⁰ This method of funding may also overcome many of the problems associated with the other funding schemes which are discussed later in this chapter.²¹

When insurance is used for funding a share purchase

Cooley, Tax Principles To Remember, (Toronto: The Canadian Institute Of Chartered Accountants, 1983) at 15.23.

¹⁷Income Tax (Canada) Act, S.C. 1970-71-72, c.33, subsections 186(1), and 186(4); See also, D. Smith, supra, note 5 at 682.

¹⁸F.H. O'Neal, & R.B. Thompson, O'Neal's Close Corporations, (Illinois: Callaghan's Company, 1987), 3d ed., c.7.37.

¹⁹H. Kellough, supra, note 1 at 475; M. Cullity, supra, note 3 at 626.

²⁰T.A. Sweeney & D.T. Tetreault, "Income Tax Considerations in Shareholders' Agreements In Context of the Budget Proposals of May 23, 1985", Shareholders Agreements and Disagreements (Toronto: Canadian Bar Association - Continuing Legal Education, 1986) at 18; D. Huberman, supra, note 4 at 550, ". . .the disaster which will create the need for cash can also be utilized to provide that cash."

²¹See further, infra, Chapter IV, notes 106-127 and accompanying text.

FUNDING

123

pursuant to a buy-sell agreement, policies are taken out on the lives of the shareholders. When a shareholder dies, the proceeds from the policy are paid out by the insurance company. This amount is then applied to the purchase of the shares of the deceased shareholder.

In the case of larger shareholdings, shareholders should not necessarily seek to fully fund the obligation to purchase on death. The amounts needed to fund such large undertakings may require high premiums, the provision of which may affect the stability of the business over a short period of time. Shareholders may therefore prefer to provide only for sufficient coverage for a substantial down payment of the purchase price with the balance payable over a period of time.²²

The legality of using life insurance to fund the buy-sell agreement seems to be generally accepted.²³ Subsection 156(e) of the Insurance Act²⁴ provides that a person has an insurable interest in the life of another if he or she has a pecuniary interest in the life of that other. The Act further

²²T. Sweeney, supra, note 20 at 16-18.

²³Re Cote Estate (1941), 3 D.L.R. 523; 22 C.B.R. 387 (Ont. H.C.J.); Re Northern Life Assurance Co. and Fawcette, [1932] 1 W.W.R. (Sask. K.B.), In both of these cases the court gave effect to the disposition of the insurance proceeds and trusts created by agreement, which required the purchase of a partnership's assets in one case, and the purchase of shares in another. The question of insurable interest was not discussed in either case.

²⁴R.S.O. 1980 c.218, as amended S.O.1987 c.8.

provides that a person has an insurable interest in the life of another only if the other person consents in writing to the taking out of the insurance.²⁵ This section allows shareholders to own insurance on the lives of each other. These provisions can be seen as covering the situations created by the buy-sell agreement.²⁶

The shareholders or the corporation, rather than the deceased shareholder's estate should be the owners and the beneficiaries of the insurance policies. This would ensure the smooth administration of the buy-sell agreement at the appointed time.

A corporate trustee or another person acting as a trustee, may be employed to administer the insurance arrangement. An experienced trustee can usually be relied on to keep the documents carefully and properly, and the possibility of the parties having to resort to legal action to enforce the buy-sell agreement would be minimized.²⁷

The trustee would be a depository to the life insurance policies and the recipient of the benefits under the policies. He or she would supervise the premium payments, receive the benefits under the insurance policy and distribute these in

²⁵Para.156(2)(b).

²⁶D. Coates, supra, note 3 at 123; D. Huberman, supra, note 4 at 551.

²⁷O'Neal, supra, note 18 at c.7.37; D.P. Coates, ibid., at 123; See generally, G.J. Couch, Couch Encyclopedia of Insurance Law (New York: The Lawyers Co-operative Publishing Co., 1984).

accordance with the agreement. He or she should also be party to the agreement and any changes in the agreement which would affect the trustee should require the consent of the trustee.²⁸

The cost of the services of a trustee may make this arrangement prohibitive to the shareholders of a small corporation with limited capital.

There are several tax consequences associated with the use of life insurance to fund buy-sell agreements.²⁹ The parties interested in employing such a scheme should consult an experienced insurance underwriter, and possibly a trust officer and a tax specialist.³⁰

One disadvantage in using life insurance to finance the buy-sell agreement is the cost of some types of insurance. The parties would have to decide in each individual situation whether the objective of such insurance justifies the cost. They also have to be aware that in the absence of insurance they may be forced to produce the required amounts on short notice.³¹

The amount of the insurance should be reviewed periodically to ensure that it is adequate to cover the needs

²⁸J. Bernstein, supra, note 12 at para.436.

²⁹See further infra, Chapter V notes 122-152 and accompanying text, for discussion on the tax consequences resulting from the use of insurance to fund buy-sell agreements.

³⁰O'Neal, supra, note 18 at c.7.37.

³¹O'Neal, ibid., at c.7.37.

of the shareholders and the corporation in accordance with the financial development of the corporation.

The buy-sell agreement should specify who is to pay which premiums and should also establish some mechanism for determining annually whether or not these premiums have in fact been paid. The services of a trustee may be useful in this instance.

The agreement may also provide that on the death of a shareholder, the estate of the deceased should assign any policy which the deceased owned on the lives of the other shareholders, to those shareholders whose lives are insured.

On termination of the agreement by reason other than death, the agreement should provide that the insurance policies on the life of the withdrawing shareholder, as well as the policy or policies which he or she holds on the lives of other shareholders, should be assigned to the remaining shareholders whose lives are insured or they should be allowed to lapse.²²

The insurance corporation may have a policy of refusing payment in some cases of fraud or suicide. Where the shares are to be purchased immediately after death, this could present a problem for the remaining shareholders and the deceased shareholder's family. Parties may provide that in such cases the payment would be negotiated at the time of death, perhaps using one of the inter vivos methods discussed

²²J. Bernstein, supra, note 12 at para.436.

below.³³

The discussion on the use of insurance to fund buy-sell agreements can be divided into two parts:

- a) the various types of insurance policies available; and
- b) the various arrangements which can be made utilizing the available policies.

A. TYPES OF INSURANCE

Before life insurance can be successfully employed, several factors have to be considered. These include the objectives of the individuals, their ages, insurability, the nature of the business, and the tax brackets of the corporation and the individual shareholders.

These factors, whether taken individually or collectively, may present a different picture in every situation. Each case would therefore have to be looked at on its particular facts to determine which type of coverage is the most suitable.

There seems to be no general rule for classifying the various types of life insurance. It is however generally accepted that the life insurance arrangements used for funding buy-sell agreements are basically variations of four types of insurance. These are:

³³See further, Chapter IV notes 106-127 and accompanying text.

- i) term insurance;
- ii) participating whole of life insurance;
- iii) term to 100 insurance; and
- iv) joint-life insurance.³⁴

These four types of insurance will be discussed individually.

I. TERM INSURANCE

This type of insurance represents coverage for the pure risk of mortality and is the least expensive. The term of the policy may be one, five or a specified number of years until the insured attains a certain age beyond which the coverage ultimately ceases to be available. The cost of term insurance is constant for the original term but it increases as the shareholder gets older.³⁵

There are many variations of this type of insurance and the price differences are based on individual premium schedules. The premium schedules available are level premium, five year increasing, and ten year increasing.³⁶ If the policy is cancelled at any time prior to death, no portion of

³⁴D.R. Drinkwalter, "The Uses Of Life Insurance Since The Repeal Of The Ontario Secession Duty Act and The Gift Tax Act" in Special Lectures of the Law Society of Upper Canada, Recent Developments in Estate Planning and Administration, (Toronto: Richard De Boo Publishers, 1980) 229 at 232-233; P. Fosbery, "The Use and Importance of Life Insurance in Shareholders' Agreements" Shareholders' Rights and Procedures, (Toronto: Insight Press, 1985).

³⁵P. Fosbery, ibid., at 1.

³⁶P. Fosbery, ibid.

the premiums are refundable to the owners of the policy.³⁷

The policy is convertible and/or renewable. Where the insurance policy is convertible, the insured has an option at any time up to a pre-determined age, to change the policy to a term to 100,³⁸ or a whole of life policy,³⁹ once he pays the cost of the changeover. However, the cost of the conversion rises steeply when the insured passes the ages of sixty, sixty-five, and seventy.⁴⁰

Renewable term insurance policies are sometimes subject to either medical or pricing assessments. This means that the insurance company reserves the right to set higher premiums where the insured's medical condition has deteriorated between the original date of the policy and the renewal date. Where interest rates are higher at the renewal date, some companies may also increase premiums to compensate for their costs.⁴¹

It may be possible to guarantee renewal without a new medical examination, by the payment of an additional cost on the original premiums to obtain a rider which would permit renewal of the policy without renewed proof of insurability.

³⁷J. Bernstein, supra, note 12 at para.308.

³⁸See further infra, Chapter IV notes 54-57 and accompanying text.

³⁹See further infra, Chapter IV notes 47-53 and accompanying text.

⁴⁰D. Drinkwalter, supra, note 34 at 232; See further, J. Bernstein, supra, note 12 at para.308.

⁴¹D. Drinkwalter, supra, note 34 at 232.

Some insurance companies do not permit renewal after the age of 65, others offer term insurance up to the age of 75.⁴²

Parties considering purchasing term insurance should make enquiries about the insurance company's practices concerning premium adjustments. If they feel uncomfortable with the uncertainty which such adjustments could create, it may be wiser for them to seek an insurance company whose rates are guaranteed.⁴³

The main advantage of term insurance is the initial low cost of the premiums, especially where the shareholders are younger. This type of insurance is also very useful in the buy-sell agreement, as it can provide for the payment of the purchase price on the death of a shareholder whenever that death occurs.⁴⁴ Also, in the case of a new business heavily encumbered by debt, term insurance may be the only type of insurance available to the parties.

However, where the shareholders are older, but are involved in a permanent business which they intend to pass on to their children, term insurance may not be the most suitable form of insurance.⁴⁵ This is because the insurance coverage ultimately ceases to be available and the face amount of the policy is only payable on death. If the policy is not

⁴²J. Bernstein, supra, note 12 at para.308.

⁴³P. Fosbery, supra, note 34 at p.1.

⁴⁴J. Bernstein, supra, note 12 at para.308.

⁴⁵D. Drinkwater, supra, note 34 at 232.

converted before the older insured shareholder dies or becomes ineligible for a policy renewal or if the insured lives beyond the age of 75, the parties would be unable to rely on the proceeds of the policy.

Because of its low cost, term insurance may be the most attractive type of insurance when the business is in its teething stage.⁴⁶ The policy can then be converted once the parties are in a position to afford the higher premiums required by the other types of insurance.

II. WHOLE OF LIFE

Whole of life, or ordinary life insurance, as it is sometimes called, is permanent insurance. It pays a face value on the death of the insured whenever that event may occur, provided the policy is still in force.⁴⁷ The whole of life policy can also be either participating (in which case the insurance company pays dividends to its owner based on the profitability of the life insurance company), or it can be non-participating.

The premiums for this type of policy are usually more expensive than term insurance, as the insurance company will inevitably be required to pay the face value.⁴⁸ Premiums are determined at the commencement of the policy and ordinarily

⁴⁶Ibid.

⁴⁷Ibid. at 233; J. Bernstein, supra, note 12 at para.308.

⁴⁸D. Drinkwater, supra, note 34 at 233.

will not vary. The exception to this is where the premiums are reduced when the insurance company pays dividends on a participating policy, and sub-dividends are credited against the premiums.⁴⁹

The premium may also be payable for a fixed period of years or until the insured dies. A medical is required on application for the policy, but no further medical examinations are required. It may also be possible to acquire fully paid-up whole of life insurance by making a lump sum payment at the commencement of the policy.⁵⁰

In the case of participating whole of life insurance, the premiums are generally more expensive than those for non-participating whole of life insurance. Where the corporation pays dividends on the participating policy however, these dividends may be used towards the payment of the insurance premiums. It may also be used to acquire additional whole or term coverage or to reduce the premium outlay on the original whole of life policy to less than the premiums on an equivalent non-participating whole of life policy.⁵¹

The whole of life insurance policy may also acquire a cash surrender value. This is the amount which the policy owner is entitled to recover if the policy is terminated before death. It represents the amount of the premiums which is in excess of

⁴⁹P. Fosbery, supra, note 34 at 4.

⁵⁰J. Bernstein, supra, note 12 at para.308.

⁵¹Ibid.; D. Drinkwater, supra, note 34 at 233.

the actual cost to the insurance company of providing coverage for the insured.²²

The disadvantage of whole of life insurance lies, in the short run, in the cost of its premiums.²³

III. TERM TO 100 INSURANCE

This form of insurance is a hybrid of whole of life insurance and term insurance.²⁴ The coverage is guaranteed for life and the policy acquires no cash surrender value. The contract carries a price slightly higher than that of term insurance.²⁵

The premiums for term to 100 insurance are guaranteed but the interest rates may be adjusted every five years. This type of insurance may also have either a limited premium paying period, or an anticipated premium payment period, after which the insurance contract is fully paid for. In other cases the insured has an option to discontinue the premium payments after five years. The insured can then accept a paid-

²²The insurance company retains a reserve fund from which to pay the life insurance proceeds. The portion of the premium in excess of the actual cost of funding the insured is a part of this reserve. Because the reserve funds are invested by the insurance company the amount for which the insurance company is actually at risk decreases, as the income of the reserve increases. The cash surrender value of the policy therefore grows accordingly. See further, J. Bernstein, supra, note 12 at para.308.

²³D. Drinkwalter, supra, note 34 at 233.

²⁴J. Bernstein, supra, note 12 at para.308.

²⁵P. Fosbery, supra, note 34 at 3.

for contract for a reduced face amount or cash value. Once payment is accepted however, this terminates the insurance contract.⁶⁶

An indexed term to 100 insurance policy is also available. This provides for an increase in the value of the policy every year, for the first ten years of the life of the policy. This increase is calculated using the consumer price index as a measure. After the first ten years, medical evidence is required to obtain further indexing for the subsequent ten year periods. Indexing is not available after the shareholder reaches the age of sixty.

This type of insurance has an advantage over other types of insurance as it allows for possible increases in the value of the shares equivalent to the rate of inflation in cases where the parties neglect to annually review their agreement.⁶⁷

IV. JOINT-LIFE INSURANCE

This type of insurance policy (also called multi-life or contingent-life insurance), covers the lives of several shareholders and begins to be payable on the death of the first shareholder, and then on the subsequent deaths of each of the other shareholders.⁶⁸ The joint life insurance policy

⁶⁶Ibid., at 4.

⁶⁷Ibid., at 3.

⁶⁸D. Drinkwalter, supra, note 34 at 233.

is easier to administer than the other types of insurance discussed, as only one or two policies are usually required.

When implementing this type of policy, parties should ensure that the policy guarantees the continued coverage of the survivors without the requirement of a further underwriting process. This would protect the other shareholders in the event of a second death occurring while they are too occupied with emotional and other problems to ponder the state of their coverage.⁹⁹

One of the main advantages of this type of insurance is that it makes the insurance arrangement easier to administer and the need to employ the services of a trustee to assist with the administration of several insurance policies is avoided.

B. INSURANCE PAYMENT ARRANGEMENTS

There is virtually no limit to the variety of insurance arrangements that can be implemented to fund buy-sell agreements. For example, provision can be made for each shareholder to pay premiums on insurance policies on the lives of each other. Each shareholder may also pay premiums on insurance policies on their own life, or the corporation may pay premiums on insurance policies on the lives of each of the shareholders.¹⁰⁰

⁹⁹Ibid.

¹⁰⁰O'Neal, supra, note 18 at c.7.37.

The proceeds of the insurance policies, on the other hand, may be made payable to the corporation, the remaining shareholders, the deceased's estate, a beneficiary designated by the insured shareholder, or a trustee.⁶¹

The three most common types of insurance arrangements which are available for funding buy-sell agreements are:

- i) criss-cross shareholder insurance;
- ii) corporate-owned insurance; and
- iii) split-dollar insurance.⁶²

The main differences between these three types of insurance are the in manner in which they are owned.⁶³

I. CRISS-CROSS INSURANCE

The criss-cross is the most commonly used insurance arrangement. This may be because criss-cross insurance is simple and easily understood by the client.⁶⁴ With this type of arrangement, each shareholder undertakes to obtain and maintain insurance on the lives of the other shareholders. The shareholders each have the responsibility of paying the

⁶¹Ibid.

⁶²See also, D. Drinkwater, "Funding of Shareholder's Agreements" Shareholder Agreements and Disagreements, (Toronto: Canadian Bar Association - Ontario Continuing Legal Education, 1986) at 9-11, for discussion of a possible new insurance product which may override some of the disadvantages of the other insurance products presently in operation.

⁶³H. Kellough, supra, note 1 at 477.

⁶⁴D. Drinkwater, supra, note 62 at 3.

insurance premiums. When a shareholder dies the proceeds from the life insurance policy are paid to the surviving shareholders, to be applied towards the purchase price of the shares of the deceased shareholder.*5

Where several shareholders are involved the parties may retain a trustee to administer their insurance arrangement. The trustee would collect and discharge the insurance premiums and receive the insurance proceeds. These would then be paid to the estate of the deceased shareholder in consideration for the deceased's shares.*6

One advantage of the criss-cross insurance arrangement is that the insurance proceeds are received tax free and the purchase price is reflected in the adjusted cost base of the shares.*7 Also these proceeds would not be exposed to creditors of the corporation because the insurance policy would be held outside of the corporation. The insurance proceeds cannot be assessed as a part of the estate of the deceased.*8

*5J. Bernstein, "Life-Insured Corporate Buy-sell Arrangements" Report of the Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report, (Toronto, Canadian Tax Foundation, 1985) 957 at 983.

*6See generally, G. Couch, supra, note 27 at 295-297; J. Bernstein, supra, note 12 at para.406.

*7J. Bernstein, supra, note 65 at 991.

*8D.I. Beach, "Price Clauses and Funding Arrangements" in Edited Lectures, Shareholders and Shareholders Agreements, (Toronto: Department of Continuing Legal Education of the Law Society of Upper Canada, 1976) at 57; D. Smith, supra, note 5 at 683.

One disadvantage is the high cost of financing the acquisition of criss-cross insurance as large premium payments are required.⁶⁹ Another disadvantage is that these payments have to be made using after-tax dollars and the shareholders may be required to take taxable capital in the form of bonuses or taxable dividends to meet these premium payments. These dividends and bonuses may also attract corporate distribution tax.⁷⁰

Another disadvantage is that the insurance funds finance the purchase of the shares of the deceased at substantial prices and these transactions may be subject to capital gains tax and succession duty.⁷¹

The fact that the insurance premiums are shared disproportionately depending on the age and state of health of the shareholders rather than on the percentage of shares owned can be seen as a further disadvantage. However, it may be possible to compensate a shareholder whose premiums are unjustly high through an adjustment by way of a bonus proportionate to the shareholding.⁷²

It may also be possible for the parties to arrange for the

⁶⁹R. Rocchi, "Funding Buy-Sell Agreements" (1979) 27 Can Tax J. 105.

⁷⁰Green Acres Fertilizer Services Ltd. v. The Queen (1980), 80 D.T.C. 6365 (F.C.A.).

⁷¹D. Beach, supra, note 68 at 58.

⁷²J. Bernstein, supra, note 65 at 985; D. Smith, supra, note 5 at 683.

shareholders to pay the premiums on their own policies, or the premium payments could be modified to reflect actual shareholdings. This latter method may however entail complicated calculations and cross payments which may be difficult to organize and which may have to be re-assessed if the amount of insurance increases in relation to economic growth of the corporation.

The criss-cross agreement also becomes more complex and difficult to administer as the number of participating shareholders increases. This is because each shareholder owns a policy or a portion of a policy on the lives of the other shareholders, and several policies may therefore be required. The complexity may be minimized by the use of a trustee. Joint life insurance policies rather than separate insurance policies may also be used to simplify the administration of the criss-cross arrangement.⁷³

II. CORPORATE-OWNED INSURANCE

In the case of corporate-owned life insurance, the corporation maintains insurance on the lives of each of the shareholders for the purpose of purchasing the deceased shareholder's interest at the relevant time. The policy is owned exclusively by the corporation and the corporation pays

⁷³J. Bernstein, *supra*, note 12 at para.406; See also, J. Bernstein, *supra*, note 65 at 985-986, for a discussion of the income-splitting opportunity, which is a variation of the criss-cross arrangement.

all the premiums. When the shareholder dies, the proceeds of the policy may be used in either of two ways to fund the buy-out. First, the corporation can use the insurance proceeds to purchase the deceased's shares for cancellation.⁷⁴

Secondly, the shareholders can enter into an agreement whereby the survivors agree to buy the shares of the deceased shareholder. The insurance proceeds are then paid to the surviving shareholders by way of dividends and these are used to pay the purchase price of the shares.⁷⁵

One advantage of this arrangement is that the insurance premiums are in essence shared proportionately, based on the individual shareholding. The amounts used to finance these premiums would otherwise have been paid to shareholders by the corporation as some form of bonus or dividend. This insurance scheme is therefore more equitable than the criss-cross arrangement where shareholders may be required to finance a disproportionate percentage of the premiums based on the age and health of the shareholders.⁷⁶

Another advantage is that the premiums for corporate-owned insurance are discharged using corporate funds. In cases where the corporate tax rate is lower than the marginal tax rate of individual shareholders, fewer after-tax dollars are

⁷⁴J. Bernstein, *ibid.*, at 998.

⁷⁵D. Ward, "Insurance Funding of Buy-Sell Agreements", (1974) 22 Can. Tax J. 484 at 490.

⁷⁶J. Bernstein, *supra*, note 65 at 1001.

utilized. Also, the need for dividends and bonuses to cover premium payments is unnecessary, and the potential liability for corporate distribution tax is therefore avoided.

When a shareholder dies, the surviving shareholder's percentage interest in the corporation would increase pro rata as a result of the corporate share repurchase, however the premiums would have been altered.⁷⁷ Where the shareholders purchase the shares, the agreement may specify whether the shareholders should purchase the shares on a pro rata basis.⁷⁸

Corporate-owned insurance may entail more legal formalities and increased legal and accounting fees in the year the insurance proceeds are distributed.⁷⁹ However, corporate-owned insurance is also more easily administered as fewer policies are involved, and the corporation pays all the premiums.⁸⁰

Corporate-owned insurance can only be operative where the relevant corporation statutes permit corporate repurchase of shares for the purpose of cancellation or where the shares are purchased by shareholders with funds dividended to them.⁸¹

The corporation would be unable to distribute the proceeds of the insurance policy if it becomes insolvent. The funds

⁷⁷J. Kennedy, supra, note 15 at 329.

⁷⁸J. Bernstein, supra, note 12 at para.418.

⁷⁹J. Bernstein, supra, note 65 at 974.

⁸⁰Ibid., at 1001; H. Kellough, supra, note 1 at 484.

⁸¹J. Bernstein, ibid.

may therefore become accessible to the corporation's creditors.^{*2} The corporation may be able to circumvent its creditors by having shareholders instead of the corporation itself pay premiums, using additional funds distributed by the corporation to shareholders by way of bonuses or dividends for this purpose.^{*3}

The corporation may be unable to repurchase its shares if it is insolvent at the time of the shareholder's death.^{*4} In such a case there may also be some question about the value of the corporation, as where the agreement provides for the sale of shares at "fair market value", the purchase price may be less than the insurance proceeds.

The agreement may provide that if the corporation is insolvent when a shareholder dies, the purchase price may be funded by the surviving shareholders. These shareholders may also undertake to put adequate funds into the corporation to render it solvent so that it can meet its obligation to purchase the shares.^{*5}

^{*2}Re Cote Estate, [1941] 3 D.L.R. 523; 22 C.B.R. 387 (Ont. H.C.J.).

^{*3}J. Bernstein, supra, note 14 at 148.

^{*4}C.B.C.A. subsection 34(2); O.B.C.A. subsection 30(2); A.B.C.A. subsection 32(2).

^{*5}J. Bernstein, supra, note 65 at 1001.

III. SPLIT-DOLLAR INSURANCE**

This type of insurance covers a variety of plans.⁷ Though these plans may vary to some extent in their detail, they all have one common feature. They are all arrangements designed to combine the advantages of corporate-owned insurance and shareholder criss-cross insurance, and to split the annual cost of life insurance between the shareholders and the corporation.

In effect, this method of coverage attempts to cover the payment of premiums with corporate funds,⁸ while avoiding the estate and valuation problems associated with corporate-owned life insurance.⁹ The premiums are therefore paid primarily by the corporation, while the shareholders are the direct recipients of the proceeds of the policy.

This type of insurance is best explained using the example of only two shareholders. These shareholders would purchase whole of life participating insurance policies, with which

**See also, infra, Chapter V, notes 137-145 and accompanying text.

⁷D. Ward, supra, note 75 at 484. Also see generally, E.H. White & H. Chasman, Business Insurance, (New Jersey: Prentice-Hall Inc., 1974) at 500-503, for some discussion of possible variations of the split-dollar insurance.

⁸Corporate funds are generally taxed at a lower level than the funds of shareholders.

⁹S. Silver, "Estate Planning in Canada" (1979) 27 Can. Tax J. 206 at 206.

they would be cross-insured.¹⁰ Contracts are then made between each shareholder and the corporation pursuant to which the corporation becomes entitled to the benefit of the cash surrender value and all (or in some cases only part) of the dividends which are expected to accrue on it.

The shareholders each pay the premiums on the policies on each other's lives until the policies acquire a cash surrender value.¹¹ The policies are then assigned to the corporation as the co-owner and the corporation undertakes to annually pay the portion of the premiums representing the increase in the cash surrender value (i.e. the amount which is payable when the whole of life policy is terminated before death). It represents the amount of the premiums which is in excess of the actual cost to the insurance corporation of providing coverage to the insured.

Corporate funds, which would be taxed at a lower level than shareholder funds are used to discharge the premiums. The balance of the premium relating to the mortality gain (i.e. the amount payable on the death of the shareholder) is paid by the shareholders and the shareholders remain the beneficiaries of the face amount of the policy.¹²

The agreement would also provide that on the pay-out of

¹⁰I.e. they themselves would be the owners and beneficiaries of the policies on the lives of each other.

¹¹S. Silver, supra, note 89 at 206; J. Bernstein, supra, note 65 at 986.

¹²S. Silver, ibid.; J. Bernstein, ibid..

the proceeds of the policy the corporation receives proceeds equal to the cash surrender value of the policy. The balance, which represents the mortality gain on the policy, is paid to the beneficiary of the policy. The cash surrender value of the policy increases annually and there is a corresponding decrease in the amount payable to the surviving shareholder.**

In order to ensure that the amount payable to the surviving shareholder is sufficient to purchase the shares of the deceased shareholder, additional term insurance on the lives of the insured shareholders, may be acquired. These policies are in an amount equal to the cash surrender value of the policy and are payable to the surviving shareholder. This insurance is usually financed with the dividends received under the original policy*4 under the fifth dividend option (i.e. the option to use the dividends payable on the participating whole of life policy to purchase additional term insurance).** The estate of the deceased therefore receives the mortality gain plus the proceeds of the additional term insurance coverage.**

**S. Silver, ibid.; See also, D.A. Ward, supra, note 75 at 485, for a split-dollar schedule which illustrates the way the premiums on split-dollar life insurance is divided between the shareholders and the corporation.

*4Because participating insurance is normally used in split-dollar insurance, the corporation receives dividends under the policy.

**See further, S. Silver, supra, note 89 at 206.

**S. Silver, ibid. at 207; J. Bernstein, supra, note 65 at 986.

This ensures that the surviving shareholder receives insurance proceeds equivalent to the face amount of the original participating policy. The corporation, on the other hand, would still collect the cash surrender value of the policy.⁷

This means that the corporation will recover an amount equal to the aggregate of the premiums previously paid by it. The interest of the corporation in the policy consists of an asset the value of which both before and after the death of the shareholder is equal to cost.⁸

The major advantage of split dollar insurance is that it allows shareholders to fund the buy-sell agreement with insurance substantially paid for by the corporation. This is an attractive option for shareholders who would otherwise have to draw additional salary or dividends from the corporation to fund the payment of premiums.

Also, although the split dollar insurance arrangement is funded by the corporation, amounts totalling the face value of the policy are paid directly to the shareholder and should not be a factor in determining the value of the shares owned by the deceased at the time of death.

A third advantage results from the fact that because the corporation receives the cash surrender value of the policy, the mortality gain should not increase the value of the shares

⁷S. Silver, ibid.; J. Bernstein, ibid..

⁸D. Ward, supra, note 75 at 486.

of the corporation for the purposes of deemed disposition on death, and should not be exposed to the creditors of the corporation.**

One disadvantage of split-dollar insurance is that the premiums may be considerably higher than those under equivalent term or non-participating insurance. This is because split-dollar insurance arrangements are structured to maximize the increase in the cash surrender value so as to minimize the premium paid by the shareholder.¹⁰⁰

C. THE UNINSURABLE SHAREHOLDER

The uninsurable shareholder may be able to assign an existing policy which the shareholder or others already owned on his or her life to fund the buy-sell agreement.¹⁰¹ Alternatively, a business concern with which the shareholder was previously connected, and which already owns a policy on the shareholder's life may be willing to sell that policy to the shareholders to permit the funding.¹⁰²

Another solution is for the insurable shareholder, who invariably has a greater life expectancy than the uninsurable shareholder, to begin purchasing the shares of an uninsurable

**J. Bernstein, *ibid.*, at 986.

¹⁰⁰*ibid.*, at 987.

¹⁰¹D. Coates, *supra*, note 3 at 124; O'Neal, *supra*, note 18 at c.7.37.

¹⁰²O'Neal, *ibid.*, at c.7.37.

shareholder while they are both still alive.¹⁰³ This should mitigate against them having to make a larger purchase on short notice if and when the uninsurable shareholder dies.¹⁰⁴ Problems would arise if one of the insurable shareholders dies unexpectedly and before the uninsurable shareholder who is normally expected to die first.

The parties may also establish a sinking fund into which installment payments equivalent to the insurance premiums may be deposited. These amounts may be used towards the payment of the purchase price at the required time.¹⁰⁵

5. INTER VIVOS FUNDING

In the case of inter vivos buy-sell transactions, the funding mechanisms, though important, are not absolutely necessary. This is especially so in relation to put-call buy-sell arrangements. The party who is unable to procure the finances needed to purchase shares would hardly consider triggering a buy-sell agreement which would require the furnishing of such amounts. It is therefore unlikely that the absence of a funding arrangement in these circumstances would threaten the success of the buy-sell agreement.

The absence of an adequate funding arrangement could be

¹⁰³D.F. Hoxie, "Business Buy-Outs and The Uninsurable Shareholder" (1962) 101 Trusts and Estates 326.

¹⁰⁴O'Neal, supra, note 18 at c.7.37.

¹⁰⁵See also infra, Chapter IV, notes 121 and accompanying text.

advantageous to the financially strong shareholder who can then enforce the put-call provisions at will. If an adequate funding arrangement is included in the agreement, both shareholders would be assured an equal bargaining position once the put-call arrangement is triggered.

Where a shareholder becomes disabled, retires, resigns, or is dismissed, some funding arrangement may be necessary to preserve the rights of a departing shareholder to receive reimbursement for shares in the corporation. The remaining shareholders should also be in a position to ensure that these shares neither pass to undesirable third parties nor remain the property of a former employee who is no longer a harmonious associate.

Insurance is usually only available in those cases where the need for funding is the result of the disability of a shareholder. There are at least five additional methods available for funding inter vivos buy-sell agreements.¹⁰⁰ The methods of inter vivos funding include:

- a) cash payment after a specified interval;
- b) payment of the purchase price in installments;
- c) a sinking fund or savings scheme to which the shareholders would contribute fixed amounts over a period of time;

¹⁰⁰Two additional methods namely; i) corporate retained earnings, and ii) the minimizing of the value of the company by the distributing of after-tax profits annually, have been discussed under the heading "Purchase by Shareholders", infra, Chapter IV, notes 14-17 and accompanying text.

- d) a bank loan;
- e) a mortgage;²⁰⁷ and
- f) disability insurance.

There are both advantages and disadvantages to the use of each method.

A. A CASH PAYMENT AFTER A SPECIFIED INTERVAL

This method of funding provides for the payment of the full amount for the shares at a specified interval after the triggering event has occurred. It may be successful if the remaining shareholders have sufficient cash reserves or borrowing ability to cover the full purchase price, or if the total value of the business is not high. However, shareholders are usually reluctant to tie up such large sums of money, but if they invested these amounts, they might be unable to realize their investment soon enough to meet their obligations under the buy-sell agreement.²⁰⁸

The shareholders may individually or collectively open a bank account into which they can deposit a certain amount every year to cover their future commitment. This recourse may prove unsuccessful if one or more of the triggering events occur before an adequate amount is acquired.²⁰⁹

²⁰⁷Most of these methods can also be used to fund buy-sell agreements operational on death. Insurance however seems to be preferred as a more efficient, and often cheaper method of achieving the same result.

²⁰⁸D. Coates, supra, note 3 at 122.

²⁰⁹Ibid.

Additionally, the shareholders may be reluctant to tie up the large sums of money needed to establish and maintain such a fund.

The source of such funding has to be resolved soon after the triggering event occurs otherwise the opportunity to attract third party offers for the shareholder's shares may be diminished or lost.

B. PAYMENT OF THE PURCHASE PRICE IN INSTALLMENTS

The parties may agree that the purchase price is to be paid in installments by the corporation or the remaining shareholders over a period of time.¹¹⁰ This is a variation of the above method and is usually preferred as being less of a financial burden on the purchasers.¹¹¹

The payments may be organized in several ways. The purchasing shareholder may agree to pay a fixed dollar amount, or a proportion of the net profit figure. Some difficulty may arise if the purchaser is unable to meet large fixed payments.¹¹² Another method is through a payment of a proportion of the net profit figure, while using the stock as security for the outstanding balance. The purchaser is also given the right to vote the shares, provided that the

¹¹⁰J. Bernstein, *supra*, note 14 at 134, para.1028; *Trimac Ltd. v. C-I-L [Alta.]* (1989), 69 Alta. L.R. 113, [1990] 1 W.W.R. 133 (Q.B).

¹¹¹O'Neal, *supra*, note 18 at c.7.37.

¹¹²D. Coates, *supra*, note 3 at 122.

installment payments are not in arrears.¹¹³

The use of the corporation's stock as security may be illusory. For example if the corporation itself is the purchaser, the pledged shares may be of little value if the corporation has to default on its obligations.¹¹⁴ Also, the assets of the business may be drained off without difficulty or fear of legal repercussions.¹¹⁵ To guard against this, the agreement may stipulate that the corporation may not increase salaries, pay dividends beyond a stated amount, or in any way dissipate its assets until the loans are paid.¹¹⁶ The parties may also prefer to use assets other than the corporation's shares to secure installment payments.

Promissory notes may also be used to furnish collateral for the outstanding balance. In such a case the rate of interest which the notes are to bear should be fixed in advance.¹¹⁷

¹¹³D. Coates, ibid.; O'Neal, supra, note 18 at c.7.37.

¹¹⁴O'Neal, ibid.

¹¹⁵D. Coates, supra, note 3 at 122.

¹¹⁶O'Neal, supra, note 18 at c.7.37.

¹¹⁷Of note, is the American case of Brigham v. M&J Corp. 352 Mass. 674, 227 NE2d 915 (1967), (as cited by O'Neal, ibid., c.7.37, note 1), where a deceased's shareholder's administrator was held not entitled to a guarantee that the close corporation purchasing the deceased's shares under the buy-sell agreement would meet its future obligations to make installment payments in the absence of a provision for the giving of security; An ordinary installment creditor has no right to require proof of his or her debtor's ability to meet future installments.

Where payments are being made in installments, it may be advisable for the parties to include some provision allowing the purchaser who takes the shares of more than one shareholder, or takes more than a stated amount, to decrease his or her payments and to spread them over a longer period.^{11*} Parties may also consider allowing purchasers to accelerate their installment payments if they wish.

The agreement may also provide for the full purchase price to become due automatically if the purchaser defaults on his payments.^{11*}

The main disadvantage of this method of funding is that the required amounts may not be readily available. This may delay transactions under the buy-sell agreement which could in turn, result in the loss of third party offers where relevant. Also, where a shareholder is dies, these amounts may be needed immediately to cover funeral and other expenses, such as estate taxes.

Where the purchase price is to be paid by the corporation this method may have the effect of mortgaging the corporation's profits for an indefinite period of time after a shareholder's death or departure. The departing shareholders or their beneficiaries are also dependent on the success of the business for their income.

Further, even in the case of installment payments the

^{11*}O'Neal, supra, note 18 at c.7.37.

^{11*}Ibid., at c.7.37, note 1.

purchaser may find difficulty in raising the cash necessary for the down payment. This is because it is usually impractical for parties to tie up such large sums of cash in advance when the date and cost of purchase are unknown.¹²⁰

C. A SINKING FUND OR SAVINGS SCHEME

Here, the shareholders periodically contribute fixed amounts over a period of time to a sinking fund. The amounts so accumulated, would then be available whenever necessary. Where the corporation is the purchaser, it may be also be possible for it to set up such a fund.

The sinking fund may also be used as an alternative to life insurance for purchasing the interest of an uninsurable shareholder. In this case, periodic amounts equivalent to the insurance premiums which would have been paid, are deposited in a fund.¹²¹

In both cases, such a fund can only be successful if it has time to mature. If the event triggering the buy-sell agreement occurs suddenly, (for example the disability of a shareholder), there is a possibility that the fund may not have matured to the required level at the time of purchase. Also, if the value of the business increases rapidly, the value of the shares may also rise beyond the original projections of the sinking fund.

¹²⁰Ibid.

¹²¹O'Neal, ibid.; J. Kennedy, supra, note 15 at 326.

D. BANK LOAN

The parties may also wish to rely on obtaining a bank loan at the required time to be used towards funding the buy-sell agreement. The shares in question may be used as security for the loan.¹²² This reliance on future bank financing may be risky, as the circumstances of the shareholders and the climate of the financial community may change substantially during the life of the agreement. Such changes may result in one or more of the shareholders being ineligible for such a loan.¹²³

There seems to be no question that the interest on loans for this purpose would be deductible under subsection 20(1)(c) of the Income Tax (Canada) Act.¹²⁴ However, there may be some question about the deductibility of funds borrowed by the corporation to purchase the interest of one of its shareholders, unless the purchase can be categorized as the substitution of debt capital for equity capital.¹²⁵

¹²²See generally, H. Sutherland, Fraser's Handbook, supra, note 7 at 197-198; See also infra, Chapter IV notes 113-115 and accompanying text.

¹²³D. Coates, supra, note 3 at 122.

¹²⁴J. Bernstein, supra, note 14 at 134, para.1028; D. Beach, supra, note 68 at 59.

¹²⁵J. Kennedy, supra, note 15 at 326; See also, Interpretation Bulletin IT-80; Trans-Prairie Pipelines Ltd. v. M.N.R., [1970] C.T.C. 537, 70 D.T.C. 6351; Bronfman Trust v. R., [1979] C.T.C. 524, 79 D.T.C. 5438.

E. MORTGAGE

It may also be possible for the purchaser to arrange a mortgage on the assets of the corporation whose shares are being purchased. The proceeds of the mortgage would then be used to assist the shareholders in effecting the purchase. This option is available if the corporation itself is the purchaser, otherwise the assets presented would have to be in support of the guarantee of the shareholder's loan by the corporation.

Under paragraph 44(2)(c)(ii) of the Canada Business Corporations Act,¹²⁶ the corporation is permitted to give financial assistance by way of loans or guarantees in accordance with a plan for the purchase of the corporation's shares. However, the Act prevents the corporation from providing such assistance where there are reasonable grounds for believing that after giving the assistance, the corporation would be unable to pay its debts or where the realizable value of corporation's assets would be less than the aggregate of the corporation's liabilities and stated capital of all classes.

Where a bank has lent money in violation of this section, the loan would be held unenforceable as against the corporate defendant. The bank would therefore be unable to enforce the mortgage to the extent that the proceeds are used to assist in

¹²⁶See also, O.B.C.A. s.20, A.B.C.A. s.42.

purchasing shares.¹²⁷

F. DISABILITY INSURANCE

Shareholders usually address the issue of the funding of their agreement in the event of death with methods such as life insurance. However they tend to disregard the question of the funding of the agreement in the event of disability.

A policy on the life of a shareholder will not usually provide funds if the shareholder becomes disabled. The disabled shareholder who is unlikely to recover may therefore be compromised in the absence of an adequate funding arrangement.

Special disability insurance may sometimes be used to fund purchases in the event of disability from sickness, accident or mental infirmity.¹²⁸ However, the variety of insurance products obtainable for disability funding is limited and those that are available are usually unsatisfactory.¹²⁹ This may be because insurance companies usually find it difficult to set a price for insurance based on the assessment of whether or when a shareholder would recover.¹³⁰

¹²⁷Royal Bank of Canada v. Stewart (1979), 8 B.L.R. 77 (B.C.S.C.); Irving Oil Ltd. v. Central and Eastern Trust Co. (1978), 5 B.L.R. 29 (N.S.S.C.); Hubley v. Stonehouse Motel et al (1976), 24 N.S.R. (2d) 262 (S.C.).

¹²⁸O'Neal, supra, note 18 at c.7.37.

¹²⁹R.A. Sabel, "Disability Insurance: Caveat Emptor" (1983) 69 Am. B.A.J. 782.

¹³⁰Op. Fosbery, supra, note 34 at 5.

The issue of who should determine disability, is a contentious one. The parties can provide for disability to be determined using the third party arbitrator provided for by the disability insurance company. Once the insured is collecting benefits under the total disability clause, the disability can be safely assumed. Partial disability may be determined on the basis of the expectancy of the insured's recovery.¹³²

The standard disability policy does not usually provide the lump-sum payment which is often needed to fund buy-sell agreements.¹³³ Where lump-sum payments are available they are usually payable in cash within days of the relevant medical authorities certifying that the shareholder is totally and permanently disabled.¹³⁴ Total disability can be defined as disability arising as a result of injuries or sickness whereby the insured is unable to perform the substantial and material duties of his or her occupation and is receiving care by a physician which is appropriate for the condition causing disability.¹³⁵

The agreement should also provide a time limit for the disabled shareholder to retain his or her shares, with a

¹³²D. Drinkwalter, supra, note 62 at 2; See also, infra, Chapter II notes 117-120 and accompanying text.

¹³³O'Neal, supra, note 18 at 7.37.

¹³⁴D. Drinkwalter, supra, note 34 at 234.

¹³⁵D. Drinkwalter, supra, note 62 at 1.

mandatory buy-out after this period has passed. A suggested period is twelve months in the case of total disability. Disability buy-out insurance is available in these instances. This type of insurance will pay up to 100% of the share value 12, 15, or 18 months after the insured is declared totally disabled.¹³⁵

Some companies make lump-sum payments based on either a fixed amount or on the value of the shares at the time of the disability. The use of share value as the measure of disability payments may have adverse results if the share value is subject to periodic fluctuations.¹³⁶

The approximate cost of this type of insurance is usually about 6% of the share value, subject to the age and insurability of the shareholder. The maximum amount available on any one life is usually \$1,000,000.¹³⁷

A disability policy can also provide for periodic payments to the disabled shareholder. This type of payment can be used in cases where arrangements have been made for the purchase price to be paid in installments.¹³⁸ In this case, the commencement of pay-outs on the insurance policy have a waiting period of between twelve and twenty-four months,

¹³⁵D. Drinkwater, ibid., at 1.

¹³⁶P. Fosbery, supra, note 34 at 6.

¹³⁷D. Drinkwater, supra, note 34 at 234.

¹³⁸Ibid.; P. Fosbery, supra, note 34 at 5.

depending on the amount at risk. The larger the amount, the longer the waiting period.¹³⁹

Some insurance companies may also insist that the partial or complete recovery of the shareholder terminates their obligation to continue payments.¹⁴⁰ This may prove unfortunate in cases where the shareholder has precipitated a buy-out contingent on the receipt of such payments because typically, the agreement has to be completed regardless of the insurance company's position. This can result in litigation which some insurance companies are anxious to avoid. Some insurance contracts therefore self-complete once payments have started regardless of whether or not the shareholder recovers.¹⁴¹

Where the insurance policy provides for periodic payments, the approximate cost is usually 6% of the share value, however the maximum amount available is usually only \$250,000.¹⁴² This amount may not always be enough to cover the payments under the buy-sell agreement, but may solve some of the funding problems that are inevitable if a shareholder becomes permanently disabled. For example, it may provide an initial down payment for the shares.

¹³⁹D. Drinkwalter, supra, note 62 at 1.; P. Fosbery, supra, note 34 at 6.

¹⁴⁰D. Drinkwalter, ibid., at 2; P. Fosbery, ibid., at 6; R. Sabel, supra, note 129 at 782.

¹⁴¹D. Drinkwalter, ibid.

¹⁴²D. Drinkwalter, supra, note 34 at 234.

5. CONCLUSION

Pre-arranged measures for funding buy-sell transactions are necessary. In the case of death, and to a more limited extent disability, insurance may be used to finance these transactions. Parties would have to review the various types of insurance arrangements in the interest of selecting the most appropriate method of funding.

There are also several alternatives available for funding inter vivos buy-sell transactions. Both the advantages and disadvantages of each of these methods would have to be considered.

CHAPTER V

INCOME TAX CONSIDERATIONS

1. GENERAL

The sale and purchase of shares involves the movement of property to and by the corporation and its shareholders.¹ As a general rule, these transfers are taxable events which give rise to a capital gain or loss.² Given that such transfers are the main objective of the buy-sell agreement, the income tax considerations associated with them are significant.³

Detailed discussion and analysis on the technical aspects of income tax law as they relate to the buy-sell agreement have been undertaken elsewhere.⁴ The present chapter will

¹For general discussion on corporate taxation, see J.R. Wilson & S.F. Bollefer, "Taxation of Corporations and their Shareholders" in Law Society of Upper Canada, Bar Admission Course Materials, Business Law 1986/87, (Toronto: Carswell, 1986) c.6.

²In some cases the Income Tax (Canada) Act, R.S.C. 1970-71-72, c.63 (as am.) permits these transfers to occur on a "rollover" basis, in which case no taxable gain or income is recognized, for example, subsections 70(5.2), (6), and (9.2). See also, Interpretation Bulletin IT-449, Sept. 26, 1987, "Meaning Of Vested Indefeasibly"; See further infra, Chapter V, notes 64-77 and accompanying text. Unless otherwise noted, statutory references are to the Income Tax (Canada) Act, [hereafter referred to as "the Act"].

³See generally, W. Grover & F. Iacobucci, Materials On Canadian Income Tax, 6th ed., (Don Mills, Ontario: Richard De Boo Publishers, 1985) at 118-134.

⁴See R.G. Witterick, "Buy-Sell Agreements" Report of the Proceedings of the Fortieth Tax Conference, 1988 Conference Report, (Toronto: Canadian Tax Foundation, 1989) 16.1; B.T. Wilson, "Buy-Sell Agreements" Report of the Proceedings of the Thirty-Ninth Tax Conference, 1987 Conference Report, (Toronto: Canadian Tax Foundation, 1988) 16.1; J. Bernstein, "Life Insured Corporate Buy-Sell Arrangements" Report of the

therefore concentrate on discussing the implications of relevant income tax principles to the operation of the buy-sell agreement and the manner in which these are dealt with by statute, judicial decisions, and administrative policy.

The aspects of the buy-sell agreement which are most affected by income tax considerations are the control of the corporation, the funding of the agreement, and the valuation of shares under the agreement. This chapter will discuss the income tax considerations as they relate to these specific areas.

2. THE ISSUE OF CONTROL

A. DE JURE CONTROL

The buy-sell agreement usually contains provisions which may affect the control of the corporation.^o This is mainly

Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report, (Toronto: Canadian Tax Foundation, 1985) 957; J.G. Vesley, "Some Inter Vivos Aspects of Buy-Sell Agreements" Report of the Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report, (Toronto: Canadian Tax Foundation, 1985) 925; R.M. Wise, "Valuation Aspects of Shareholders' Buy-Sell Agreements" Report of the Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report, (Toronto: Canadian Tax Foundation, 1985) 1013.

^oThe issue of control has several additional implications for corporate taxation. For a breakdown of the specific aspects of corporate taxation which relate to the issue of control, see R.E. Levine, "Income Tax Implications Of Shareholders Agreements" Legal Problems Relating To Shareholders Agreements, (Vancouver: The Continuing Legal Education Society of British Columbia, 1982) at 4-5; See also, R.J. Reid, "Income Tax Implications of a Change In Control" Select Income Tax Aspects of the Purchase and Sale of a Business, Conference Management Tax Conference 1984, (Toronto: Canadian Tax Foundation, 1984) at 85, for a

the result of the rights and restrictions which result from such an agreement or the option to acquire shares on the occurrence of a particular event.⁶ The question of who controls the corporation will determine whether the parties are dealing at arm's length,⁷ whether the corporation is classified as a Canadian Controlled Private Corporation (CCPC),⁸ and whether two or more corporations are associated for the purposes of the Act.⁹ These considerations will ultimately determine the amount of tax which is payable by the corporation.

The term "control" is not defined in the Act,¹⁰ and the common law definition as provided by Jackett P. in the case of Buckerfield Ltd. v. M.N.R.¹¹ has prevailed,

history of the evolution of the concept of control, as well as some discussion of its present meaning and implications for the assessment of income tax.

⁶See further, infra, Chapter III, notes 47-51.

⁷See further, infra, Chapter V, notes 39-62 and accompanying text.

⁸See further, infra, Chapter V, notes 63-66 and accompanying text.

⁹See further, infra, Chapter V, notes 67-71 and accompanying text.

¹⁰The Act only provides definitions of control for certain purposes, e.g. para.112(6)(b) provides,

". . . .For the purposes of this section,
. . . .(b) one corporation is controlled by another corporation if more than 50% of its issued share capital (having full voting rights under all circumstances) belongs to the other corporation, to persons with whom the other corporation does not deal at arm's length, or the other corporation and persons with whom the other corporation does not deal at arms' length."

¹¹[1964] C.T.C. 504; 64 D.T.C. 5301 (Ex. Ct.).

"the word "control" contemplates the right of control that rests in the ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors".¹²

Control was therefore defined as meaning de jure control, that is, exercised through legal means, rather than de facto control, that is, existing for all practical purposes, but not through legal means.¹³

A recent decision of the Supreme Court of Canada,¹⁴ has challenged the generality of this distinction between de jure and de facto control on the grounds that it is "not an entirely accurate description of the processes of determination of the presence of control in one or more shareholders for the purpose of paragraph 256(1)(a)".¹⁵ The

¹²Ibid., C.T.C. at 507, D.T.C. at 5303; International Iron & Metal Co. Ltd. v. M.N.R., [1969] C.T.C. 668, 69 D.T.C. 5145 (Ex. Ct); aff'd [1972] C.T.C. 242 (S.C.C.).

¹³M.N.R. v. Dworkin Furs Ltd., [1967] C.T.C. 5067, 67 D.T.C. 5035 (S.C.C.); Re. A. Zimet Ltd. (1985), 31 B.L.R. 277 (Ont. S.C.); R. v. Mars Finance Inc., [1980] C.T.C. 216 (F.C.T.D.). In these three cases, the parties were found to have de jure control of several companies, but were not in a position to exercise same. The court however found that once de jure control has been established, the issue of de facto control is no longer relevant. But see, Special Risks Holdings Inc. v. M.N.R., [1986] 1 C.T.C. 201 (F.C.A.), where an agreement between parties which in fact created de facto control was held to override the lack of de jure control for the purposes of the relationship and accordingly the parties could not be found to be dealing at arm's length.

¹⁴R. v. Imperial General Properties Ltd., [1985] 2 S.C.R. 288; (1985), 31 B.L.R. 77, [1985] C.T.C. 299, 85 D.T.C. 5500 (S.C.C.).

¹⁵Para. 256(1)(a) reads, "(1) For the purposes of this Act, one corporation is associated with another in a tax year, if at any time in that year,

(a) one of the corporations is controlled by the other. ."

taxpayer corporations in this case were thus held to be associated in spite of the fact that the beneficial ownership of the shares had been passed to others. These taxpayer corporations had however maintained the right to cause the liquidation of the corporation without cause. In arriving at his decision, Estey J. made these comments,

"In determining the proper application of subsection 39(4) to the circumstances before the court, the court is not limited to a highly technical and narrow interpretation of the legal rights attached to the shares of a corporation. Neither is the court constrained to examine those rights in the context only of their immediate application in a corporate meeting. It has long been said that these rights must be assessed in their impact "over the long run."¹⁶

It has also been held that in order for a person to control a corporation, he or she does not have to possess direct ownership of shares in that corporation.¹⁷ This means therefore that if, for example, a person owns 60% of the shares in a corporation, which in turn owns 60% of the shares in a second corporation, the individual will be regarded as having control of the second corporation.¹⁸

¹⁶R. v. Imperial Properties Ltd., *supra* note 14 at C.T.C. 302, D.T.C. 5503. See also, T.A. Sweeny & D.T. Tetreault, "Income Tax Considerations in Shareholders' Agreements in Context of the Budget Proposals of May, 23, 1985" Shareholders Agreements and Disagreements, (Toronto: Canadian Bar Association - Ontario Continuing Legal Education, 1986), at 20, for a critique of this case.

¹⁷Vineland Quarry & Crushed Stone Ltd. v. M.N.R., [1966] C.T.C. 69, 66 D.T.C. 5092 (Ex. Ct.); Express Cable TV Ltd. v. M.N.R., [1982] C.T.C. 2447, 82 D.T.C. 1431 (T.R.B.).

¹⁸R. Reid, *supra*, note 5 at 85; See also, R.B. Miner, "More Corporations To Be Associated Under New Tax Laws" (May, 1988) 1 Can. Corp. Rep. S1 at S3-S4.

Where there are no specific statutory rules overriding this general principle,¹⁹ the mere existence of an option to acquire shares under a contract (or to control the voting rights of shares) is not construed as a right to control unless and until such option is exercised.²⁰

Also, the right to dictate the redemption of preference shares and thereby obtain control does not by itself confer control on the person possessing such a right.²¹ The courts have held further that where a corporation is controlled by one person it cannot be concurrently controlled by a group of persons.²²

The above position on de jure control has been further qualified by Revenue Canada which has stated, with respect to paragraph 251(5)(a), that where a related group is in a position to control a corporation, that group is deemed to be a related group which controls the corporation whether or not it is a part of a larger group which in fact controls the corporation.²³

¹⁹See for example, para.251(5)(b) and subsection 256(8).

²⁰E.P. Taylor v. M.N.R. (1961), 61 D.T.C. 513 (T.A.B.); Rous & Mann Press Ltd. v. M.N.R. (1953), 53 D.T.C. 326 (T.A.B.).

²¹Artic Geophysical Ltd. v. M.N.R., [1967] C.T.C. 57, 68 D.T.C. 5013 (Ex. Ct).

²²Southside Car Market Ltd. v. R., [1982] C.T.C. 214, 82 D.T.C. 6179 (F.C.T.D.); See also, R. Miner, supra, note 17 at 84.

²³See also, Interpretation Bulletin, IT-64R2, Dec. 20, 1983, "Corporations: Association and Control", para.27.

In the recent case of International Mercantile Factors Ltd. v. R.,²⁴ the question of control was discussed in order to determine whether the taxpayer corporation qualified for a small business deduction or whether it was controlled by a public corporation.

The facts of this case established that two public corporations C Ltd. and H Ltd. each held 50 percent of the voting rights attaching to the taxpayers' shares, while R Ltd., a private corporation owned by B, held the remaining 50 percent.

The shareholder agreement was to terminate upon the termination of a management agreement between the taxpayer corporation and B Ltd. (another private corporation owned by B). The management agreement could be terminated without notice by the taxpayer upon payment to B Ltd. of a lump sum equal to one-third of the annual management fee provided for B Ltd.

The Minister had denied this business deduction for several years on the grounds that during those years, it was not a Canadian Controlled Private Corporation (CCPC). The taxpayer appealed and its appeal was dismissed.

After examining several of the leading authorities in this area the courts concluded that deciding factor in determining the issue of "control" was not the fact that C Ltd. and H Ltd. together held 50 percent, but rather that neither side

²⁴90 D.T.C. 6390 (F.C.T.D.).

could effectively alter the composition of the taxpayer's board of directors during the currency of the management agreement.

Also, throughout the taxation years in issue, both agreements were in force, and there was no agreement as to how many persons would represent each shareholder of the board of directors. In fact, the board comprised four representatives from C Ltd. and H Ltd. and only one from R Ltd. C and H thus had legal and effective control of the taxpayer at all material times.

Teitelbaum J. concluded,

"This finding may not be "on all fours" with the findings in the cases of Buckerfield and Dworkin Furs (supra). As in the cases of Oakfield or Imperial Properties (supra) the Supreme Court went further than the Buckerfield and Dworkin Furs cases by defining the issue of control not on the fact of equal voting rights, but by the fact that one 50% shareholder could cause the liquidation of the Company giving it control. I also, following the principle in Oakfield and Imperial Properties, am satisfied that because Charter and Hamilton have retained, for as long as they wish, the majority of the Board of Directors, they have retained legal and effective control of the Plaintiff corporation as control was defined in s. 125(6) of the Income Tax Act".²⁵

Control was therefore established as de facto control, rather than de jure control.

In the case of trusts and voting agreements, unless the contrary is proven, a mere nominee or a bare trustee is deemed to have voted in accordance with the wishes of the beneficial owner and the beneficial owner is considered to have the

²⁵Ibid., at p.6399.

vote.²⁶ Where a legal trust is set up however, the trustees who own the shares subject to the trust arrangement or provisions in a will are regarded as having control. The courts may however look behind the trust to establish who exercises control.²⁷

In the case of Lusita Holdings Ltd. v. R.,²⁸ an individual was the corporate trustee for four separate trusts. In each case the second trustee was an unrelated person. The first trustee had a right at will to require the second trustee to resign and thereafter to name a replacement. The issue was whether the individual controlled the voting rights of the shares owned by the trust either directly or by virtue of paragraph 251(5)(b).²⁹ The court noted that at all times the first trustee could not act without a second trustee and that both trustees had to agree on how to vote the shares. The court therefore concluded that the first trustee did not have de jure control of the right to control the voting rights of the trust's shares in the corporation. A similar reasoning

²⁶R. Reid, supra, note 5 at 86-88; Aaron's (Prince Albert) Ltd. v. M.N.R., [1966] C.T.C. 330, 66 D.T.C. 5244 (Ex. Ct.); aff'd [1967] C.T.C. 50, 67 D.T.C. 5035 (S.C.C.).

²⁷R. Reid, ibid., at 86; M.N.R. v. Consolidated Holdings Co. Ltd., [1972] C.T.C. 18, 72 D.T.C. 6007 (S.C.C.); folld. H.A. Fawcett & Son Ltd. v. R., [1980] C.T.C. 293, 80 D.T.C. 6195 (F.C.A.).

²⁸[1982] C.T.C. 351, 82 D.T.C. 6297 (F.C.T.D.); aff'd 84 D.T.C. 6346 (F.C.A.).

²⁹See further infra Chapter V, notes 39-62 and accompanying text.

was also applied in at least two later cases.²⁰

The question of whether the existence of a shareholder agreement can affect de jure control was looked at in the case of Aaron's Ladies Apparel Ltd. v. M.N.R.²¹ This case held that restrictions on the voting power of the shareholder would not affect the control of the corporation unless they are incorporated into the articles of incorporation. Hall J. stated,

"A contract between shareholders to vote in a given or agreed way is not illegal. The Articles of Association are in effect an agreement between the shareholders and binding upon all shareholders."²²

This is a strict application of the notion of de jure control.

The issue was further discussed in the case of International Iron & Metal Co. Ltd. v. M.N.R.²³ The court found that,

"The fact that the shareholders of such a corporation may be bound under contract to vote in a particular way regarding the election of directors (as in this case), is irrelevant to the said meaning of "controlled" because the corporation has nothing to do with such a restriction.

Instead, the only relevant fact is that the voting power in such a corporation remains in the owners of such a number of shares. In other words, they do not in any lesser way control the corporation because they themselves may be liable to certain external control by such a contract.

As a consequence, in my view, this said agreement was not the kind of contract among shareholders discussed in

²⁰Re A. Zimet Ltd., *supra*, note 13; Rostal Sales Agency Ltd. v. R., [1983] C.T.C. 5, 83 D.T.C. 5036 (F.C.T.D.).

²¹[1967] C.T.C. 50; 67 D.T.C. 5035 (S.C.C.).

²²Ibid., at C.T.C. 61; D.T.C. 5041.

²³Supra, note 12.

(Aaron's Ladies Apparel) because in that case, by virtue of statute it became part of the constitution of the Company"³⁴

This finding was later upheld by the Supreme Court of Canada.

Though the decision in the Aaron's case³⁵ was distinguished, the decision in the International Iron case may cast some doubt on the effect of a unanimous shareholder agreement on the issue of de jure control. However, it is significant that the court distinguished the two cases on the grounds that the agreement in the Aaron's Ladies Apparel case was protected by statute.

The unanimous shareholder agreement is now given special status in most of the Canadian business corporations statutes, and directors and officers must act in accordance with the provisions in the agreement.³⁶ This type of agreement seems to more closely resemble the agreement in the Aaron's case, and the findings of the courts seem to suggest that such an agreement can affect the issue of control.³⁷ This can be construed as movement away from the strict de jure control notion.

Where a corporate share repurchase agreement exists, the shareholders are not regarded as having the right at any time

³⁴Ibid., C.T.C. at 674-675; D.T.C. at 5448.

³⁵Supra, note 31.

³⁶See further, infra, Chapter VI notes 47-63 and accompanying text.

³⁷R. Reid, supra, note 5 at 90.

to acquire shares or to control the voting rights because these rights are vested in the corporation.³⁹

B. THE ARM'S LENGTH RULE

The question of who controls the corporation is important for establishing whether or not the parties to the agreement were dealing at arm's length at the time of the agreement. The question of control will also determine whether or not two corporations are associated and therefore deemed not to be dealing at arm's length.⁴⁰

The term "arm's length" is used several times in the Act, but no general definition is provided for all the arm's length relationships.⁴⁰ Section 251 specifies two classes of persons for the purpose of establishing the relationship. These are "related persons" and "persons not related to each other" (unrelated persons). The term "related persons" is defined by subsection 251(2) of the Act and includes individuals connected by blood relationship, marriage, and adoption.⁴¹

³⁹W.J. Bies, "Certain Tax Aspects of Shareholder Agreements" Shareholders Rights and Agreements, (Toronto: Insight Press, 1985) at 6.

⁴⁰See generally, S. Eng, "The Arm's-Length Rules" Report of the Proceedings of the Fortieth Tax Conference, 1988 Conference Report, (Toronto: Canadian Tax Foundation, 1989) 13.1.

⁴⁰Interpretation Bulletin, IT-419, July 10, 1978, "Meaning of Arm's Length".

⁴¹See subsections 251(3)-(6) inclusive, for expansion and clarification of the definition as provided in subsection 251(2).

For the purposes of the Act, related persons are deemed not to deal at arm's length.⁴² In the case of H. and L. Kushnir v. M.N.R.,⁴³ transactions between related persons, though conducted on a seemingly arm's length basis, were held to be non-arm's length transactions. This case seems to be authority for the proposition that, once it is determined that persons are related, there is an irrebuttable presumption that they could not have dealt at arm's length.

The question of whether unrelated persons were dealing at arm's length at a particular time is one of fact,⁴⁴ and each transaction must be examined on its own merits.⁴⁵ Three main factors are employed in determining whether, as a matter of fact, such a transaction is at arm's length. The first of these is the existence of a common mind, that is, if the same party determined the terms of the bargain on behalf of both parties.⁴⁶

Secondly, Revenue Canada will determine whether the parties acted in concert, that is, interdependently rather

⁴²Para.251(1)(a).

⁴³[1985] 1 C.T.C. 2301 (T.C.C.).

⁴⁴IT-419; Para.251(1)(b).

⁴⁵IT-419.

⁴⁶Estate of Karma May v. M.N.R. (1988), 88 D.T.C. 1189 (T.C.C.); M.N.R. v. Estate of T.R. Merit, [1969] C.T.C. 207 (Ex. Ct.); IT-419, para.12. But see, Robinson v. M.N.R., [1987] 1 C.T.C. 2055 (T.C.C.).

than independently.⁴⁷ The third factor to be considered is de facto control.⁴⁸

Paragraph 251(2)(b) governs the relationship between a person and a corporation. This section provides that for a non-arm's length relationship to exist, between an individual and a corporation, that corporation must be controlled by that shareholder, either singly⁴⁹ or through a related group.⁵⁰ In cases where a shareholder and a corporation are deemed not to be related by virtue of this section, there is a general presumption that they are dealing at arm's length.⁵¹

When determining whether a person and a corporation are related and therefore deemed not to be dealing at arm's length paragraph 251(5)(b) applies. This section provides,

"A person who had a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares in a corporation, or to control the voting rights of shares in a corporation, shall, except where the contract provided that the right is not exercisable until the death of an individual designated therein, be deemed to have had the same position in relation to the control of the corporation as if he owned the shares; . . ."⁵²

⁴⁷Pender Enterprises Ltd. v. M.N.R., [1965] C.T.C. 343 (Ex. Ct.).

⁴⁸Noranda Mines Ltd. v. M.N.R., [1987] 2 C.T.C. 2089; 87 D.T.C. 379 (T.C.C.); IT-419, paras. 11 and 13. See further infra, Chapter V notes 5-38 and accompanying text.

⁴⁹Para.251(2)(b)(i).

⁵⁰Para.251(2)(b)(ii).

⁵¹IT-419, para.19.

⁵²The preamble to this section states that the rule only has effect for subsection 251(2) and s.256.

This paragraph seems to be aimed at ensuring that if a person is put in a position where he or she is entitled to control, even contingently, he or she would be subject to the same disadvantages as if they actually had control.²³

Where the buy-sell agreement grants a shareholder a right or an option to acquire the shares of another shareholder, paragraph 251(5)(b) will apply regardless of whether the option is exercisable on the occurrence of a specific event.²⁴

Paragraph 251(5)(b) does not apply unless all parties have either a right or an obligation to buy or sell. Accordingly, this paragraph is held not to apply to either the right of first refusal,²⁵ or the shotgun provision.²⁶ The reason for this is that a right of first refusal cannot be construed as a right to acquire shares. It is merely an option to acquire a right to acquire shares if the owner of the shares decides to offer them for sale to a third party.²⁷

In the case of the shotgun provision, the right to acquire the shares is contingent on the shotgun clause being invoked.

²³D.W. Smith, "Buy-Sell Agreements" Report of the Proceedings of the Thirty-First Tax Conference, 1979 Conference Report, (Toronto: Canadian Tax Foundation, 1980) 665 at 668. See also, IT-419, para.8.

²⁴W. Bies, supra, note 38 at 4.

²⁵IT-64R2, para.31; IT-419, para.8; See further infra, Chapter II notes 94-108 and accompanying text.

²⁶IT-64R2, para.31. See further infra, Chapter II notes 73-90 and accompanying text.

²⁷IT-64R2, para.31; IT-419, para.8; W. Bies, supra, note 38 at 5.

It is only then that one shareholder has the right to acquire the shares of the offeror by accepting the offer. The offeror's right to acquire, on the other hand is contingent on his offer being rejected by the offeree.¹⁰

Paragraph 251(5)(b) does not apply where the contract provides that the right to acquire the shares is not exercisable until after the death of the individual designated therein. It will therefore not apply where one shareholder has a right to acquire the shares of another shareholder on his or her death.¹¹

It has been argued that the words "in the future" and "contingently" in paragraph 251(5)(b) modify the word "right". Therefore the right to acquire shares pursuant to a shotgun or first refusal clause should be considered a contingent or future right.¹²

Notwithstanding the above, Revenue Canada has ruled that it would not allow the controlling shareholders to argue that paragraph 251(5)(b) has the effect of divesting them of control by giving the appearance of divesting control by "selling" the controlling shares to some other person while retaining an option to repurchase them.¹³ Also, paragraph

¹⁰W. Bies, ibid.

¹¹IT-64R2, para.32; R. v. Alroy Industries Ltd. (1976), 76 D.T.C. 6220 (F.C.T.D.); Toric Optical Ltd. v. R. (1978), 78 D.T.C. 6310 (F.C.T.D.).

¹²W. Bies, supra, note 38, at 5. This argument has found some support in the obiter dicta of Mahoney J. in Lusita Holdings, supra, note 28 at 6299.

¹³IT-64R2, para.33.

251(5)(b) does not deny that actual control is held by the person who holds it, otherwise it would be possible for the person who does control the corporation to argue that he or she was divesting control pursuant to that paragraph, by giving an option to some other person which such person has no intention of exercising.*2

C. CANADIAN-CONTROLLED PRIVATE CORPORATION (CCPC)

The issue of control as determined by the buy-sell agreement, is important for establishing whether a corporation qualifies as a Canadian Controlled Private Corporation (CCPC). A CCPC is defined in the Act as "a private corporation that is a Canadian corporation,*3 other than a corporation controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation) or by any combination thereof".*4

The fact of whether or not a corporation qualifies as a CCPC is important for establishing whether it is entitled to

*2IT-64R2, paras.33-35; Viking Food Products Ltd. v. M.N.R. (1967, 67 D.T.C. 5067 (Ex. Ct); M.N.R. v. Fritz Werner Ltd. (1972), 72 D.T.C. 6239 (F.C.T.D.); Yardley Plastics of Canada Ltd. v. M.N.R., [1966] C.T.C. 215 (Ex. Ct.).

*3Defined in subsection 89(1).

*4Para.125(7)(b) and subsection 247(1); See further, Interpretation Bulletin, IT-458, Sept. 8, 1980, "Canadian Controlled Private Corporation".

the small business deduction⁶⁵ from the tax otherwise payable for a year as provided for under the Act.⁶⁶

D. ASSOCIATED CORPORATIONS

The question of control also determines whether or not two corporations are associated.⁶⁷ According to the Act, two corporations are associated if one corporation controls the other, or both corporations are controlled by the same person or group of persons.⁶⁸ The most significant consequence of association is that where corporations are found to be associated, they are obliged to share the one annual small business deduction and the total business limit.⁶⁹ The full small business deduction may not be claimed by each of them.⁷⁰

⁶⁵I.e. 20% of its active business income for that year up to a maximum of \$200,000 - subsection 125(2); See further, Interpretation Bulletin IT-73R4 September 13, 1988, "Small Business Deduction".

⁶⁶Subsection 125(2), para.(6)(a); IT-64R2, para.2.

⁶⁷See generally, W.G. Beach & M.F. Wheeler, "Associated Corporations" Report of the Proceedings of the Fortieth Tax Conference, 1988 Conference Report, (Toronto: Canadian Tax Foundation, 1989) 10.1; P. Truster, "Associated Corporations: The New Rules" Report of the Proceedings of the Fortieth Tax Conference, 1988 Conference Report, (Toronto: Canadian Tax Foundation, 1989) 11.1; R.B. Miner, Associated Corporations (Toronto: Carswell Legal Publications, 1983).

⁶⁸Subsections 256(1), (2), and (3)-(6) inclusive, provide exceptions in certain circumstances where the application of the general rules would be inappropriate.

⁶⁹See further, W. Beach, supra, note 67 at 10.2; R. Miner, supra, note 18 at S1-S5, for a discussion of the other effects of association for the purposes of the Act.

⁷⁰Subsections 125(2)-(3); IT-64R2, para.1.

Because the buy-sell agreement provides for rights or options to purchase shares, care must be taken when drafting the agreement to ensure that two corporations do not inadvertently become associated or lose their CCPC status.⁷¹

3. THE DEATH OF A SHAREHOLDER

The Act provides that the taxpayer is deemed to have disposed of non-depreciable capital property (such as shares of a corporation) immediately before death for proceeds of disposition equal to the fair market value of the property at that time.⁷²

The deemed disposition rules do not apply (and the tax may be deferred), if the capital property is bequeathed to a spouse or a testamentary spouse trust.⁷³ This is called a spousal rollover. Where the shares are bequeathed outright to the spouse, para.70(6)(a) provides a rollover at death, once the shares vest indefeasibly in the widow or widower within 15

⁷¹W. Bies, supra, note 38 at 3.

⁷²Paras.70(5)(a) and (c); If the capital gain arises on death, the executors may elect to pay the resulting tax in ten consecutive installments - subsection 159(5); F. P. Kirby, "The Capital Gains Exemption: Other Than Qualifying Small Business Corporation Shares", Report of the Proceedings of the Fortieth Tax Conference Report, 1988 Conference Report, (Toronto: Canadian Tax Foundation, 1989) 30:1 at 30:36; J. Bernstein, supra, note 4 at 976.

⁷³Subsection 70(6); Para.73(1)(c) defines a spouse trust as a trust under the terms of which a spouse is entitled to receive all of the income of the trust that arises before the spouse's death and no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or of the capital of the trust.

months of the death of the taxpayer.⁷⁴

Revenue Canada's view is that a property vests indefeasibly in a spouse or child of the deceased, when such person obtains a right to absolute ownership of that property in a manner that such right cannot be defeated by any future event even though that person may not be entitled to the immediate enjoyment of all the benefits arising from that right.⁷⁵

Where the spouse of a deceased shareholder is the beneficiary of the shares and the spouse is not subject to a mandatory buy-sell agreement, the deemed disposition on death may be avoided.⁷⁶

If the shares which were owned by the deceased immediately before death are bequeathed to a beneficiary and are subject to a buy-sell agreement, the vesting of the shares in the beneficiary depends on the terms of the agreement. If a person acquires shares subject to a buy-sell agreement under a deceased person's will, and is bound to sell them, the shares would not be considered to have vested indefeasibly in the beneficiary for the purposes of subsection 70(6) (which deals

⁷⁴See further, R. Witterick, supra, note 4 at 16.17-16.18; J Bernstein, supra, note 4 at 977. See also, infra, Chapter V, note 2.

⁷⁵IT-449, para.1; P. Dontigny Estate v. R., [1974] C.T.C. 532 (F.C.A.).

⁷⁶IT-449, para.8(d); J. Bernstein, Tax Planning for Professionals and Executives, (Don Mills, Ontario: CCH Canadian Ltd., 1983) at 146; Parkes Estate v. M.N.R., [1986] 1 C.T.C. 2262, 86 D.T.C. 1214 (T.C.C.).

with transfers and distributions to a spouse or a spouse trust), if they passed subject to the buy-sell agreement.⁷⁷

On the other hand, in those cases where the terms of the agreement simply grant the remaining shareholders an option to acquire the deceased's shares, an executor is required to sell and the other party to buy the shares before settling the estate, therefore the shares would not be considered to vest indefeasibly. Once the taxpayer's executors transfer the shares to the beneficiary before the option is exercised, the shares would be considered to have vested indefeasibly in the beneficiary at the time of the transfer.⁷⁸

This result could be avoided if the spouse is made a party to the buy-sell agreement, with the surviving shareholders having a call option to purchase the shares of the deceased in the event of death, failing which the spouse would be entitled to a put option.⁷⁹ In such a case, neither party is compelled to sell or purchase the shares and therefore the indefeasible vesting can occur.⁸⁰

⁷⁷IT-449, para.8(d); Parkes Estate v. M.N.R., ibid.; See also, R.M. Wise, "Valuation and the Income Tax Act" (1981) 29 Can. Tax J. 626 at 631; J. Bernstein, supra, note 4 at 976-978.

⁷⁸IT-449, para.8(d); This would also apply where the beneficiary is a trust.

⁷⁹R. Witterick, supra, note 4 at 16.18; R. Wise, supra, note 77 at 631; J. Bernstein, supra, note 76 at 148; See further, infra, Chapter II notes 72-74 and accompanying text.

⁸⁰R. Wise, ibid., at 631; R. Witterick, ibid., at 16.12-16.17.

If the purchase price is payable over a period of time, the capital gains reserve may be available.^{*1} The shares would be acquired at their adjusted cost base to the deceased^{*2} and the sale by the spouse of the shares for proceeds in excess of the adjusted cost base would give rise to a capital gain.^{*3}

Where the spousal rollover is not available, the deceased will be deemed to have disposed of the shares immediately prior to death for proceeds equal to their fair market value at that time.^{*4} A capital gain may result and the estate will acquire the shares at a cost base equal to the fair market value of the shares on death.^{*5}

^{*1}Para.40(1)(a)(iii), if however there is adequate life insurance, the purchase price would be paid in full at the closing and no reserve would be available - 75(5)(d); J. Bernstein, supra, note 4 at 983.

^{*2}Para.70(6)(b); The adjusted cost base, as it applies to property other than depreciable property, is defined in para.54(a) as the cost to the taxpayer of the property adjusted, as at that time, in accordance with the provisions of s.53. Section 53 describes a variety of specific situations, in which amounts that would otherwise be treated as capital gains or losses (see note 80 below), or amounts of ordinary income, have instead been deferred and applied to reduce or increase the cost base of the property for purposes of measuring a future capital gain or loss - G. Colley, Tax Principles to Remember, (Toronto: The Canadian Institute of Chartered Accountants, 1983) at 9-10.

^{*3}Para.40(1)(a); A capital gain occurs when capital property is disposed of and the proceeds of disposition exceed the cost (or adjusted cost base) of the property plus the costs of disposition - G. Colley, ibid., at 9-01.

^{*4}Para.70(5)(a); J. Bernstein, supra, note 4 at 978.

^{*5}Para. 70(5)(c); J. Bernstein, ibid.

If the shares are sold pursuant to the buy-sell agreement for a price equal to the fair market value of the shares at the time of death, the estate would realize neither a gain nor a loss on the subsequent disposition of the shares.

Where the shares are subject to a deemed disposition on death, and are sold to the surviving shareholders by the deceased's estate for fair market value as determined in the buy-sell agreement, the value determined in the agreement has been held to be the value for both the deemed disposition and the actual sale, therefore no additional tax should arise.**

If the purchase price as set in the agreement is less than the actual proceeds of the sale of the shares by the estate, the estate will realize a capital loss or possibly a business investment loss (BIL).^{*7} If the loss was incurred within the first taxation year of the estate the capital loss could be employed to reduce the capital gain arising on death.**

**Re Estate of Warwick Beament (1970), 11 D.L.R. (3d) 237 (S.C.C.); See also infra, Chapter V notes 152-157 and accompanying text.

^{*7}J. Bernstein supra, note 76 at 979.

**Subsection 164(6) - This subsection provides that where in the course of administering the estate of a deceased taxpayer, the legal representative has, within the first taxation year of the estate, disposed of capital property of the estate so that a net capital loss arises, the legal representative shall be deemed to have paid, on account of the tax payable by the estate for its first taxation year, an amount equal to the difference between the tax payable by the deceased for the taxation year in which he died and the tax that would have been payable in the year of death if such excess capital loss (or part thereof) is subject to an election to be treated as a capital loss of the deceased for the year of death. If such an election is made, the capital

4. FUNDING

A. CORPORATE PURCHASE

Corporate legislation in many of the Canadian jurisdictions has been amended to permit a corporation to redeem or repurchase the shares of a deceased or departing shareholder for cancellation. The corporation may maintain insurance for the purpose of funding the buy-out.**

The treatment by Revenue Canada of insurance proceeds payable to the corporation depends on the date on which the corporation became a beneficiary under the policy.*° If the shares owned by the deceased are purchased for cancellation, and the maximum capital dividend is declared, there is a possibility that the deceased and the estate will not be taxable.*¹

Where the corporation is a beneficiary under a life insurance policy on June 28, 1982, it is deemed not to have been a beneficiary under such a policy on or before June 28, 1982 where at any time after December 1, 1982 a prescribed premium has been paid under the policy or there has been a prescribed increase in any benefit on death under the

loss is deemed not to be a loss to the estate so as to avoid a duplication. See further, J. Bernstein, supra, note 4 at 980-982, for a discussion of the implications of this subsection.

**J. Bernstein, ibid., at 998; See further, infra, Chapter IV notes 74-85 and accompanying text.

*°Subsection 89(2)(a).

*¹J. Bernstein, supra, note 4 at 999.

policy.²²

Where shares are purchased for cancellation, a deemed dividend arises to the extent that the redemption proceeds exceed the paid-up capital of the shares.²³ If the vendor is an individual, the deemed dividend is treated as an ordinary dividend, and is therefore given full gross-up and tax dividend credit.²⁴ If the shareholder is a corporation, the deemed dividend is a an inter-corporate dividend and the recipient may be entitled to a deduction equal to the amount of the deemed dividend.²⁵

The corporation may also qualify for a dividend refund of all or a part of its refundable dividend tax on hand as a result of the deemed dividend that occurs on the purchase of its shares.²⁶ The corporation may elect to treat the deemed dividend as a capital dividend.²⁷ This will be received on a tax-free basis by the estate.²⁸

The amount of the deemed dividend is not included in the

²²Subsection 89(2).

²³Subsections 54(c), 54(h), and 84(3); J.F. Kennedy, "Shareholder Agreements" in Special Lectures of the Law Society of Upper Canada, Recent Developments In Estate Planning and Administration, (Toronto: Richard De Boo Publishers, 1980) 317 at 328; D. Smith, supra, note 53 at 679.

²⁴Para.82(1)(b) and s.121.

²⁵Subsection 112(1).

²⁶S.129; R. Witterick, supra, note 4 at 16.9.

²⁷Para.83(2)(a).

²⁸Para.83(2)(b).

proceeds of disposition when calculating whether the vendor has any capital gain or loss on the transaction.¹⁰⁰ This usually results in the vendor having a capital loss equal to the deemed dividend.¹⁰⁰

Where the rollover is not available, the estate is deemed to have acquired the shares for a cost equal to the deemed proceeds to the deceased (that is, the fair market value immediately prior to death).¹⁰¹ If a capital dividend is paid to the estate, it will not reduce the adjusted cost base of the shares owned by the estate.

If the vendor or his or her estate and the corporation deal at arm's length and the corporation is a small business corporation, then the loss may qualify as a business investment loss (BIL).¹⁰² An allowable business investment is deductible in full against income of the vendor from any source, and any unused remainder forming part of the non-capital losses of the vendor. Therefore, it will be available against past and future income of the vendor from any source within the normal limits applicable to any non-capital

¹⁰⁰Para.54(h)(x); R. Kirby, supra, note 72 at 30:36.

¹⁰⁰R. Witterick, supra, note 4 at 16.7.

¹⁰¹J. Bernstein, supra, note 4 at 999; Para.70(5)(c).

¹⁰²Para.39(1)(c); Interpretation Bulletin IT-484R "Business Investment Losses" May 5, 1989; See also infra, Chapter V notes 109-113 and accompanying text.

losses.¹⁰³

If the vendor controls the corporation, then there is no BIL and any capital loss is denied under subsection 85(4) (which deals with losses from disposition of property to controlled corporations).¹⁰⁴

Where the shares are bequeathed to a spouse or a spouse trust,¹⁰⁵ a spousal rollover may be available on death and the proceeds from the estate would not be taxable. The deemed disposition will occur on death and a capital gain may result to the estate.¹⁰⁶

Where the shares are purchased for cancellation, the adjusted cost base of the shares of the surviving shareholders remain constant notwithstanding that the value of those shares would have increased with the elimination of the shares of the deceased. Consequently, there is no increase in the tax cost of the survivors' shares. Survivors therefore prefer to purchase shares of the deceased outright in order to increase the average tax cost base of the shares owned by them.¹⁰⁷ When the shareholders purchase the shares from the deceased's estate the shares have an adjusted cost base equal to the

¹⁰³S.38; R. Witterick, *ibid.*; J. Vesley, *supra*, note 4 at 940.

¹⁰⁴R. Witterick, *supra*, note 4 at 16.8.

¹⁰⁵para.73(1)(c).

¹⁰⁶See also *infra*, Chapter V, notes 64-77 and accompanying text.

¹⁰⁷D. Smith, *supra*, note 53 at 679.

price paid.^{10*}

B. SHAREHOLDER PURCHASE

In cases where the shareholders purchase shares from each other (cross-purchase), there are income tax considerations for both the vendor and the purchaser.

The vendor or his or her estate realizes a capital gain or loss on the sale. This gain or loss is determined by comparing the proceeds of distribution with the adjusted cost base of the sold shares. The capital gain realized on the sale is eligible for exemption under the lifetime capital gains exemption. However, the amount of capital gains eligible for exemption at any time is reduced by the taxpayers cumulative net investment claimed after 1987.^{10*}

Where the vendor and purchaser deal at arm's length and the corporation qualifies as a small business corporation as defined in subsection 248(1), any loss may qualify as a business investment loss (BIL)^{11*} to the extent that the loss exceeds the capital gains exemption claimed in previous years.¹¹¹

Only arm's length transactions can result in BILs, so if

^{10*}J. Bernstein, supra, note 76 at 149; D. Smith, supra, note 53 at 679.

^{10*}R. Witterick, supra, note 4 at 16.4.

^{11*}para.39(1)(c); See further, J. Vesley, supra, note 4 at 939-940.

¹¹¹subsection 39(9); R. Witterick, supra, note 4 at 16.4.

the buy-sell agreement falls within the provisions of paragraph 251(5)(b),¹¹² and shareholders are found not to be dealing at arm's length, they may not be able to claim losses as BILs.¹¹³

If payment of the purchase price is deferred, the vendor may be entitled to an exemption under paragraph 40(1)(a)(iii) (which sets out the general rules for the taxpayer's gain for a taxation year from the disposition of any property).¹¹⁴ This is significant in those cases where the shareholders agree to pay the purchase price in installments.¹¹⁵

Where the purchaser acquires borrowed funds to purchase the shares and the sale price received by the vendor is less than the borrowed funds, the interest is no longer deductible if the proceeds are not invested in a future qualifying event.¹¹⁶

Where the shares are sold as a result of the death of a shareholder, the adjusted cost base of shares acquired by the

¹¹²See infra, Chapter V notes 39-62 and accompanying text.

¹¹³J. Vesley, supra, note 4 at 940.

¹¹⁴R. Witterick, supra, note 4 at 16.5; J. Vesley, supra, note 4 at 931, and 937-938.

¹¹⁵See further, infra, Chapter IV notes 110-120 and accompanying text; See also, J. Bernstein, supra, note 4 at 993-998.

¹¹⁶Emerson v. R. (1986), 86 D.T.C. 6184 (F.C.A.), aff'g 85 D.T.C. 5236 (F.C.T.D.); McKay et al v. M.N.R. (1984), 84 D.T.C. 1699 (T.C.C.); Trans-Prairie Pipelines Ltd. v. M.N.R. (1970), 70 D.T.C. 6351 (Ex. Ct.); R. Witterick, supra, note 4 at 16.5; J. Vesley, supra, note 4 at 931.

deceased shareholder's estate will be the amount of the deemed proceeds in the deceased's final tax year. When the shares are sold under the buy-sell agreement no capital gain or loss would be realized if the price under the buy-sell agreement is equivalent to the fair market value of the shares immediately before death. The capital gain or loss would have been realized in the deceased's final year.¹¹⁷

If the fair market value is higher than the price set in the buy-sell agreement, a capital loss would be realized. This may offset the capital gain in the year of death if the provisions of subsection 164(6) of the Act,¹¹⁸ can be employed.¹¹⁹ If the sale is not at arm's length, then no capital gain can be realized because the sale would be deemed to have taken place at fair market value.¹²⁰

The tax treatment of purchasing shareholders is the converse of the tax treatment of the selling shareholder or his or her estate. The purchasing shareholder would have an adjusted cost base equivalent to the purchase price paid to the vendor.¹²¹

¹¹⁷D. Smith, supra, note 53 at 677.

¹¹⁸This section provides the terms and conditions for the disposition of property by the legal representative of the deceased taxpayer; See also, infra, Chapter V note 88.

¹¹⁹D. Smith, supra, note 53 at 678.

¹²⁰Interpretation Bulletin, IT-140R2, "Buy-Sell Agreements", April 14, 1989, para.6.

¹²¹R. Witterick, supra, note 4 at 16.6; D. Smith, supra, note 53 at 678.

The purchaser has a step-up in the calculation in his or her adjusted cost base, but there is no increase with respect to the paid-up capital of corporation's shares. The purchaser is therefore unable to recover sufficient tax-free funds from the corporation to cover the payment of the purchase price for the shares.

C. LIFE INSURANCE

Income tax considerations are important where life insurance is used to fund the purchase of shares upon the death of a shareholder. The most commonly used insurance arrangements are:

- i) criss-cross insurance;
- ii) corporate-owned insurance; and
- ii) split-dollar insurance.¹²²

In addition to the specific income tax considerations which may affect these types of insurance arrangements, there are some general rules which influence the payment of premiums on an insurance policy. These rules will also be discussed.

I. CRISS-CROSS INSURANCE

In this type of arrangement, the parties each undertake to obtain and maintain insurance on the lives of the other shareholders. The shareholders are responsible for the

¹²²See also *infra*, Chapter IV, notes 60-85 and accompanying text for detailed discussion of these insurance arrangements.

payment of the premiums and, when a shareholder dies the proceeds of the policy are used to purchase his or her shares.

The insurance premiums are not deductible¹²³ and after-tax dollars are used to fund the premiums.¹²⁴ The corporation may therefore have to provide the shareholders with additional funds in the form of dividends or bonuses to pay the premiums. These funds may attract the corporate distributions tax.¹²⁵

When the shareholder dies, the insurance proceeds are received tax-free by the surviving shareholders and the purchase of these shares from the deceased's estate, increases their adjusted cost base. This means that the surviving shareholders receive the shares at an adjusted cost equal to the fair market value of the shares at the time of death.¹²⁶

The insurance proceeds are also beyond the reach of the corporation's creditors because the insurance policy is held outside of the corporation. Also, these proceeds cannot be included by Revenue Canada when valuing the shares for the purposes of deemed disposition on death, and would not affect the status of the corporation as a small business

¹²³Green Acres Fertilizer Services Ltd. v. R., 80 D.T.C. 6365 (F.C.A.); In limited circumstances, part of the premiums may be claimed as a cost of borrowing money under para.20(1)(e)(ii): Interpretation Bulletin IT-309R, Jan. 10, 1979, "Expense of Borrowing Money - Life Insurance Premiums".

¹²⁴J. Bernstein, supra, note 76 at 145; T. Sweeny, supra, note 16 at 16.

¹²⁵Section 183.1; J. Bernstein, supra, note 4 at 985.

¹²⁶J. Bernstein, ibid., at 984; R. Witterick, supra, note 4 at 16.34.

corporation.¹²⁷

If no rollover applies on death however, or if sufficient capital gains exemption is not available, the deceased shareholder would realise a capital gain on the deemed disposition of his or her shares subject to subsection 70(5), once the fair market value exceeds the adjusted cost base.¹²⁸

II. CORPORATE-OWNED INSURANCE

In this case, the corporation maintains insurance for the purpose of funding the buy-out of shares. The corporation itself is the policyholder and it also pays all the premiums. When the shareholder dies the proceeds of the policy are used to purchase the deceased shareholder's interest. This may be done in either of two ways. The corporation itself can repurchase the share for cancellation or it can distribute dividends or bonuses to the remaining shareholders to purchase the shares.

Two amendments to the Act, the reduction of the personal tax rates and a change in the calculation of the dividend tax credit (making dividends subject to tax at a similar rate to taxable capital gains), have had some influence on the

¹²⁷J. Bernstein, ibid., 985; D. Drinkwalter, "Funding of Shareholder's Agreements" Shareholder Agreements and Disagreements, (Toronto: Canadian Bar Association - Ontario Continuing Legal Education, 1986) at 3; J. Bernstein, Shareholder Agreements: A Tax and Legal Guide, (Don Mills, Ontario: CCH Canadian Ltd., 1988) at para.406.

¹²⁸R. Witterick, supra, note 4 at 16.34; J. Bernstein, ibid., at para.406.

operation of this type of insurance.¹²⁹ It is therefore more advantageous for the corporation, rather than the shareholders to pay the insurance premiums where the corporation enjoys a lower rate of corporate tax.¹³⁰

Where the corporation qualifies for a small business deduction, the advantages are increased as the corporation would have more after-tax dollars available to pay the premiums. Alternatively, the corporation may pay additional funds in the form of dividends or bonuses to the shareholders to finance payment of the premiums.¹³¹

When a shareholder dies the proceeds of the policy are received free of tax and the amount by which these proceeds exceed the adjusted cost base of the policy immediately before death, is added to the corporate capital dividend account.¹³² This can later be distributed as a capital dividend out of the capital dividend account and no part of the dividend will be

¹²⁹J. Bernstein, supra, note 76 at 148.

¹³⁰B. Wilson, supra, note 4 at 16:11; See also, infra, Chapter V, notes 87-105 and accompanying text.

¹³¹See also, J. Bernstein, supra, note 73 at 148, for a detailed illustration of how this concept works.

¹³²The Capital Dividend Account - para.89(1)(b)(iv), which replaced the Life Insurance Capital Dividend Account (LICDA) (repealed effective May 23, 1985) has important implications for the taxation of the proceeds under the buy-sell agreement. For discussion of these accounts, see R. Witterick, supra, note 4 at 16.11 -16.12; B. Wilson, supra, note 4 at 16.7 -16.11; J. Bernstein, supra, note 4 at 966-973; M.H. Ibister, "Shareholders' Agreements - Revisited" (1985) 33 Can. Tax J. 835; D. Drinkwalter, supra, note 127 at 2; T. Sweeny, supra, note 16; IT-66R5, "Capital Dividends and Life Insurance Capital Dividends".

included in the income of the shareholder.¹³³

The adjusted cost base of the purchaser's shares remain constant. The insurance proceeds may be distributed to the surviving shareholders through the capital dividend account, and these funds are then used to discharge the debt owing for the purchase of the deceased's shares. The capital dividend can also be used for the deemed dividend arising from corporate purchase.¹³⁴

One of the problems with corporate-owned insurance is that Revenue Canada may assess a capital gain on the basis that the fair market value of the shares includes a portion of the insurance proceeds received by the corporation.¹³⁵ In Quebec, where the Succession Duty Act is still in force, the insurance proceeds would be included in the valuation of shares.¹³⁶

III. SPLIT-DOLLAR INSURANCE

Here, the individual shareholders purchase participating whole of life policies on a criss-cross basis and pay all the premiums until the policies acquire a cash surrender value. The policies are then assigned to the corporation as co-owner, and it undertakes to pay that portion of the premiums

¹³³D. Smith, supra, note 53 at 684.

¹³⁴R. Witterick, supra, note 4 at 16.35-16.36; D. Smith, ibid., at 683-684.

¹³⁵See infra, Chapter V notes 166-173 and accompanying text.

¹³⁶J. Bernstein, supra, note 76 at 128.

representing the increase in the cash surrender value. The balance of the premium, which amounts to the mortality gain of the policy, is paid by the shareholders.

Additional term insurance may then be acquired using the fifth dividend option in the policy.¹³⁷ When a shareholder dies, his or her estate would receive an amount equal to the face value of the original policy, (because it would be entitled to be paid the mortality gain under the policy, plus the additional coverage). The corporation, on the other hand, would be paid the cash surrender value of the original policy.¹³⁸

Corporate funds which have been taxed at the corporate rather than at the shareholder level are used to discharge an increasingly higher portion of the premiums. Where the shareholders' tax rates exceed that of the corporation, this represents a distinct advantage as fewer after-tax dollars are used towards the payment of premiums.¹³⁹

It could also be argued that, since the proceeds of the policy are payable directly to the surviving shareholders, this should not be a factor in determining the value of the shares owned by the deceased at the time of death for the purposes of the deemed disposition on death under the Act.¹⁴⁰

¹³⁷See further infra, Chapter IV note 94-95 and accompanying text.

¹³⁸See further Chapter IV notes 86-98 and accompanying text.

¹³⁹S. Silver, "Estate Planning in Canada" (1979) 27 Can. Tax J. 206 at 207; J. Bernstein, supra, note 4 at 986.

¹⁴⁰Ibid..

However, the tax authorities may include the premiums paid by the corporation in computing the income of each shareholder. The basis for this concern is that there is a differential between the premium cost which the corporation would pay for ordinary insurance and the premium for the less expensive term insurance, which would be paid by the shareholder under the policy.¹⁴¹

This difference may be assessed as either an employee benefit, an appropriation of property to a shareholder, or a loan.¹⁴² This is based on the fact that after the first few years the corporation will pay the premiums on the policy, and the shareholder would still be entitled to an amount equal to the full proceeds of the policy.¹⁴³ Because the corporation receives the cash surrender value of the policy it may be possible to argue that the corporation has not conferred a benefit on the employee and thus remains entitled to reimbursement for the premiums which it has paid.¹⁴⁴

Revenue Canada has not yet formulated an assessing practice for this type of insurance. However, if the proceeds of the insurance policy do not qualify for exemption from income tax, the corporation may be taxable on the income

¹⁴¹J. Bernstein, supra, note 4 at 986.

¹⁴²Para.6(1)(a), subsection 15(1), or subsection 15(2); J. Bernstein, ibid., at 987; D. Smith, supra, note 53 at 685.

¹⁴³S. Silver, supra, note 139 at 207.

¹⁴⁴J. Bernstein, supra, note 4 at 987.

element.¹⁴⁵

IV. PREMIUMS

The cost of life insurance premiums can be borne either by the shareholders or by the corporation itself.

Where the corporation is in a lower tax bracket than the individual shareholder, it is more advantageous to have the corporation bear the insurance premiums. Alternatively, the corporation may distribute additional funds to the shareholders by way of dividends or bonuses to finance premium payments.¹⁴⁶ If the premiums on the insurance policy are financed by the individual shareholders, rather than by the corporation, the proceeds of the policy may be protected from the corporation's creditors.¹⁴⁷

The premiums paid under the life insurance policy are generally not regarded as a deductible expense for tax purposes.¹⁴⁸ The administrative exception to this rule occurs where a lender has required the assignment of a term life insurance policy as collateral security.¹⁴⁹ Revenue Canada

¹⁴⁵I.e. the amount by which the accumulating fund, at the end of the fiscal year, exceeds the adjusted cost base of the corporation at the end of that year. See further, J. Bernstein, ibid., at 965, note 22.

¹⁴⁶J. Bernstein, ibid., at 973.

¹⁴⁷J. Bernstein, ibid., at 974.

¹⁴⁸IT-309R; Green Acres Fertilizers Services Ltd. v. R., supra, note 123; Equitable Acceptance Corporation Ltd. v. M.N.R. (1964), 64 D.T.C. 5045 (Ex.Ct); Bernstein, supra, note 4 at 973.

¹⁴⁹Para.20(1)(e)(ii); IT-309R.

has held, that it will not accept the deductions on a whole of life policy even where by reason of poor health or advanced age an individual is unable to acquire term insurance and instead assigns an existing whole life insurance policy.¹⁵⁰

The funds for the payment of the premiums would have to be borrowed for business or investment purposes rather than for personal expenses before the premiums could be deductible.¹⁵¹ When determining the reasonableness of the amount of the deduction claimed, Revenue Canada will consider the outstanding amount of the loan and other collateral provided.¹⁵²

5. VALUATION

The rights and restrictions attached to the shares under the buy-sell agreement may affect the way in which these shares will be valued for income tax purposes.¹⁵³ They will

¹⁵⁰"Revenue Canada Round Table", Report of the Thirty-Third Tax Conference, (Toronto: Canadian Tax Foundation, 1982) at 726-66, question 46, at 759-60; But see, Antoine Guertin Ltee. v. R. (1981), 81 D.T.C. 5268 (F.C.T.D.), where an amount equal to the premiums for term insurance covering the amount of the loan was held to be deductible.

¹⁵¹Rousseau Metal Inc. v. M.N.R., (1979), 79 D.T.C. 467 (T.R.B.); Direct Lumber Company Ltd v. M.N.R., (1981), 81 D.T.C 627 (T.R.B.); Economy Carriers Ltd. v. M.N.R., (1984), 84 D.T.C. 1230 (T.C.C.); Cote-Reco Inc. v. M.N.R., (1980), 80 D.T.C. 1012 (T.R.B.); But see Green Acres Fertilizers Ltd. v. R., supra, note 121.

¹⁵²J. Bernstein, supra, note 4 at 975; IT-309R.

¹⁵³Min. of Finance of British Columbia v. Estate of William Mann, [1972] 5 W.W.R. 23 (B.C.S.C.); aff'd [1972] C.T.C. 561 (B.C.C.A.); aff'd [1974] C.T.C. 222 (S.C.C.). But

also determine whether or not parties to the transaction are dealing at arm's length at the time of the agreement and therefore whether the shares will be valued according to the agreement or given their fair market value.

The question of whether or not the valuation provided in the buy-sell agreement will be acceptable for the purposes of subsection 70(5) of the Act (which deals with the valuation of shares on the death of the taxpayer), was looked at in the case of Estate of Arthur Warwick Beament v. M.N.R.¹⁰⁴ The court in this case upheld a buy-sell agreement which provided for the corporation to be wound-up as soon as possible after the death of the deceased. They held that the value of the shares for income tax purposes could not exceed the value which the executor could receive on a winding-up. In the words of Chief Justice Cartwright,

"Once it is established (and it has been conceded) that the contract binding the deceased and his executors to have the Company wound up was valid, the real value of the shares cannot be more than their holder would receive in the winding-up. To suggest that they have in fact any other value would be altogether unrealistic. When the true value of the shares in the circumstances which exist is readily ascertainable, I can find nothing in the Act that requires the computation of the value they would have had under completely different circumstances followed by an inquiry as to whether any deductions should be made from that value.

It would of course, be within the power of Parliament to enact that an asset of a deceased person which in fact could produce only \$10,725.98 for his estate should be valued for the purposes of taxation at ten times that amount but, in my opinion that would require clear and

see, Winram v. M.N.R., [1972] 27 D.L.R. (3d) 763 (F.C.).

¹⁰⁴Supra, note 86.

unambiguous words to bring about such a result. Nowhere in the words of the statute can I find the expression of such an intention applicable to the facts of the case at bar."¹⁵⁵

This issue was discussed further in the case of J.J. West Estate v. Min. of Finance for the Province of British Columbia¹⁵⁶. Here a buy-sell agreement provided for the price of the shares to be determined by a formula method of valuation and under specific circumstances. The price so determined fell below the fair market value of these shares. The question for the court was whether or not this price constituted the "value" of the shares for the purposes of the Succession Duty Act of British Columbia.¹⁵⁷ The courts held that the transfer restriction under the agreement was relevant and therefore the fair market value of the shares for the purposes of the Act, was as determined under the agreement.

The two cases discussed above seem to establish clearly that the price as determined under the buy-sell agreement would be the accepted price for these shares once the parties are dealing at arm's length.¹⁵⁸

¹⁵⁵Ibid., at 242.

¹⁵⁶[1976] C.T.C. 313 (B.C.S.C.).

¹⁵⁷R.B.S.C. 1960, c.372.

¹⁵⁸The corresponding American position is that the price fixed by the agreement will be accepted if four conditions are satisfied. These are:

- (1) the agreement restricts the rights of a shareholder to dispose of his shares during his lifetime;
- (2) the estate is obligated to sell at death either under a mandatory agreement or at the option of a designated purchaser;

The situation is somewhat different if the parties do not deal at arm's length.¹⁵⁹ Revenue Canada's position is that where the property is acquired in a non-arm's length transaction, it is a question of fact whether or not the fair market value of shares will be determined by subsection 70(5), without reference to the buy-sell agreement".¹⁶⁰ When the estate of the deceased shareholder sells the property to the surviving shareholders pursuant to the buy-sell agreement, para.69(1)(b) applies¹⁶¹ and it is also a question of fact whether the fair market value will be determined without reference to the buy-sell agreement.¹⁶²

-
- (3) the price must be either fixed by the terms of the agreement or there must be a method stated for its determination in the agreement;
 - (4) the agreement must represent a bona fide arm's length transaction and not a substitute for a testamentary disposition.

I.R. Campbell, "The Concept of Fair Market Value" in Special Lectures of the Law Society of Upper Canada, Recent Developments in Estate Planning and Administration, (Toronto: Richard De Boo Ltd., 1980) 297 at 312-313; R. Wise, supra, note 77 at 683.

¹⁵⁹See infra, Chapter V notes 39-62 and accompanying text.

¹⁶⁰Section 69; IT-140R3, para.2.

¹⁶¹IT-140R3, para.2; Para.69(1)(b) reads,
 "Except as expressly otherwise provided in this Act, . . .
 (b) where a taxpayer has disposed of anything
 (i) to a person with whom he was not dealing at arm's length for no proceeds or for proceeds less than the fair market value thereof at the time he so disposed of it, or
 (ii) to any person by way of gift inter vivos, he shall be deemed to have received proceeds of disposition therefor equal to that fair market value . . ."

¹⁶²IT-140R3, para.3.

These rules would usually apply whether the agreement is between shareholders only or between shareholders and the corporation.¹⁶³

Problems may arise if Revenue Canada's assessment of the value of the deceased's shares exceeds the amount which the estate receives for the shares under the buy-sell agreement. In such a case, the estate would be taxed at a rate higher than the amount which it actually received for the deceased's shares.

Cullity, Forbes and Brown, in their text provide a useful illustration of the anomaly that this situation can create,

"Assume the parties are not at arm's length. The adjusted cost of the deceased's shares is \$100,000.00. Under the buy-sell agreement the shares are to be sold for \$200,000.00. Fair market value for purposes of subsection 70(5) is deemed to be \$300,000.00. The deceased's capital gain is \$300,000.00 - \$100,000.00. = \$200,00.00. The estate will acquire the shares at a cost of \$300,000.00. The estate will only receive \$200,000. on the sale pursuant to the agreement. Nevertheless, the estate cannot claim to have realized a capital loss. It is deemed to have received proceeds equal to the fair market value or \$300,000."¹⁶⁴

To guard against such a situation, shareholders are advised to be cautious when fixing a pre-determined price in a buy-sell agreement, especially where the parties do not deal at arm's length. Where there are no other significant overriding considerations, one possible solution may be for the parties to attempt to calculate a purchase price by

¹⁶³R. Levine, supra, note 5 at 21.

¹⁶⁴M.C. Cullity, R.E. Forbes & C.A. Brown, Taxation and Estate Planning, (Toronto: Carswell, 1984) at 632-633.

reference to the proceeds which the deceased would be deemed to have received in his terminal year.¹⁶⁵

Paragraph 70(5)(a) provides further that a shareholder is deemed to have disposed of his or her property immediately before death for an amount equivalent to the fair market value at that time. In some cases, a corporate share repurchase plan may exist through which the corporation may own a life insurance policy on the life of the deceased shareholder. The proceeds of such a plan would be used either by the corporation or the remaining shareholders to purchase the shares of the deceased.¹⁶⁶

In the event of such an arrangement, questions may be raised as to the extent to which these proceeds or the value of the insurance policy on death should be taken into account in valuing the deceased shareholder's shares.¹⁶⁷

The issue appeared to have been dealt with in the case of Mastronardi Estate v. M.N.R.¹⁶⁸ where it was held that insurance proceeds received by the corporation as a result of the shareholder's death should not be taken into account when valuing the shares of the deceased shareholder prior to his death in accordance with section 70(5).

¹⁶⁵M. Cullity, ibid., at 632.

¹⁶⁶See further infra, Chapter IV notes 6-13 and accompanying text.

¹⁶⁷M. Ibister, supra, note 132 at 835.

¹⁶⁸[1977] C.T.C. 355 (F.C.A.).

The Mastronardi decision was somewhat modified by the enactment of subsection 70(5.3) of the Income Tax (Canada) Act. This subsection provides for the determination of the fair market value of shares immediately before the death of a shareholder and where the disposition of these shares are deemed to be as a direct consequence of the shareholder's death.

Subsection 70(5.3) also provides that where the corporation is the beneficiary of any life insurance policy on the life of the deceased shareholder, and where the death occurred before December 1, 1982, the value of the policy shall be its cash surrender value immediately before death as determined under paragraph 148(9)(b) ¹⁶⁶

Revenue Canada has held that, in determining the cash surrender value of an insurance policy for the purposes of subsection 70(5.3), elements such as outstanding policy loans, policy dividends and interest payable on such dividends, as well as prepaid premiums and dividends left on deposit are to be disregarded.¹⁷⁰ This is so, even though the value of these

¹⁶⁶ Interpretation Bulletin IT-416R3, July 10, 1987, "Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder" para.2; Para.148(9)(b) of the Act reads,

"(b) "cash surrender value". - "cash surrender value" at a particular time of a life insurance policy means its cash surrender value at that time computed without regard to any policy loans made under the policy, any policy dividends (other than paid-up additions) payable under the policy or any interest payable on such dividends:"

¹⁷⁰ IT-416R3, para.3.

elements may affect the value of the shares of the corporation which is the owner and beneficiary of the policy.¹⁷¹

The above factors are of minimal significance if the insurance policy has little or no cash surrender value. However, where the policy has a substantial cash surrender value, the effect of subsection 70(5.3) may be to increase the capital gain realizable on the shares as the cash surrender value may be included in the overall value of the shares.¹⁷²

Where the parties have dealt at arm's length, such an increase may be offset by a capital loss realized on the sale of the shares after death pursuant to the buy-sell agreement. The sale would have to be effected within the first taxation year of the estate if this particular benefit is to be realized.¹⁷³

Where subsection 70(5.3) does not apply, i.e. where the death occurred before Dec. 2, 1982, the valuation will be based on the relevant facts pertaining to the deceased in the particular case shortly before death. The factors to be considered include the cash surrender value of the policy, the life expectancy of the insured based on mortality tables, and the state of health of the insured as it would have been known

¹⁷¹Ibid.

¹⁷²M. Cullity, supra, note 164 at 633-634. See further, M.H. Ibister, supra, note 132 at 840-842; H.J. Kellough & P.E. McQuillan, Taxation of Private Corporations and Their Shareholders, (Toronto: Canada Tax Foundation, 1983) at 533-535.

¹⁷³Subsection 164(6); IT-140R3, para.4; See further infra, Chapter V, note 88 and accompanying text.

to others.¹⁷⁴

It may also be arguable that the value of the shares was reduced as a result of the death of a key employee.¹⁷⁵

6. CONCLUSION

The foregoing discussion on some of the income tax considerations relevant to the buy-sell agreement has just skimmed the surface of a very complex area of income tax law. The most significant implications of this subject seem to result from the determination of control as established by the buy-sell agreement. These determinations will also affect share valuation and the financing of the agreement.

This area is by no means the domain of laypersons. The limited discussion undertaken in this chapter has therefore aimed at alerting the reader to the range of relevant issues. The parties preparing the buy-sell agreement are advised to consult a tax specialist if they wish to avoid unpleasant surprises at a later date.

¹⁷⁴IT-416R3, paras.4-5: Para.5, details this example:
". . . the value of an insurance policy could approach its face value if it were known that the insured had a terminal illness or was critically injured as a result of an accident and not expected to recover. Conversely, it would have little added value if a person in apparently excellent health were to die unexpectedly as a result of an accident or heart attack"

¹⁷⁵J. Bernstein, supra, note 4 at 965; IT-416R3.

CHAPTER VI

THE LEGALITY AND EFFECTIVENESS OF THE BUY-SELL AGREEMENT

1. GENERAL

The concept of a contract between shareholders of a corporation is not novel. The courts have approved the use of agreements among shareholders from time to time.¹ However, these agreements were only valid to the extent that they affected the shareholders in their capacity as shareholders.² The legality of agreements between shareholders is now endorsed by many of the business corporations statutes in Canada³ through the provisions sanctioning the unanimous shareholder agreement.

Once the buy-sell agreement meets certain specified conditions, that is, it is in writing, restricts the powers of directors, and is signed by all shareholders it becomes a unanimous shareholder agreement within the statutory

¹P. Finn, "Shareholder Agreements" (1978) 6 Aus. L.J. 97 at 99-100; M.A. Pickering, "Shareholders Voting Rights and Control" (1965) 81 L.Q.R. 248.

²Ringuet v. Bergeron, [1960] 24 D.L.R. (2d) 449, S.C.R. 672 (S.C.); Motherwell v. Schoof, [1949] 4 D.L.R. 812 (Alta. S.C.).

³Canada Business Corporations Act, S.C. 1974-75-76, c.33, s.140, as amended by S.C. 1978-79, c.9, s.42, (hereafter called the C.B.C.A.). Unless otherwise noted, statutory references in this chapter are to the C.B.C.A. For the purposes of comparison however, references shall also be made to, Business Corporations Act 1982, S.O. 1982, c.4 s.108, (hereafter called the O.B.C.A.); Business Corporations Act, S.A. 1981, c.B-15, s.140, (hereafter called the A.B.C.A.).

provisions.⁴

2. THE PRESUMPTION OF TRANSFERABILITY

The major objection to the validity of the buy-sell agreement has always been based on the fact that stock was seen as being personal property and therefore transferable as personal property unless there was some binding restriction.⁵ In the case of the shareholder agreement, the limitation on the transfer of shares was discouraged on grounds of public policy.⁶

The American position, which has been buttressed in many instances by legislation, traditionally prohibited restrictions in any form.⁷ However, neither the English nor Canadian courts have customarily viewed stock solely as personal property inalienable by nature.⁸ In the case of Greenlaugh v. Mallard,⁹ Lord Greene stated,

"Questions of construction of this kind are always difficult, but in the case of the restriction of transfer

⁴See further infra, Chapter VI notes 47-63 and accompanying text.

⁵Greenlaugh v. Mallard, [1943] 2 All.E.R. 234 (C.A.).

⁶W. Painter, "Stock Transfer Restrictions: Continuing Uncertainties and A Legislative Proposal" (1960) 6 Vill. L. Rev. 48 at 49-50.

⁷F.H. O'Neal, R.B. Thompson, O'Neal's Close Corporations 3d ed., (Illinois: Callaghan's Company, 1987), c.7.08, 7.09.

⁸L.C.B. Gower, "Some Contrasts Between British and American Corporation Law" (1956) 69 Harv. L.R. 1369 at 1377-78.

⁹Supra, note 5.

of shares I think it is right for the courts to remember that a share, being personal property, is prima facie transferable, although the conditions of the transfer are to be found in the terms laid down in the articles. If the right of transfer, which is inherent in property of this kind, is to be taken away or cut down, it seems to me that it should be done by language of sufficient clarity to make it apparent that was the intention."¹⁰

In reality the corporate share can be seen as possessing the contradictory characteristics of both contractual and personal property. Problems of defining the nature of a share can be seen as directly related to the failure of the courts to take account of its dual nature.¹¹

The attitude of the courts has changed over time and the validity of restrictions are now determined within stated guidelines with each case being decided on its own merits.¹²

3. THE ATTITUDE OF THE COURTS

The validity of the buy-sell agreement has been generally accepted by the courts.¹³ The courts will, however, view the restrictions created by the buy-sell agreement on the basis of

¹⁰Ibid., at 237.

¹¹D.P. Coates, "Share Transfer and Transmission Restrictions in the Close Corporation" (1968) 3 U.B.C. L. Rev. 96 at 106; Painter, supra, note 6 at 54.

¹²See O'Neal, supra, note 7 at c.7.06, for a review of these guidelines.

¹³Trimac Ltd. v. C-I-L Inc. (1987), 52 Alta. L.R. (2d) 263 (Q.B.); (1987), 53 Alta. L.R. (2d) 97 (C.A.); Fleisher v. Rosenbloom (1988), 53 Man. R. (2d) 247 (Q.B.); Re Daniels & Fielder (1988), 65 O.R. (2d) 629 (H.C.J.), are just a few examples of cases in which the validity of the buy-sell agreement was accepted without discussion.

whether the facts of a particular case merit the bypassing of the policy considerations against restricting alienation of personal property.

If these restrictions are reasonable in the circumstances and the transferee had notice of them, they will usually be upheld by the courts. When determining the validity of transfer restrictions, the courts have considered factors such as the size of the corporation, the type of restriction, and the likelihood that the restraint will promote the best interests of the corporation as a whole.²⁴

The courts have held that they will not permit the rights of a shareholder to be cut down by vague equivocal language.²⁵ Likewise, absolute restrictions have been held by the courts to be invalid.²⁶ Where the restriction is limited in time, it may be upheld if it is thought to be reasonable and necessary in the circumstances.²⁷

In some cases, directors may have a discretion to refuse their consent to a proposed transfer of shares. This discretion must be exercised bona fide and in the best interests of the corporation.²⁸ The onus of proving improper

²⁴O'Neal, supra, note 7 at c.7.06-7.09.

²⁵Re Smith & Fawcette, [1942] Ch. 304 (C.A.) at 306.

²⁶Ontario Jockey Club v. McBride, [1927] 4 D.L.R. 30, [1927] A.C. 916 (P.C.); See further, infra, Chapter II, notes 51-57 and accompanying text.

²⁷G.D. Hornstein, "Judicial Tolerance of the Incorporated Partnership" (1953) 18 Law and Contemporary Problems 435 at 447; See further infra, Chapter II, notes and accompanying text.

²⁸Re Smith and Fawcette, supra, note 15.

conduct is on the party alleging the breach.¹⁹

The buy-sell agreement may take a variety of forms depending on the facts of a particular case and the circumstances of the parties involved. The validity of the agreement will however depend, on both its form and the circumstances under which it is being imposed.²⁰

In the case of Ontario Jockey Club v. McBride,²¹ Lord Wrenbury stated,

"That restrictions may be placed upon a shareholder's right of transfer of his shares cannot be questioned. The cases are numerous in which such restrictions have been upheld. Shares are prima facie transferable. But there is no law which precludes the shareholders from contracting for value that they shall submit to any reasonable restriction which they choose to agree to. It may be for the benefit of the company that, for instance, shares shall not be transferred to rivals in the company's trade. A restriction which precludes a shareholder altogether from transferring may be invalid but a restriction which does no more than give a preemptive right is valid."²²

The decision in the case of Mica Management Centre Inc. v. Lockett²³ also seems to confirm this position. The facts of this case were that L, the defendant, was a minority shareholder in M, the plaintiff corporation. L was also party to a buy-sell agreement which provided the method for setting

¹⁹Ibid.; See further infra, Chapter II notes 58-64 and accompanying text.

²⁰See further infra, Chapter II.

²¹Supra, note 16.

²²[1927] A.C. 917, per Lord Wrenbury, at 923.

²³(1986), 37 B.L.R. 209 (Ont. H.C.J.).

the purchase price for his shares. The defendant exercised his right to dissent under section 184 of the Ontario Business Corporations Act, 1982. M accordingly complied with subsection 184(11) by endorsing the share certificate in blank. The plaintiff corporation later offered to purchase the defendant's shares in accordance with the buy-sell agreement on the basis that they considered the price therein to be the fair market value of the defendant's shares. The defendant rejected the offer and M applied to the courts to fix a fair value. The question for the court was whether the provisions of section 184 (of the Ontario Business Corporations Act) overrode those of the buy-sell agreement between the parties. The court rejected the submission that M had waived its rights under the buy-sell agreement by complying with section 184 of the statute. Reid J. stated,

"The sanctity of contracts freely entered into by business people has always been accepted by Judges as fundamental to business life. There is reason to think that legislators hold the same view. The Courts are reluctant to interfere and do so only in the cause of justice. Legislators have as well been traditionally reluctant to interfere. Given that, it is difficult for me to read into s.184 an intention to override a contract which dealt, in effect, with the very situation contemplated by the section and which appears on its face to be otherwise valid. In the pending action its validity is not challenged."²⁴

This decision was given without reference to the earlier case of Re Bury and Bell v. Gouinlock,²⁵ against which it

²⁴Ibid., at p.217.

²⁵(1985), 12 D.L.R. (4th) 451; [1984] 48 O.R. (2d) 57 (H.C.J.).

could be viewed. The court in this case stated in relation to paragraph 247(3)(c)²⁶ of the Ontario Business Corporations Act that,

"Since the court has been given power to remodel a shareholder's agreement, it seems to me that the court must also have authority under the section to set limits to the exercise of a power given by a shareholders' agreement, if the court finds that a particular exercise of power has the effect aimed at by section 247(2)".²⁷

The court therefore determined that section 247 may give relief in face of a valid contract between the parties. The court also noted that this was particularly true of the present case where no attempt was being made to invalidate any provision in the agreement but rather was intended to provide relief from oppressive conduct.²⁸

These two decisions would therefore lead one to the conclusion that any interference by the courts with the terms of the buy-sell agreement is discretionary. The courts seem reluctant to invalidate such agreements without just cause²⁹ but are prepared to grant relief contrary to the terms of an agreement without questioning the validity of the agreement.³⁰

²⁶This paragraph deals with an application under the oppression remedy for an order to regulate a corporation's affairs by amending the articles or by-laws or creating or amending the unanimous shareholder agreement.

²⁷Ibid., at 58. This case is discussed further under the heading, "The Effect of Statute on the Validity of the Buy-Sell Agreement" infra, Chapter VI notes 68-72 and accompanying text.

²⁸Mica Management Centre Inc., supra, note 23.

²⁹Ibid.

³⁰Re Bury and Bell Gouinlock Ltd., supra, note 25.

4. THE RULE AGAINST PERPETUITIES

The rule against perpetuities is defined as a rule that invalidates contingent property rights that vest too remotely.³¹ It was generally assumed not to apply to transfer restrictions. The authority for this proposition has been the case of Borland Trustees v. Steel & Co.,³² where the restriction was upheld on the grounds that it was a personal contract and that the rule against perpetuities had no application to personal contracts.

This ruling has been challenged by the case of Re Ogilvy,³³ in which Leiff J. stated that,

"The options or conditions calling for the sale of the shares to the Ogilvy estate are therefore unenforceable on two grounds: they create interests which may not vest within the perpetuity period, and they constitute general restraints on alienation"³⁴

This would suggest that the rule against perpetuities applies to contracts, including a shareholder's rights under an agreement to purchase the interest of other shareholders, to the extent that they create such interests.³⁵ For example,

³¹Report on the Rule against Perpetuities, Report #49, (Law Reform Commission of Manitoba, 1982); S. Robinson, "Shareholder Agreements: Control and Divorce Provisions" Critical Issues Inside Major Business Agreements, (Toronto: Insight Press, 1984) at 23; E. H. Burn, Cheshire's Modern Law of Real Property, 13th ed. (London: Butterworths, 1982) at 295.

³²[1901] 1 Ch. 279.

³³(1966), 58 D.L.R. (2d) 335 (Ont. H.C.). See also, D. Coates, supra, note 11 at 105, where these two cases are distinguished.

³⁴Re Ogilvy, ibid.

³⁵Report on the Rule against Perpetuities, supra, note 31.

at common law, a transferable option to purchase shares, unlimited in time, would be invalid.³⁶ The justification for applying the rule to such an option is thought to be that the goods involved are unique and the contract is capable of specific performance. The option thus creates a property right in the optionee.³⁷

The question in each case is whether or not the right to acquire the shares created a property interest in the person possessing the right. Where the right creates such an interest, the rule would apply.³⁸

In the case of Canadian Long Island Petroleum Ltd. v. Irving Industries (Irving Wire Products Division) Ltd.,³⁹ the courts held that the rule against perpetuities does not apply to the right of first refusal. The reasoning here suggested that because the right of first refusal was merely a right to acquire only after another person decided to sell, it did not create a property right in its holders.⁴⁰

The application of the rule against perpetuities is unclear in relation to contingent rights to acquire shares in the close corporation, such as the shotgun. In each case, the

³⁶O'Neal, supra, note 7 c.7.05, note 12.

³⁷S. Robinson, supra, note 31 at 23.

³⁸Ibid., at 24.

³⁹(1979), 50 D.L.R. (3d) 265 (S.C.C.); Perpetuities Act (Alberta) S.A. 1988, c.S-61, subsection 17(4).

⁴⁰Canadian Long Island, ibid., at 277.

question is whether the right creates a property interest in its holder. If it does it would be subject to the rule. Like the right of first refusal, the shotgun is merely a right to acquire shares contingent on these being offered for sale on the one hand, or on an offer being refused on the other hand. The shotgun provision may therefore come within the ruling of the Canadian Long Island case.⁴¹

Also, in many cases, rights such as these which do create some property interests capable of vesting beyond the perpetuity period, are saved by the "wait and see" clause in the Perpetuities Act.⁴² The wait and see clause states that where a contingent interest is capable of vesting within or beyond the perpetuity period, it is presumptively valid until actual events establish that the interest is incapable of vesting within the perpetuity period, in which case it would be void.⁴³ It also provides that where the interest is incapable of vesting beyond the perpetuity period, it shall be treated as valid.⁴⁴

The Ontario statute however provides that general powers are presumed valid until it is established that they cannot be

⁴¹S. Robinson, supra, note 31 at 24.

⁴²R.S.O. 1980, c.374 as amended 1986, c.64; S.A 1976, c.P-4; S. Robinson, supra, note 31 at 24; See generally, Report on the Rule against Perpetuities, supra, note 31.

⁴³Perpetuities Act, R.S.O. 1980, c.374 as amended 1986, c.64, para.4(1)(a).

⁴⁴Ibid., para.4(1)(b).

exercised within the perpetuity period. Specific powers, options or any such rights which would have been valid but for the Act, are void for remoteness only and if the right is not exercised within the perpetuity period.⁴⁵

When drafting the buy-sell agreement, the parties should be aware of the potential for invalidation of these provisions and should advise their clients accordingly.⁴⁶

5. THE EFFECT OF STATUTE ON THE VALIDITY OF THE AGREEMENT

A. THE UNANIMOUS SHAREHOLDER AGREEMENT

The various business corporations statutes play a very important role in determining both the legality and the effectiveness of the buy-sell agreement.

Section 146(2) of the Canada Business Corporations Act, reads,

"(2) **Unanimous shareholder agreement.**- an otherwise lawful written agreement among all the shareholders of a corporation, or among all the shareholders and a person who is not a shareholder, that restricts, in whole or in part, the powers of the directors to manage the business and affairs of the corporation. . . "47

If the buy-sell agreement meets these conditions it becomes a unanimous shareholder agreement and is therefore protected by the provisions of the business corporation statutes relating to the unanimous shareholder agreement.

⁴⁵Ibid., subsections 4(2)-(3).

⁴⁶S. Robinson, supra, note 31 at 25.

⁴⁷See also, s. 146; O.B.C.A. s.108; A.B.C.A. s.140.

The application of the unanimous shareholder agreement raises some technical problems which have not yet been resolved by the courts.⁴⁸ In the first instance, one may wish to question whether it is necessary for the unanimous shareholder agreement to specify the word "unanimous" within the agreement itself before it can be said to comply with the provisions of statute.⁴⁹ The primary purpose behind the statute is to validate transfers of management powers from directors to shareholders if they so desire.

Once the unanimous shareholder agreement restricts the power of the directors, it should be regarded as being within the provisions of the statute.⁵⁰ Nonetheless, it is advisable that the agreement state specifically that it is a unanimous shareholders agreement in the body of the agreement to avoid any possible limitations on its effectiveness.⁵¹

The question of whether the unanimous shareholder

⁴⁸S. Robinson, supra, note 31 at 5. Some of these problems seem to have been corrected by both the O.B.C.A and A.B.C.A; Also, see generally, Proposals For a New Alberta Business Corporations Act, (Edmonton: Institute of Law Research and Reform, 1980) Vol.1 at 21; Vol.2, p. 202.

⁴⁹S. Robinson, ibid.; J.S. Elder & S.H. Ash, "Shareholder Rights, Obligations and Procedures" The New Ontario Business Corporations Act: Responding to the Proclamation (Toronto: Insight Press, 1984).

⁵⁰S. Robinson, ibid., at 6; R.J. Hay & L.A. Smith, "The Unanimous Shareholder Agreement: A New Device In Shareholder Control" (1985) 10 Can Bus L. J. 440, 443. See generally, Proposals For a New Alberta Business Corporations Act, supra, note 48 at 21 & Vol.2 at 202.

⁵¹J. Elder, supra, note 49 at 24.

agreement can be amended is not addressed by the Canada Business Corporations Act. The Ontario Business Corporations Act, 1982 permits such amendment if the agreement so provides but specifies that an amendment "may be effected in the manner specified".²² The Alberta Business Corporations Act also attempted to deal with this matter by providing for the "written consent of all those who are shareholders at the effective date of the amendment".²³

This requirement may not be altered by the unanimous shareholder agreement unless the agreement excludes the application of the entire statutory scheme.²⁴ It is likely that the question of amendment of the unanimous shareholder agreement under the Canada Business Corporations Act will be resolved in the same manner as under the other two Acts.²⁵

In the interest of enforceability, the parties should also ensure that the agreement complies with the minimum statutory requirements. The agreement should therefore be in writing²⁶ and all shareholders must be party to it.²⁷

²²Para.108(6)(a).

²³Subsection 140(8).

²⁴Subsection 140(9).

²⁵L. Wright, "Shareholders' Agreements in Today's Context" Shareholders' Agreements and Disagreements (Toronto: The Canadian Bar Association, Ontario Continuing Legal Education, 1986) at 5.

²⁶C.B.C.A. subsection 146(2); O.B.C.A. subsection 108(2); A.B.C.A. subsection 1(z).

It is not clear whether the expression "all shareholders" in the definition of the unanimous shareholder agreement includes non-voting shareholders and beneficial shareholders. It may therefore be safer to make both of these groups parties to the agreement. This would ensure that the statutory requirement of unanimity is met.⁸⁸ If the agreement is not signed by all the shareholders, it is not a unanimous shareholder agreement but an ordinary shareholder agreement which under common law cannot validly restrict the powers of directors.⁸⁹ This may not alter its effectiveness as a buy-sell agreement, but would make the agreement ineligible for the protection granted the unanimous shareholder agreement under the various Canadian business corporations statutes.

The Canada Business Corporations Act also specifies that the agreement must be "otherwise lawful".⁹⁰ This stipulation has been dropped by some of the subsequently enacted

⁸⁷Ibid., the term "shareholder" is not defined in the legislation, therefore leaving some doubt as to whether it refers only to shareholders of record, or also includes beneficial shareholders and shareholders of record. It has therefore been suggested that both categories of shareholders be required to sign the USA to prevent future challenges to its validity. See further, R. Hay, supra, note 50 at 445.

⁸⁸See further, R. Hay, ibid., at 445; J. Elder, supra, note 49 at 23.

⁸⁹J. Elder, ibid., at 23; Rinquet v. Bergeron, supra, note 2; Motherwell v. Schoof, supra, note 2.

⁹⁰Subsection 146(2).

provincial business corporations statutes.*¹

The restrictions on the transfer of shares of existing shareholders must be authorised by the corporation's articles of association.*² The buy-sell agreement should therefore provide that the articles be amended to reflect new restrictions. The Alberta Business Corporations Act provides additionally, that a statement of the nature of the restrictions that appear in the unanimous shareholder agreement can be substituted for a statement of the nature of the restrictions in the articles of association itself.*³

B. ENDORSEMENT OF THE SHARE CERTIFICATE

Subsection 146(4) of the Canada Business Corporations Act states that any transferee of shares which are subject to a unanimous shareholder agreement will be bound by the unanimous shareholder agreement.*⁴ This position is however qualified by section 60 of the Act*⁵, which provides,

"(1) Title of purchaser.- On delivery of a security the purchaser acquires the rights in the security that his transferor had or had authority to convey, except that a purchaser who has been a party to any fraud or

*¹See for example, O.B.C.A. subsection 108(2); A.B.C.A. subsection 140(1).

*²C.B.C.A. para.(6)(1)(d); O.B.C.A. para.5(1)(d); A.B.C.A. para.6(1)(c).

*³A.B.C.A. para.6(1)(c)(ii).

*⁴See also, O.B.C.A. subsection 108(4), A.B.C.A. subsection 140(3).

*⁵See also, O.B.C.A. s.69; A.B.C.A. s.56.

illegality affecting the security or who as a prior holder had notice of an adverse claim does not improve his position by taking from a later bona fide purchaser.

(2) Title of a bona fide purchaser.- A bona fide purchaser, in addition to acquiring the rights of a purchaser, also acquires the security free from any adverse claim."

Subsection 146(4) is further qualified by paragraph 49(8)(c) of the Act which provides that any restriction is ineffective against a transferee who has no actual knowledge of it, unless it, or a reference to it, is "noted conspicuously" on the share certificate.** Consequently, a shareholder who takes without notice of the agreement is not bound by it. The agreement loses its unanimity in such a case and ceases to be a valid unanimous shareholder agreement within the terms of the statute.

C. CANADA BUSINESS CORPORATIONS ACT PARAGRAPH 241(3)(c)

Paragraph 241(3)(c) of the Canada Business Corporations Act (the oppression remedy) reads,

"(3) Powers of courts.- In connection with an application under this section, the courts may make any interim order it thinks fit including, without limiting the generality of the foregoing, . . .

(c) an order to regulate a corporation's affairs amending the articles or by-laws or creating or amending a unanimous shareholder agreement;"⁷

**See also, O.B.C.A. subsections 56(3); and A.B.C.A. subsection 45(8), however, by virtue of subsection 140(4)-(5) of the A.B.C.A., bona fide purchasers not having knowledge can demand that they be bought out by the corporation.

⁷See also, O.B.C.A. para.247(3)(c). But see, A.B.C.A. para.234(3)(d).

By virtue of the above provisions, the courts have been granted the specific power to remodel the unanimous shareholder agreement. This section was implemented in the case of Re Bury and Bell v. Gouinlock.** The facts of the case were that Bury, a stockbroker and a shareholder employee in the defendant corporation, entered into a unanimous shareholder agreement with the corporation. Through this agreement he agreed to sell his shares to the corporation when his employment was terminated. The agreement also spelled out the process and terms under which the shares were to be sold. The corporation also had the right to extend the purchase and sale date from six months to twelve months at its option.

The plaintiff had gone to work for another brokerage house and wanted to become a shareholder thereof, so as to be able to take advantage of the benefits accruing to their shareholder employees. The by-laws of the Investment Dealer Association and the Toronto Stock exchange forbid an individual from owning shares in two brokerage houses at the same time.

The defendants exercised their contractual rights to postpone the purchase of the plaintiff's shares from six months to twelve months. This action prevented the plaintiff from becoming a shareholder of his new employer.

Bury commenced an action under section 247 (Ontario

**Supra, note 25; See also infra, Chapter VI notes 24-28 and accompanying text.

Business Corporations Act, 1982) contending that the conduct of the defendant corporation was oppressive.

The court found that the defendant's only motive was to embarrass the plaintiff and consequently, its actions were oppressive. Eberle J. stated,

"Indeed section 247(3)(c) expressly provides that the courts make any order it thinks fit including, without limiting the generality of the foregoing, . . .

(c) an order to regulate a corporation's affairs amending the articles or by-laws or creating or amending a unanimous shareholder agreement;

This is a far-reaching provision. Since the court has been given power to remodel a shareholder's agreement, it seems to me that the courts must also have authority under the section to set limits to the exercise of a power given by a shareholders' agreement, if the court finds that a particular exercise of power has the effect aimed at by section 247(2). The appropriate canon of interpretation has been stated in Re Ferguson and Imax Systems Corp. (1983) O.R. (2d) 128 at p.137, 150 D.L.R. (3d) 718 at p. 727, as follows, ". . . and the section should be interpreted broadly enough to carry out its purpose".**

Relief was accordingly granted.

By virtue of paragraph 247(3)(c), the courts now seem to have the jurisdiction to override an agreement between parties. Therefore, even where there is no evidence of inequality of bargaining power or any difficulty in determining the terms of the agreement itself, the agreement may be set aside if the court is satisfied that actions subsequent to the execution of the agreement do not achieve

**Ibid., at 58.

its interpretation of fairness and equity.⁷⁰ This power may be questioned on the basis that it represents an erosion of the ability of a party to a contract to rely on its express terms.⁷¹

The reality of this for both the shareholders and the corporation is that regardless of how cautious the parties are in drafting the agreement, its validity may be of no consequence when viewed against the facts of a particular case.

It is therefore now in the shareholders' best interests to ensure that fairness prevails, not only in the agreement itself, but also in the manner in which they conduct their affairs in relation to the corporation both before and after the execution of the agreement.⁷²

6. INSTRUMENTS IMPOSING THE BUY-SELL ARRANGEMENT

This dissertation recommends that the buy-sell agreement be drafted as a separate unanimous agreement dealing with all issues pertaining to the transfer of the corporation's shares. However, where the buy-sell arrangement does not exist as a

⁷⁰D.L. Little & K.L. Schlemmer, "It's Time To Sue" Shareholders' Agreements and Disagreements, (Toronto: The Canadian Bar Association, Ontario Continuing Legal Education, 1986) at 12-13.

⁷¹D. Little, ibid.; Mica Management Centre Inc. v. Lockett, supra, note 23.

⁷²D. Little, ibid.; M.A. Waldron, "Corporate Theory and The Oppression Remedy" (1981-82) 6 Can. Bus. L.J. 129.

separate unanimous agreement the provisions for the sale and purchase of shares must be included in another document. The instrument in which the buy-sell provisions are contained, may have some bearing on their effectiveness in the future. There are at least three possible documents in which the buy-sell provisions may be located. These are:

- a) the governing statute;
- b) the articles of incorporation; and
- c) the unanimous shareholder agreement.

A. THE GOVERNING STATUTE

The governing statute may provide a limited number of restrictions on the sale and purchase of the corporation's shares.⁷³ The main advantage of restrictions as provided in the governing statute is that they are well drafted and are binding on all the shareholders as well as the corporation.

One disadvantage of relying on these restrictions is the reality that the statutory provisions may change independent of the wishes of the shareholders. Shareholders relying on the statutory provisions must keep abreast of all relevant statutory modifications to ensure that these continue to correspond with their wishes in relation to the corporation.

A shareholder's interest in the corporation may be better

⁷³See for example, C.B.C.A. s.34; O.B.C.A. s.30; A.B.C.A. s.32, which provide for the acquisition by the corporation of its own shares and pre-emptive regghys contained in the articles of the corporation.

served by a written agreement between the shareholders and the corporation. In this way parties can make provision for a wider variety of share transfers and an aggrieved shareholder can bring an action against the corporation or his fellow shareholders.⁷⁴

B. THE ARTICLES OF INCORPORATION

At common law, the articles of incorporation create a contract not only as between the shareholders and the corporation⁷⁵ but also as between the shareholders themselves, including shareholders who are directors.⁷⁶ The articles do not form a contract between a corporation and a third party, or between shareholders and shareholder/directors when they are acting in their capacity as directors.⁷⁷

Section 6 of the Canada Business Corporations Act⁷⁸ provides the prescribed form for the articles of incorporation. Paragraph 6(1)(d) provides further that,

" . . . Articles of incorporation shall be in the prescribed form and shall set out, in respect of the

⁷⁴E.F. Horsey, "Control and Restrictions on the Ownership of Shares" Legal Problems Relating to Shareholders Agreements, (Vancouver: Legal Education Society of British Columbia, 1982) at 16.

⁷⁵Hickman v. Kent, [1915] 1 Ch. 881.

⁷⁶Rayfield v. Hands, [1960] Ch 1, [1958] 2 W.L.R. 851 (Ch. D.).

⁷⁷Elley v. Positive Government Security Life Association Co., [1876] Ex. D. 88; 34 L.T. 190 (C.A.).

⁷⁸See also, O.B.C.A. ss.4-5; A.B.C.A. s.6.

proposed corporation ,. . .

"(d) if the issue, transfer or ownership of shares of the corporation is to be restricted, a statement to that effect and a statement as to the nature of such restrictions. . .".

One of the disadvantages of placing the restriction in the articles of incorporation, is the inconvenience involved in making amendments. The various business corporations statutes provide for a corporation to amend its articles to add, change, or remove restrictions on the issue of shares or ownership of shares by a special resolution.⁷⁹ A special resolution is defined in the Act as a resolution passed by a majority of not less than two-thirds of the votes cast by the shareholders who are entitled to vote on that resolution.⁸⁰

This provides some degree of entrenchment for the shareholders rights but by the same token, the rights of a minority shareholder may be eroded by the passing of such a resolution.

C. THE UNANIMOUS SHAREHOLDER AGREEMENT

The unanimous shareholder agreement is provided for in the various business corporations statutes.⁸¹ This form of agreement is protected by statute which provides means for the

⁷⁹See for example, C.B.C.A. para.173(1)(n); O.B.C.A. para.167(1)(n); A.B.C.A. para.167(1)(1) - subject to subsection 45(8).

⁸⁰See for example, C.B.C.A. subsection 2(1); O.B.C.A. subsection (1)(43); A.B.C.A. subsection (1)(f).

⁸¹C.B.C.A. s.146; O.B.C.A. s.108; A.B.C.A. s.140.

summary enforcement of rights under the agreement. The court has the power to "make any order it thinks fit" to restrain or remedy breaches.²²

The unanimous shareholder agreement is the most effective instrument in which to house the buy-sell provisions. In this way, the shareholder's rights are protected by statute and the corporation and all its shareholders are bound by the agreement.

The shareholders should however, be wary of the additional power given to the courts under this section to make any order amending the unanimous shareholder agreement in order to grant relief under the oppression remedy.²³ This may have the effect of making the agreement vulnerable to litigation.²⁴

Also, in the absence of a special provision, the USA can only be amended by unanimous consent. Thus, the buy-sell agreement may be difficult to amend.

7. CONCLUSION

The validity of the buy-sell agreement seems to be well established. However the lawyer or drafter needs to be aware of some additional safeguards if the effectiveness of the buy-

²²See for example, C.B.C.A. s.246; O.B.C.A. s.252; A.B.C.A. s.240.

²³C.B.C.A. para.241(3)(c); O.B.C.A. para.247(3)(c); A.B.C.A. para.234(3)(d).

²⁴Re Bury and Bell v. Gouinlock, *supra*, note 25.

sell agreement is to be assured. These include, the endorsement of the share certificate and the effects of subsection 241(3)(c) of the Canada Business Corporation Act on the agreement. The agreement should also comply with the requirements in the various business corporations statutes, to ensure that it receives the added protection afforded the unanimous shareholder agreement by these statutes.

CHAPTER VII

REMEDIES

1. DISPUTE AVOIDANCE

The old maxim "prevention is better than cure" is appropriate when discussing the remedies available under a buy-sell agreement. Once a buy-sell agreement is properly planned and executed, adequate methods can be provided by which the parties can settle their differences, and the need to employ the more lengthy and complicated remedies provided by the common law and statute can be reduced.

The following are some of the provisions which may be included in the agreement to ensure its effectiveness at the required time.

The agreement should stipulate within itself that it be binding on the heirs and assignees of the signatories and that the parties so bound shall make, execute and deliver all documents necessary for the enforcement of the agreement.²

The agreement should specify the particular provincial legal system by which it would be governed. It should also state that the law so specified should continue to be in force even if one or more of the parties are no longer resident in that province when the agreement is to be implemented.

An additional safeguard has the parties make reference to

²D.S.M. Huberman, "Buy and Sell Agreements for Close Corporations" (1963) 41 Can. B. Rev. 539 at 565.

the buy-sell agreement in their wills. These wills should state specifically that the said shares are subject to a buy-sell agreement. The wills should further direct that the executors do whatever is necessary to ensure that the transfer of the deceased's shareholdings is conducted within the provisions of the buy-sell agreement.² These precautions would alert the executors and beneficiaries of the estate to the existence of the buy-sell agreement and the desires of the deceased shareholder with respect to it. Misunderstandings and disputes among the surviving shareholders and the beneficiaries would therefore be reduced.³

The agreement may also make provision for the appropriate monetary damages to be awarded for breach of the agreement. Such a stipulation may serve as a deterrent to those parties who may otherwise attempt such a breach. An order for specific performance may also be provided for in the agreement.⁴

Lawyers preparing buy-sell agreements are also urged to advise their clients to obtain independent legal advice before signing. This would protect both the lawyers themselves and their clients, as well as the other shareholders. After

²Ibid., at 566.

³Ibid.

⁴It is felt that the courts may be more inclined to entertain such a solution if it is contemplated by the agreement, see further, R.J. Hay and L.A. Smith, "The Unanimous Shareholder Agreement: A New Device in Shareholder Control" (1985) 10 Can. Bus. J. 440 at 459.

receiving such advise neither party can plead ignorance as a basis for rejecting the agreement at a later date.⁵

The above precautions may not always be enough to prevent disputes among the shareholders. Events may occur in the shareholder relationship which make its continuation undesirable.⁶ Moreover, it is unlikely that the parties to the agreement would be able to contemplate all circumstances which may result in dissent. The agreement should therefore include some general provisions for resolving future disputes.

2. TRUST AGREEMENT

In cases where the shares are subject to a right of first refusal provision, shareholders may wish to ensure that none of the shares which are the subject of the buy-sell agreement are transferred to unauthorized persons. This concern is even more pertinent when viewed against the provisions in the various Canadian business corporations statutes⁷ which state

⁵D.C. Ross, "Shareholder Agreements" in Law Society of Upper Canada, Bar Admission Course Materials, Business Law 1986/87, (Toronto: Carswell, 1986) at 56.

⁶Close corporations are said to be notorious for shareholder disputes. See R. Hay, supra, note 4 at 458, note 89.

⁷Canada Business Corporations Act, S.C. 1974: 5-76, c.33, s.140, as amended by S.C. 1978-79, c.9, s.42, (hereafter called the C.B.C.A.), unless otherwise noted, statutory references in this chapter are to the C.B.C.A. For the purposes of comparison however, references shall also be made to, Business Corporations Act (Ontario), 1982, S.O. 1982, c.4 s.108, (hereafter called the O.B.C.A.) and Business

that a transferee is not bound by a restriction if he or she has no knowledge of it and if it is not noted in the agreement.* Further, a bona fide purchaser without notice acquires a security free from any adverse claim.*

To prevent the unauthorized transfer of shares, the parties may enter into a trust agreement whereby they transfer legal title to their shares to a trustee. The trustee would ensure that transfers are made only in accordance with the terms and conditions of the agreement.¹⁰

The trust agreement can provide that the trustee either holds the shares which are subject to the buy-sell agreement, or holds the shares as security for the performance of the obligations under the agreement.¹¹

3. ARBITRATION

An arbitration clause may be included in the agreement, to deal with possible disputes. The Business Corporations Act

Corporations Act, S.A. 1981, c.B-15, s.140, (hereafter called the A.B.C.A.).

*C.B.C.A. subsection 49(8).; O.B.C.A. subsection 56(2); A.B.C.A. subsection 45(8).

*C.B.C.A. subsection 60(2); O.B.C.A. subsection 69(2); A.B.C.A. subsection 56(2).

¹⁰S. Robinson, Shareholder Agreements: Control and Divorce Provisions", Critical Issues Inside Major Business Agreements, (Toronto: Insight Press, 1984) at 27.

¹¹S. Robinson, Ibid.; The trust arrangement could also be used to administer the insurance funding arrangement. See also infra, Chapter IV 27-28 notes and accompanying text.

(Ontario), 1982 provides specifically for the use of arbitration to settle shareholder disputes pertaining to the unanimous shareholder agreement and within the terms and procedures specified in the unanimous shareholder agreement.¹²

The courts may also grant relief under the oppression remedy by ordering that an arbitration panel be set up to resolve shareholder disputes.¹³

The agreement should designate an arbitrator or at the very least, outline the procedure for the selection of an arbitrator or an arbitration panel. Such a clause would allow the shareholders to select beforehand an arbitrator who is acceptable to both parties.¹⁴ The circumstances under which a shareholder can request that a dispute be referred to arbitration, should also be included in the agreement.¹⁵

The range of sanctions available to the arbitration may be outlined. The majority decision of the arbitrators would usually govern and the agreement could stipulate that its award would be binding on all concerned.¹⁶

The parties can provide for the arbitration procedure to

¹²O.B.C.A. para.108(6)(b).

¹³C.B.C.A. s.241; O.B.C.A. s.247; A.B.C.A. s.234; Re Daniels & Fielder (1988), 65 O.R. (2d) 629 (H.C.J.).

¹⁴R. Hay, supra, note 4 at 459.

¹⁵P. Finn, "Shareholder Agreements" (1978) 6 Aus. L.J. 97 at 103.

¹⁶J. Bernstein, Tax Planning for Professionals and Executives, (Don Mills, Ontario: CCH Canadian Ltd. 1983) at 159; R. Hay, supra, note 4 at 459.

be governed by the relevant provincial Arbitration Act.¹⁷ It has however been found that the arbitration procedure prescribed by the Act is both time consuming and costly.¹⁸ The shareholders may therefore wish to prescribe their own arbitration procedure in the interest of saving both time and money.

Some disputes relating to the shareholder agreement cannot be arbitrated.¹⁹ Questions of law and questions of mixed fact and law must be determined by the courts.²⁰ Questions of law include questions relating to the interpretation of the contract.²¹ The inclusion of an arbitration clause would therefore be meaningless if the questions which are likely to arise revolve around the interpretation of the shareholder agreement. Where there are questions of fact however, the parties may prefer to use an arbitrator in the interest of saving time.²²

¹⁷R.S.O. 1980, c.25; S.A. 1986, c.A-43.

¹⁸P.R. Lockyer, "Shareholders' Agreements: Dispute Avoidance and Resolution" Shareholders' Agreements and Disagreements, (Toronto: The Canadian Bar Association, Ontario Continuing Legal Education, 1986) at 9.

¹⁹D. Ross, supra, note 5 at 211.

²⁰Arbitration Act (Alberta), S.A. 1986, c.A-43, s.14.

²¹Phillips Electronics Ltd. v. Westinghouse Can. Inc. (1984), 27 B.L.R. 54 (Ont. H.C.).

²²D. Ross, supra, note 5 at 211.

4. VOLUNTARY LIQUIDATION OF THE CORPORATION OR TERMINATION OF THE AGREEMENT

The agreement may provide for the voluntary liquidation of the corporation or the automatic termination of the agreement upon the occurrence of particular events. These may include the bankruptcy of the corporation, and the death of both shareholders in a common disaster (this is usually characterised as both parties dying within thirty days of each other). Liquidation or termination may also occur at the option of one shareholder under specific circumstances, or may occur where the owner of a policy on the life of another shareholder either allows the policy to lapse or assigns, surrenders or borrows against the policy.²³

The agreement may also provide for the corporation to be dissolved or the agreement to be terminated at the request of a certain percentage of the shareholders or where there are no prospective purchasers for the shares offered for sale.²⁴

A provision entitling a shareholder to require the liquidation or dissolution of a corporation can be seen as the most drastic remedy that the parties can include in their agreement. Before inserting such a clause in the agreement, each shareholder should carefully weigh the benefit of possessing such a right against the reality that the other shareholders have an equivalent right, which they can exercise

²³D. Huberman, supra, note 1 at 565.

²⁴R. Hay, supra, note 4 at 460.

at a time when the other shareholders may not want to liquidate.²⁵

The enforcement of a liquidation provision has been made much easier by paragraph 214(1)(b)(ii) of the Canada Business Corporations Act which permits the courts to make such an order once it is satisfied that the shareholder is entitled within the provisions of the Act.²⁶ The parties may include in their agreement a clause providing that the liquidation proceedings be governed by the liquidation provisions in the Act.²⁷

Where the shareholders are reluctant to leave any role to the discretion of the courts, they may provide in their agreement for a procedure for the liquidation of the corporation to be automatically implemented by either party giving notice of their decision to liquidate.²⁸

Once the agreement is terminated, the insurance policies on the life of the withdrawing shareholder and the policies which the withdrawing shareholder holds on the lives of the other shareholders, should be either reassigned to the shareholders whose lives are insured or they should be allowed

²⁵S. Robinson, supra, note 10 at 42.

²⁶O.B.C.A. para.206(1)(b)(i); A.B.C.A. para.207(1)(b)(i).

²⁷See further infra, Chapter VII notes 70-92 and accompanying text.

²⁸S. Robinson, supra, note 10 at 43.

to lapse.²⁹

5. RESORT TO THE COURTS

The launching of a court action is often regarded as the least attractive option for resolving a shareholder dispute as this may involve lengthy and expensive proceedings. Additionally, statute has now granted to the courts, broad discretionary powers for hearing and settling these disputes. These new powers may result in unexpected and sometimes unsatisfactory results for all the parties involved.³⁰

In some cases, a lengthy investigation may also be required before the courts can resolve the dispute. Where the corporation is labour intensive or a growing concern, the possible disrupting effect of such an investigation could prove detrimental to the survival of the business.

The mere threat of such an action is therefore usually enough to encourage shareholders to settle their difference in a more equitable manner without resort to the courts.³¹ If all else fails however, the aggrieved parties have resort to remedies under the common law and equity as well as those available under the various business corporations statutes.

²⁹J. Bernstein, "Life Insured Corporate Buy-Sell Arrangements" in Report of Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report, (Toronto: Canadian Tax Foundation, 1985) at 1011.

³⁰See infra, Chapter VI, notes 67-72 and accompanying text.

³¹P. Lockyer, supra, note 18 at 9.

A. COMMON LAW AND EQUITY

The buy-sell agreement is a form of contract and as such the common law and equitable remedies for breach of contract can apply to a breach of the buy-sell agreement. These remedies include:

- i) damages for breach;
- ii) an order for specific performance; and
- iii) an injunction.

I. DAMAGES

A shareholder may be awarded damages for breach of the agreement.²² Damages for breach of contract are awarded in an attempt to compensate the plaintiff for the loss of the benefits which would have been received had the contract been carried out without delay. Damages may not be available if the evidence indicates that the plaintiff was in a better position as a result of the delay.²³ There are three possible types of damages which can normally be awarded for such breach. These are damages for reliance, damages for restitution, and damages for loss of bargain.²⁴ Reliance

²²p. Finn, supra, note 15 at 103.

²³Trimac Ltd. v. C-I-L. Inc. [Alta.] [1990] W.W.R. 133, (1989), 69 Alta. L.R. 113 (Q.B.).

²⁴Punitive damages are not available for breach of contract. See generally, G.H. Treitel, Remedies for Breach of Contract: A Comparative Account, (New York: Oxford University Press, 1988); Bradshaw Const. Ltd. v. Bank of N.S. (29 June, 1989) Victoria 2135/84 (B.C.S.C.).

damages are awarded as reimbursement for the monies paid to third parties in expectation of the contract being honored. Restitution damages, on the other hand, are damages awarded as reimbursement for monies paid directly to the defendant in anticipation of the contract being honored.³⁵

An award for damages for loss of bargain entitles the plaintiff to the recovery of the potential profits which would have been earned had the contract been carried out. Damages for loss of bargain therefore attempt to place the plaintiff in as good a position as if the defendant had performed his obligations.³⁶ This is probably the form of damages which is most relevant to a breach of the buy-sell agreement. However, it may be possible for the plaintiff to combine claims for all three forms of damages.³⁷

The case of Leitch Transport Ltd. v. Neonex Transport Ltd.³⁸ is authority for the proposition that the courts will award damages for breach of the buy-sell agreement. The parties here entered into an agreement which involved a number of transactions, one of which was a put-call option to purchase shares in a corporation partially owned by the parties. A part of the transaction later became unattractive

³⁵H.D. Pitch & E. Carmen, Damages for Breach of Contract (Toronto: Carswell, 1985) at 2-4.

³⁶Ibid., at 2-4.

³⁷See further, ibid., at 3-4.

³⁸(1979), 8 B.L.R. 257 (Ont. C.A.).

to one of the parties and he decided against completing the deal.

The plaintiff successfully applied to the courts for, among other things, damages for loss of bargain through breach of the put-call option. The measure of damages was held to be the difference between the contract price and the market price at the time of the breach.³⁹

II. SPECIFIC PERFORMANCE

Specific performance is an equitable remedy which involves a positive obligation to do or to convey something. As a rule, equitable remedies are discretionary and are not available as of right. Disobedience of a court order for an equitable remedy amounts to contempt of court, and is punishable by a fine or imprisonment.⁴⁰

It seems to be well established that the remedy of specific performance is available for breach of the buy-sell agreement. The courts have held that where a shareholder has acquired a right to purchase the shares of another shareholder, an order for specific performance could be

³⁹Though this case involved a public corporation, the circumstances are similar to those of a private corporation, as there was a limited market available for the sale of the shares, and the large quantity being sold made it difficult to dispose of them on the stock exchange.

⁴⁰G. Treitel, supra, note 34 at 63.

granted to give effect to that right.⁴¹ Such an order is also available to require the defendant to transfer shares pursuant to a shotgun clause in the buy-sell agreement, once the plaintiff has met all the conditions under the agreement and has committed no anticipatory or actual breach which would permit the defendant to resale.⁴²

In the case of Fleisher v. Rosenbloom,⁴³ the court granted the plaintiff a remedy for specific performance to compel the defendant to complete the purchase of the plaintiff's shares under the terms and conditions of the buy-sell agreement. The court ruled that, "to do otherwise renders the agreement meaningless, and ineffective, when the shareholder wishes to dispose of his shares".⁴⁴

Where one of parties to the agreement has already disposed of their interest in breach of the agreement and prior to the proceedings for the order of specific performance, the court may make an order compelling the outside third party to honour the agreement. In the case of

⁴¹Canadian Long Island Petroleum Ltd. v. Irving Indus. Ltd. (1974), 50 D.L.R. (3d) 265 (S.C.C.); Trimac Ltd. v. C-I-L, supra, note 33; Connor et al v. MacCulloch et al (1977), 18 N.S.R. (2d) 404 (S.C.).

⁴²Charlwood Pac. Corp. v. Samoth Fin. Corp. Ltd. (11 April, 1989) Vancouver C886008 (B.C.S.C.).

⁴³(1988), 53 Man. R. (2d) 247 (Q.B.)

⁴⁴Ibid., per Kennedy J. at 249.

Canadian Long Island Petroleum Ltd. v. Irving Indus. Ltd.,⁴⁵

Maitland J. held,

"As I have already indicated, the provisions of cl. 13 involve a negative covenant not to part with Sadim's interest in the land to any other person without giving a first right of refusal to the respondents. This was a restrictive covenant given to the respondents for the benefit of their undivided one-half interest in the land. In equity the covenant bound the appellant Long Island unless it could establish, as clearly on the evidence it could not, that it had obtained the title without notice of the covenant."⁴⁶

The decree for specific performance granted in the court below was accordingly upheld.

III. INJUNCTION

Where one shareholder is desirous of preventing a fellow shareholder from disposing of their interest contrary to the terms of the buy-sell agreement, an application may be made to the courts for an interim injunction. Such an order would restrain the shareholder from acting in any manner contrary to the terms previously agreed upon by the parties.⁴⁷

In the case of American Cyanamid v. Ethicon⁴⁸ the court held that it was not necessary for an applicant in such a case to establish a strong prima facie case. The court must

⁴⁵Supra, note 41. Though this case deals with the sale of land, the principles established are equally relevant to the sale of shares.

⁴⁶Ibid., at 280-281.

⁴⁷Ibid.; Manchester Ship Canal Co. v. Manchester Recourse Co., [1901] 2 Ch. 37 (C.A.).

⁴⁸[1975] A.C. 396; [1975] All.E.R. 504 (H.L.).

however be satisfied that the case was not a frivolous and vexatious one, and that there were substantial issues to be tried. Once these conditions were satisfied, the court would then consider other matters including the threatened harm to the applicant which may not be adequately compensated by damages, the balance of convenience, and the effect of the injunction on both parties. The court held further that, when granting such an order, it did not have to be satisfied that the parties had a strong enough case to win at trial.⁴⁹

The interim injunction offers only a temporary remedy and the parties still have to seek a more permanent means of resolving their differences.⁵⁰ The successful plaintiff may also be required to undertake to accept responsibility for damages that may result to the defendant as a result of the granting of the injunction.⁵¹

B. STATUTORY REMEDIES

By virtue of sections 241 and 247 of the Canada Business Corporations Act, shareholders have resort to the courts to resolve shareholder disputes.⁵² These sections provide for the oppression remedy and the compliance and restraining

⁴⁹Bernard v. Vallenti (1978), 3 B.L.R. 138 (Ont. S.C.); Mason v. M.O.W. Holdings Ltd. (1983), 23 B.L.R. 255 (Man. Q.B.).

⁵⁰Bernard v. Vallenti, ibid.

⁵¹ibid.

⁵²See also, O.B.C.A. s.248 and subsection 252(1); A.B.C.A. ss. 234 and 240.

orders. Both these sections deal specifically with the unanimous shareholder agreement. In addition to these rights, the various business corporations statutes provide three avenues by which shareholders may recover the value of their shareholdings. These are, the winding-up of the corporation by a court order,²³ the right to dissent,²⁴ and to a limited extent, the derivative action.²⁵ These five statutory remedies are discussed individually.

I. THE OPPRESSION REMEDY

Section 241 of the Canada Business Corporations Act provides specifically for the oppression remedy.²⁶ Under this section the complainant²⁷ may to apply to the courts for an

²³See for example, C.B.C.A. s.214; O.B.C.A. s.206; A.B.C.A. s.207.

²⁴See for example, C.B.C.A. s.190; O.B.C.A. s.184; A.B.C.A. s.184.

²⁵See for example, C.B.C.A. ss. 238-240; O.B.C.A. ss. 244-246; A.B.C.A. ss. 231-233.

²⁶See generally, S.M. Beck, "Minority Shareholder's Rights in the 1980's" Corporate Law in the 80's Law Society of Upper Canada, Special Lectures, (Toronto: Richard De Boo Publishers, 1982) at 312; Kebo Hldg. Ltd. v. Noble (1987), 52 Alta. L.R. (2d) 195, 38 D.L.R. (4th) 368, 78 A.R. 131 (Alta. C.A.) for a summary of the history and meaning of the oppression remedy as applied in Canada.

²⁷Broadly defined in the C.B.C.A. s.238 to include, "a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation, a director or an officer, or a former director or officer of a corporation or its affiliates, the director, or any other person who in the discretion of the court is a proper person to make an application . . . ". See also O.B.C.A. s.244; A.B.C.A. s.231.

order. If the court is satisfied that there is conduct that in respect of a corporation or any of its affiliates that (a) any act or omission of the corporation or any of its affiliates effects a result, (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 effect a result that is "unfairly oppressive, or unfairly prejudicial to, or that disregards the interests of any security holder, creditor, director or officer". The court may then make an order to rectify the matter complained of.²⁰

The Act does not require the complainant to have personally been the object of the oppression but the oppression must have been suffered by a person directly related to the corporation, for example, a creditor, a director, or a shareholder. The remedy is available whether the conduct complained of has occurred or is threatened, and the leave of the court to bring the action is not required.²¹

Once started the proceedings cannot be stayed, settled,

²⁰C.B.C.A. subsection 241(2). See also, O.B.C.A. subsection 247(2); A.B.C.A. subsection 234(2).

²¹The courts have also held, in dealing with the corresponding section under the O.B.C.A., that a local judge has jurisdiction to hear an application for oppression, Re MacMasters and Labombards Chatam Ltd. (1985), 50 O.R. (2d) 775.

discontinued or dismissed without the approval of the court.⁶⁰

Also, where an action is brought under section 141, the complainant is not required to give security for costs.⁶¹ The corporation may be required to pay the interim costs of the shareholder.⁶²

Under section 241(3) of the Act, the court has wide powers "to make interim or final orders as it thinks fit" to remedy the oppression. These include the power to issue an order restricting the conduct complained of,⁶³ power to amend the articles and by-laws, power to create or amend the unanimous shareholder agreement,⁶⁴ and power to liquidate or dissolve the corporation.⁶⁵

Actual or potential shareholder ratification is no longer a defence to an application for a finding of oppression.⁶⁶

⁶⁰C.B.C.A. subsection 242(2). See also, O.B.C.A. subsection 248(2); A.B.C.A. subsection 235(2).

⁶¹C.B.C.A. subsection 242(3). See also, O.B.C.A. subsection 248(3); A.B.C.A. subsection 235(3).

⁶²C.B.C.A. subsections 242(3)-(4). See also, O.B.C.A. subsection 248(4); A.B.C.A. subsection 235(4).

⁶³C.B.C.A. para.241(3)(a). See also, O.B.C.A. subsection 247(3); A.B.C.A. para.234(3)(a).

⁶⁴C.B.C.A. para.241(3)(c). See also, O.B.C.A. para. 247(3)(c); A.B.C.A. paras.234(3)(c)-(d); Re Bury and Bell Gouinlock (1985), 12 D.L.R. (4th), (1984), O.R. (2d) 57 (H.C.).

⁶⁵C.B.C.A. para.241(3)(l). See also, O.B.C.A. para.247(3)(l); A.B.C.A. para.234(3)(n).

⁶⁶C.B.C.A. subsection 242(1). This is contrary to the common law position established in North-West Transport v. Beatty, [1877] 12 A.C. 589 (J.C.P.C.), which held that any matter which could be ratified by the shareholders in a

Evidence of such ratification may be taken into account by the court when making its order under sections 214, 240 and 241 of the Act.*7

The wide range of remedies available to the courts under section 241, along with the power to invoke equity in their determinations, has taken this remedy beyond the scope of mere statutory interpretation.** The courts therefore now have the discretion to make a determination based on the particular facts of each case.**

Accordingly, on an application for an order for a winding-up, the courts used the powers granted them under the oppression remedy to order instead, that the applicants be bought out at a fair price by the defendants.70

Also, where the corporation had agreed to purchase the

general meeting is not actionable.

*7C.B.C.A. subsection 242(1). See also, O.B.C.A. subsection 248(1); A.B.C.A. subsection 235(1).

**See generally, M.A. Waldron, "Corporate Theory and the Oppression Remedy" (1981-82) 6 Can. Bus. L.J. 129.

**D.T. Little, "It's Time To Sue" Shareholder Agreements and Disagreements, (Toronto: Canadian Bar Association-Ontario Continuing Legal Education, 1986) at 10; Mica Management Centre Inc. v. Lockett (1986), 37 B.L.R. 209 (Ont. H.C.J.); Re Bury and Bell Gouinlock Ltd (1985), supra, note 63; See also, infra, Chapter VI, notes 60-102 and accompanying text.

70Re Daniels and Fielder, supra, note 13, where the court found that the deliberate exclusion of the applicant shareholder from participation and management in the corporation amounted to oppression, which merited that she be bought out for fair value, rather than the corporation be wound up.

shares of a departing shareholder on certain terms, a move by the corporation to extend the period of time in which to effect the purchase without explanation was rejected by the court on the grounds of oppression.⁷¹

The wide powers of the courts under this section overlap to a large extent the other remedies provided in the Act. It is therefore likely that most shareholder actions will be started under this section.⁷²

There is some question as to whether the oppression remedy is available where the parties are not deadlocked, but each own 50% of the corporation's shares. This issue was discussed in the case of Veldova v. Garden House Ltd.⁷³ In coming to a decision, Anderson J. first examined some dictionary definitions of the terms "oppressive" and "fair". He then concluded,

"In my view, the application, insofar as it pertains to oppression or unfairness, is misconceived. Section 247 is a further protection, to those holding minority interests, from adverse treatment by the majority. The relief available is to be determined by tests less stringent than those which traditionally had to be met in order to procure an order for winding up. But in my view they continue to be confined to protection of minorities. Specifically, they are not intended as a method of mediating between opposing groups of shareholders acting from a position of equality. On the material before me, the latter is the situation with which I am faced. In the context of s.247 "oppressive" connotes an inequality of power or authority. There is none in this instant case. "Unfair" connotes an obligation to act equitably

⁷¹Re Bury and Bell Gouinlock Ltd, *supra*, note 69.

⁷²D.T. Little, *supra*, note 68 at 7.

⁷³(1985), 29 B.L.R. 236 (Ont. H.C.J.).

or impartially in the exercise of power or authority. I find no such obligation here. I find no such obligation where, as here power and authority, in the legal sense, are equally divided, and are so divided by pre-existing arrangement. The conduct of the respondents may in the view of the applicants, be obstinate, perverse and recalcitrant. It may be so in fact; I express no view. It is not "oppressive" or "unfair" within the meaning of s.247."⁷⁴

This decision can be viewed against the later case of Re Gandalman Investment Inc.⁷⁵ Here, the power and authority were not equally divided, but were held exclusively by one 50% shareholder. The courts held that the oppression remedy "could not be read so restrictively as to preclude a 50% shareholder from ever applying for relief thereunder".⁷⁶ The expression "any security holder" in the Act was thus held to include 50% shareholders in a deadlock situation.

The Veldova case was distinguished on the grounds that in that case the power and authority were equally divided between the parties.

This distinction would suggest that the oppression remedy would be available to shareholders with equal shareholding once they can prove that there was no corresponding equality of control.

II. APPLICATION FOR A RESTRAINING OR COMPLIANCE ORDER

Section 247 makes provision for a complainant or a

⁷⁴Ibid., at 240.

⁷⁵(1986), 52 O.R. (2d) 614 (H.C.J.).

⁷⁶Ibid., per Callon J. at 616.

creditor to apply to the court for a compliance order forcing persons having dealings with the corporation to comply with, among other things, the unanimous shareholder agreement. Under this section a creditor or complainant may also apply for a restraining order to prevent such persons from acting in breach.⁷⁷

This remedy is more appropriate for the enforcement of direct rights and primary rectifications of a direct nature.⁷⁸ It is also possible for a shareholder to apply for a restraining order under the oppression remedy.⁷⁹

III. APPLICATION FOR A WINDING-UP

The action for the winding-up of the corporation is covered by section 214 of the Canada Business Corporation Act.⁸⁰ The winding-up order is also available under the oppression remedy.⁸¹ Under these two sections, a shareholder may apply to the courts for an order for the dissolution of the corporation.⁸² Once the court is satisfied that the

⁷⁷See also, O.B.C.A. subsection 252(1); A.B.C.A. s.240.

⁷⁸Re Goldhar & Quebec Manitou Mines (1975), 9 O.R. (2d) 740, 61 D.L.R. (3d) 612 (Div. Ct.).

⁷⁹C.B.C.A. para.241(3)(a). See also, O.B.C.A. para.247(3)(a); A.B.C.A. para.234(3)(a). This was successfully achieved in the case of Mason v. MOW Holdings Ltd. (1983), 23 B.L.R. 255 (Man. Q.B.).

⁸⁰See also, C.B.C.A. s.206; A.B.C.A. s.207.

⁸¹C.B.C.A. para.241(3)(1); O.B.C.A. para.247(3)(1); A.B.C.A. para.234(3)(n); Oakley v. McDougall (1987), 14 B.C.L.R. (2d) 128 (C.A.).

⁸²See also, O.B.C.A. s.206; A.B.C.A. s.207.

conduct complained of is "oppressive and unfairly prejudicial to or that it unfairly disregards the interest of a security holder, creditor, director, or officer of the corporation", an order for the dissolution of the corporation will be made.³³

An order for dissolution will also be granted if the unanimous shareholder agreement entitles a complaining shareholder to demand such a dissolution after the occurrence of a specific event and that event has occurred.³⁴ Where the court is satisfied that it is "just and equitable" that the corporation should be liquidated and dissolved,³⁵ it then has wide powers under the Act to grant relief.³⁶

The Business Corporations Act (Ontario), 1982 provides additionally for a winding-up order to be granted where proceedings have begun to wind up the corporation voluntarily in the interest of contributories and creditors and the court is satisfied that such proceedings should be continued under its supervision.³⁷ Such an order may also be granted where the corporation, though not insolvent, cannot by reason of its

³³C.B.C.A. para.214(1)(a) and subsection 241(2). See also, O.B.C.A. para.206(1)(a) and subsection 247(2); A.B.C.A. para.207(1)(a) and subsection 234(2).

³⁴C.B.C.A. para.214(1)(b)(i); O.B.C.A. para.206(1)(b)(i); A.B.C.A. para.207(1)(b)(i).

³⁵C.B.C.A. para.214(1)(b)(ii). See also, O.B.C.A. para.206(1)(b)(iv); A.B.C.A. para.207(1)(b)(ii).

³⁶C.B.C.A. subsections 214(2) and 241(3). See also, O.B.C.A. subsections 206(2) and 247(3); A.B.C.A. subsections 207(2) and 234(3).

³⁷O.B.C.A. para.206(1)(b)(ii).

liabilities continue its business and it is advisable to wind it up.**

The courts usually seem reluctant to permit the use of the winding-up provision as a means of granting relief, especially where the corporation is a viable entity.** In the case of Elder v. Elder,¹⁰ it was held that this remedy was only available "in the last resort, and in the absence of feasible alternative methods".¹¹

The expression "just and equitable" seems to be the major test which the courts have used to establish whether or not such relief is necessary. In the Elder case, the Lord President went on to say,

"where the "just and equitable" jurisdiction has been applied in cases of this type, the circumstances have always, I think, been such to warrant the inference that there has been, at least an abuse of powers and an impairment of confidence in the probity with which the corporation's affairs are being conducted, as distinguished from mere resentment on the part of a minority . . ."

In the case of Scottish Cooperative Wholesalers Society v. Meyer,¹² the test seems to have been interpreted to mean

**O.B.C.A. para.206(1)(b)(iii).

**G.J. Vesley, "Some Inter Vivos Aspects of Buy-Sell Agreements" Report of Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report (Toronto: Canadian Tax Foundation, 1985) 925 at 927; F.H. Buckley, M.Q. Connelly, Corporations: Cases Texts and Materials, (Toronto: Emond Montgomery Publications Ltd., 1984) at 645; Re Cucci's Restaurant Ltd.: Burnett v. Tsang (1985), 29 B.L.R. 196 (Alta.Q.B.).

¹⁰[1952] S.C. 49 (Sc. Ct. Sess.).

¹¹Ibid.

¹²[1959] A.C. 324 (H.L.).

"burdensome, harsh and wrongful".³³ The court in this case did not order a winding-up but instead ordered that the shares of the respondents be bought out at fair value.

The courts have also held that the desire to be bought out is not enough to justify an order for a winding-up especially if there is no evidence of mismanagement or questionable dealings on the part of the directors.³⁴

Where the parties to the agreement are deadlocked the courts may be more inclined to grant the relief sought by virtue of a winding-up order.³⁵ The term deadlock implies either an inability to elect directors, an equal split among even numbers of directors on a fundamental policy, or that the corporation's business could not be performed from day to day.³⁶ Constant fighting and mutual sabotage among owners whose cooperation is necessary for the conduct of the business would therefore amount to a deadlock and would entitle the parties to a winding-up order.³⁷

In Re Pre-Delco Machine Tool Ltd.³⁸ where a complete

³³Ibid., per Viscount Simmonds at 342.

³⁴Re Daniels & Fielder, supra, note 13; But see Ebrahimi v. Westbourne Galleries, [1978] 2 W.L.R. 1289, [1973] A.C. 60 (H.L.).

³⁵Re Dunham and Apollo Tours Ltd. (1978), 20 O.R. (2d) 9 (H.C.); Re Daniels & Fielder, ibid.

³⁶Re Yenidje Tobacco Co., [1916] 2 Ch. 426 (C.A.).

³⁷Re Bondi Better Bananas Ltd., [1951] O.R. 845, [1952] 1 D.L.R. 277 (C.A.).

³⁸[1973] 3 O.R. 115, 36 D.L.R. (3d) 50 (H.C.).

breakdown had occurred between the two shareholders, an application by the minority shareholder for the winding up of the corporation was granted. The court found that the matters could not be equitably resolved by internal proceedings.

The courts have also held that whether a corporation is operating profitably is a very important consideration when deciding whether a liquidation order should be made. This fact is not conclusive in favour of denying such an order.¹⁹⁹

In the case of Meltzer v. Western Paper Box Co.,²⁰⁰ therefore, an application for a winding-up was dismissed as the court found that the majority shareholder had turned the business into a successful enterprise and had justified termination of the applicant's employment. Additionally, the court determined that the applicant was offered a fair price for the shares and held that there was no justification for a winding-up.

In light of the above authorities, it seems clear that there is no generally accepted rule as to what would categorically determine when a corporation can be wound up. This was reiterated by Lacourciere J.A. in the case of Rogers v. Agincourts Holdings Ltd.,²⁰¹ where it was stated that,

"It is quite proper to draw upon previous cases for general guidance but counsel and the Courts must be

¹⁹⁹Re Sharon Golf & County Club Ltd. (1975), 2 C.B.R. (N.S.) 159 (H.C.).

²⁰⁰[1978] 1 W.W.R. 451, 3 B.L.R. 113 (Q.B.).

²⁰¹(1977), 1 B.L.R. 102 (Ont. C.A.).

careful not to construe the authorities as the setting of a series of restrictive principles which would confine the phrase "just and equitable" to rigid categories, for each case depends to a large extent on its own facts."¹⁰²

IV. THE RIGHT TO DISSENT

Under section 190 of the Canada Business Corporations Act a shareholder has a right to dissent from actions of the corporation.¹⁰³ This right arises under specific circumstances including a resolution by the corporation to add, remove, or change any provisions restricting the transfer, or ownership of shares of a particular class.¹⁰⁴

Once a shareholder dissents to a resolution, their right to be bought out by the corporation for fair value is established.¹⁰⁵ The shareholder also has a right to reject the corporation's offer and to seek a valuation by the courts.¹⁰⁶

A shareholder who exercises the right to dissent under section 190 does not forfeit the right to challenge oppressive conduct under the oppression remedy. As former security

¹⁰²Ibid., at 108.

¹⁰³Subsection 190(1). See also, O.B.C.A. s.184; A.B.C.A. s.184.

¹⁰⁴C.B.C.A. para.190(1)(a). See also, O.B.C.A. para.184(1)(a); A.B.C.A. para.184(1)(a).

¹⁰⁵C.B.C.A. subsection 190(3). See also, O.B.C.A. subsection 184(4); A.B.C.A. subsection 184(3).

¹⁰⁶C.B.C.A. subsections 190(12)-(16). See also, O.B.C.A. subsections 184(13)-(17); A.B.C.A. subsections 184(5)-(10).

holders, they qualify as a complainant under section 238 of the Act,¹⁰⁷ and may therefore employ both remedies. The statement "in addition to any other rights he may have. . ." in subsection 190(3) of the Act,¹⁰⁸ is aimed at preserving any rights the shareholder may have under the oppression remedy.¹⁰⁹

In cases where the shares are subject to a buy-sell agreement, the courts have refrained from imposing this section and have held that the valuation would be conducted in the manner provided by the agreement.¹¹⁰

V. THE DERIVATIVE ACTION

The derivative action (formerly called a representative action) is an equitable remedy devised by the courts to permit a shareholder, acting as a complaint, to bring an action on behalf of the corporation.¹¹¹ This form of action is now provided for under section 239 of the Canada Business

¹⁰⁷See also, O.B.C.A. s.244; C.B.C.A. s.231.

¹⁰⁸See also, O.B.C.A. subsection 184(4); A.B.C.A. subsection 184(3).

¹⁰⁹Re Brant Investments Ltd. and Keeprite Inc. (1983), 5 D.L.R. (4th) 116 (Ont. H.C.).

¹¹⁰Mica Management Centre Inc. v. Lockett, *supra*, note 69.

¹¹¹See generally, S.M. Beck, "The Shareholder's Derivative Action" (1974) 52 Can. Bar Rev. 158.

Corporation Act.¹¹² The courts have wide discretionary powers to grant relief.¹¹³

This provision overrides the general rule that it is the corporation's decision whether to sue for a wrong done to the corporation. It therefore forces the corporation to sue for a wrong done to the corporation itself rather than to the shareholder.¹¹⁴

The derivative action can only be commenced with the leave of the court and after giving notice to the corporation. Thereafter, the court will not grant relief unless it is satisfied that the directors will not bring, diligently prosecute or defend an action already commenced, that the shareholder is acting in good faith, and that it is in the best interests of the corporation that the action be brought.¹¹⁵

The courts have held that because the leave of the court must be obtained before a derivative action can be brought, such an action will be struck down if the leave is not

¹¹²C.B.C.A. s.239. See also, O.B.C.A. s.245; A.B.C.A. s.233; It has been held that where there are only two shareholders, and one shareholder is desirous of commencing a derivative action against the other, he can do so, even though no other shareholder is there to represent: Feld v. Glick (1975), 8 O.R. (2d) 7, 56 D.L.R. (3d) 649 (H.C.).

¹¹³C.B.C.A. s.240. See also, O.B.C.A. s.246; A.B.C.A. s.233.

¹¹⁴D. Little, supra, note 68 at 5; Rogers v. Bank of Montreal (1985), 30 B.L.R. 41 (B.C.S.C.).

¹¹⁵C.B.C.A. subsection 239(1). See also. O.B.C.A. subsection 245(2); A.B.C.A. subsection 232(2).

acquired.¹¹⁶

The derivative action has limited application for granting relief under the buy-sell agreement as it only applies where the corporation itself has been wronged. The derivative action was therefore held not to afford relief in a situation where a shareholder, who had agreed through a buy-sell agreement to sell his shares on the termination of his employment, was fired and forced to comply with the agreement.¹¹⁷

The derivative action is also seen as being additional to and not as a replacement for any other rights which may be available to the applicant under the common law or statute.¹¹⁸

¹¹⁶Shield Dev. Co. v. Snyder, [1976] 3 W.W.R. 44 (S.C.C.).

¹¹⁷Anderson v. Witich (1979), 8 B.L.R. 209 (Ont. H.C.J.)

¹¹⁸D. Little, supra, note 69 at 7.

CHAPTER VIII

CONCLUSION

The main purpose of the buy-sell agreement is to ensure the continued availability of a market for shares and mandatory transfers in certain circumstances and to control the entry of third parties as shareholders into the corporation. This dissertation has outlined the utility of the buy-sell agreement for these purposes as well as for regulating and administering the transfer of shares in a close corporation. This was done by providing in one text an overview of the various aspects of the buy-sell agreement using for reference the available literature and case law in this area.

This exercise was prompted by the observation that even though the buy-sell agreement has been in use for a number of years, the concept of this form of agreement as a viable instrument for regulating all matters relating to the transfer of the corporation's shares is still developing. Additionally, the literature available on this subject is very selective, relating almost exclusively in some cases to income tax considerations, which are only one aspect of the buy-sell agreement.

The increasing volume of litigation in Canada relating both directly and indirectly to the buy-sell agreement would suggest that this type of agreement is gaining recognition and

acceptance among shareholders. Its development has been further buttressed by the introduction of the unanimous shareholder agreement by the various business corporations statutes. Once the buy-sell agreement meets the relevant conditions, it can receive the protection awarded the unanimous shareholder agreement under these statutes.

Where the buy-sell agreement is found to be defective the courts, using both the common law and the provisions of the various business corporations statutes, are also developing a wide range of solutions for both interpreting and implementing the provisions of the buy-sell agreement.

The use of the buy-sell agreement for estate purposes has also prompted some development in the area of income tax law, as well as the development of some new insurance products.

Notwithstanding these developments, the various aspects of the buy-sell agreement are still not viewed as a total package. The potential of a well-drafted agreement to avert future complications among shareholders regarding the transfer of shares, is therefore not appreciated.

Consequently, in many cases where the buy-sell agreement is employed, it is only partially utilized, for example, a buy-sell clause, regulating the purchase and sale of shares may be included in the corporation's articles of association or the shareholder's agreement without a corresponding provision for funding and valuation.

This dissertation advocates the implementation of the

buy-sell agreement as a separate unanimous agreement catering to the individual requirements of the parties. Factors to be considered include, the number of shareholders, their ages, the nature of the business, potential benefactors of the shareholders' estates, the availability of outside third party purchasers, and the likely interest of the parties in autonomy.

There is no question that a properly drafted buy-sell agreement can be a very useful and important tool in a close corporation. However, such an agreement must be tailor-made to fit the particular needs of the shareholders and the corporation, and must take account of at least some of the factors discussed if it is to be truly effective.

BIBLIOGRAPHY**BOOKS**

- Bernstein, Jack, Shareholder's Agreements - A Tax and Legal Guide, Don Mills, Ontario: CCH Canadian Ltd., 1988.
- Bernstein, Jack, Tax Planning for Professionals and Executives, Don Mills, Ontario: CCH Canadian Ltd., 1983.
- Bonbright, James C., The Valuation of Property, Virginia: The Mitchie Company, 1965, Vols. I and II.
- Buckley, F.H., and Connelly, Mark Q., Corporations: Principles and Policies, Toronto: Emond Montgomery Publications Ltd., 1988.
- Buckley, F.H., and Connelly, Mark Q., Corporations: Cases Texts and Materials, Toronto: Emond Montgomery Publications Ltd., 1984.
- Burn, E.H., Cheshire's Modern Law of Real Property, 13th ed. (London: Butterworths, 1982).
- Campbell, Ian R., Canada Valuation Service, Toronto: Richard De Boo Publishers, 1988.
- Cochrane, Cal and Goodman, Sheldon, Associated Corporations in Canada, 5th ed., Don Mills, Ontario, CCH Canadian Ltd., 1983.
- Cooley, Geoffrey M., Tax Principles To Remember, (Toronto: The Canadian Institute of Chartered Accountants, 1983).
- Couch, George J., Couch Cyclopedia of Insurance Law, 2d ed, New York: The Lawyers Co-operative Publishing Co., 1984.
- Cullity, Maurice C., Forbes, Robert E., Brown, Catherine A., Taxation and Estate Planning, Toronto: Carswell, 1984.
- Emerson, Garfield H., Canadian Corporation Precedents, 3d ed., Toronto: Carswell, 1989, Vol III.
- Foster, G. Financial Statement Analysis, 2d ed., New Jersey: Prentice Hall, 1986, c.12.
- Grover, Warren and Iacobucci, Frank, eds. Materials on Canadian Income Tax, 6th ed., Don Mills Ontario: Richard De Boo Publishers, 1985.

- Honsberger, John D. and Wainberg, J.M., eds., O'Brein's Encyclopedia of Forms, 10th ed., Agincourt, Ontario: Canada Law Book Ltd., 1980, Vol. VI.
- Kantor, Jeffrey, Valuation of Unlisted Shares, Don Mills, Ontario: CCH Canadian Ltd., 1986.
- Kellough, Howard J. and McQuillan, Peter E., Taxation of Private Companies and Their Shareholders, Toronto: Methuen Publications, 1972.
- O'Neal, Hodge F. and Thompson, Robert B., O'Neal's Close Corporations, 3d ed., Illinois: Callaghan & Co., 1987.
- Ovens, G., Beach, Donald I., and Grant, Carl T., Business and Securities Valuation, Toronto: Methuen Publications, 1972.
- Meehan, Eugene, Cases and Materials on Business Associations Law, Ottawa: University of Ottawa, 1987.
- Meehan, Eugene, & Vaarton, Peter, Creditors' Remedies in Alberta, Calgary: Carswell Co. Ltd., 1987.
- Meyer, William F., Life and Health Insurance Law, New York: The Lawyers Co-operative Publishing Co., 1972.
- Neff, Charlotte, ed., The Annotated Business Corporations Act of Alberta, 2d ed. Alberta: Carswell, 1984.
- Miner, Richard B. Associated Corporations, Toronto: Carswell, 1983.
- Pitch, Harvin D., Damages for Breach of Contract, Toronto: Carswell, 1985.
- Rohrlich, C., Organising Corporate and Other Business Enterprises, New York: Matthew Bender and Co. Inc., 1988, Vol. II.
- Spindler, H.O., and Timbrell, D.Y., Canadian Estate Planning, Don Mills, Ontario: CCH Canadian Ltd., 1966.
- Strikeman, Howard H. and Elliot, Fraser R., Doing Business In Canada, New York: Matthew Bender & Co. Inc., 1988, Vol. II.
- Sutherland, H., Horsley, D.B., and Gillespie, J.B., Fraser's Handbook on Canadian Company Law, 7th ed. Toronto: Carswell, 1985.

- Treitel, G.H., Remedies for Breach of Contract, New York: Oxford University Press, 1988.
- Walker, Jack and Ash, Harvey, J., debtor - Creditor Relations: Cases and Materials, Toronto: Butterworths, 1978.
- White, Edwin H., and Chasman, H., Business Insurance, 4th ed., New Jersey: Prentice Hall Inc., 1949.

ARTICLES

- Barrowdale, A., "The Effect of Breach of Share Transfer Restrictions" The Journal of Business Law (July, 1988), 307-319.
- Budd, Ruth R., and Somerville, Kurt, F., "The Impact of Buy-Sell Agreements" 7-8 Family Advocate (1984-86), 18.
- Campbell, Ian, "How to Evaluate a Closely Held Small Business" The Bottom Line, (October, 1988) 26.
- Coates, Dennis P., "Share Transfer and Transmission Restrictions in the Close Corporation" 3 U.B.C.L. Rev. (1968), 96.
- Crawford, W.E., "Shareholders' Agreements - A Need for Greater Flexibility" 31 Can. Tax J. (1983), 257.
- Davidson, Allen B., "Tax Considerations in the Close Corporation" 3 U.B.C.L. Rev., (1968), 143.
- Elfin, R., "Suggested Revisions of the Law Pertaining to the Dissolution of Partnerships and Close Corporations" 25 Am. Bus. L.J. (1987), 93.
- Finn, P., "Shareholder Agreements" 6 Aus. Bus. L.R. (1980), 97.
- Feld, Alan, "The Implications of Minority Interest and Stock Restrictions in valuing Closely Held Shares" 122 U. Pa. L. Rev., (1974), 934.
- Fox, D.W., "Compulsory Purchase of Shares in a Private Company - Some Recent Developments" The Journal of Business Law (July, 1987), 276.
- Fox, D.W., "Problems of Transferring Shares in Private Companies" 130 Sol. J. (Oct. 1986), 718.

- Gampel, P., "Valuing Minority Interest in Closely-Held Company A Complex Task" National (June 1987), 32.
- Getz, Leon, "Some Aspects of Corporate Share Repurchases" 9 U.B.C.L. Rev. (1974), 9.
- Ghinger, John J., "Shareholders' Agreements for Closely Held Corporations: Special Tools for Special Circumstances" U. Balt. L.R. (1974-75), 211.
- Goodman, "The Effect of a Shareholder Agreement on the Valuation For Income Tax Purposes of Shares of a Closely Held Corporation" 24 Can. Tax J. (1976), 193.
- Gordon, G., "Husband and Wife Ltd. - The Relationship Between Company Law and Divorce" 50 Conveyancer and Property Lawyer (1986), 335.
- Gower, L.C.B., "Some Contrasts Between British and American Corporation Law" 69 Harv. L.R. (1956), 1369.
- Hall, Thomas D., "Comment: Valuating Closely Held Stock: Control Premiums and Minority Discounts" 31 Emory L.J. (1982), 139.
- Hay, R.J., and Smith, L.A., "The Unanimous Shareholder Agreement: A New Device in Shareholder Control" 10 Can. Bus. J. (1985), 440.
- Haynsworth, "Valuation Of Business Interests" 32 Mercer L. Rev. (1982), 457.
- Hornstein, G.D., "Judicial Tolerance of the Incorporated Partnership" Law and Contemporary Problems (1953), 435.
- Hoxie, D.F., "Business Buy-Outs and the Uninsurable Shareholder" 101 Trusts and Estates (1962), 320.
- Huberman, David S., "Buy and Sell Agreements for Canadian Close Corporations" 41 Can. B. Rev. (1963), 538.
- Ibister, M.H., "Shareholder's Agreements - Revisited" 33 Can. Tax J. (1985), 835.
- Krishna, Vern, "Determining The "Fair Value" of Corporate Shares" 13 Can. Bus. Law J. (1987-1988), 132.
- Kellough, Howard J. and Zien, Randolph B. "Corporate Share Repurchase Plans: An Alternative to Shareholders' Buy-Sell Arrangements" 25 Can. Tax J. (1977), 475.

- Miner, Richard B., "More Corporations To Be Associated Under New Tax Laws" 1 Can. Corp. Law Reporter (May 1988), S1.
- Moore, Phillip M., "Valuation Revisited" Trusts and Estates (February 1987), 40.
- Ovens, Geo, "Methods of Valuation for Privately-Owned Businesses and Closely-held Companies" 36 Can. Bar Rev., 57.
- Painter, William H., "Stock Transfer Restrictions: Continuing Uncertainties and A Legislative Proposal" 6 Vill. L. Rev. (1960), 48.
- Pickering, M.A. "Shareholder's Voting Rights and Company Control" 81 L.Q.R. (1965), 248.
- Rocchi, Rosanne, "Funding Buy-Sell Agreements" 27 Can. Tax J. (1979), 105.
- Rotenburg, Charles M., "What's Fair About Fair Market Value" 4 Estates and Trusts Quarterly (1977-78), 352.
- Sabel, Robert A., "Disability Insurance: Caveat Emptor" 69 Am. B.A.J. (1983), 782.
- Sage, Barbara, "Shotgun Clause to be Applied Strictly or Not At All" The Lawyer's Weekly (June 5, 1987), 8.
- Silver, Sheldon, "Estate Planning in Canada" 27 Can. Tax J. (1979), 206.
- Waldron, Mary A., "Corporate Theory and the Oppression Remedy" 6 Can. Bus. L.J. (1981-82), 129.
- Ward, David A., "Insurance Funding of Buy-Sell Agreements" 22 Can. Tax J. (1974), 484.
- Wise, Richard M., "Fair Market Value Determinations - A Few More Requirements" 31 Can. Tax J. (1983), 337.
- Wise, Richard M., "Valuation and the Income Tax Act" 29 Can. Tax J. (1981), 626.

EDITED LECTURES AND ESSAYS

- Beach, Donald I., "Price Clauses and Funding Arrangements" in Edited Lectures, Shareholders and Shareholders Agreements, Toronto: Department of Continuing Legal Education of the Law Society of Upper Canada, 1976.

- Bradshaw, J.A., "Structuring and Financing Private Companies" in Special Lectures of the Law Society of Upper Canada Corporate law in the 80's, Toronto: Richard De Boo Publishers, 1982, 579.
- Brown, D.R., "Shareholder Agreements and the Alberta Business Corporations Act", in Alberta Bar Admission Course Materials Corporations, Edmonton: Legal Education Society of Alberta, 1980.
- Campbell, Ian R., "The Concept of Fair Market Value", in Special Lectures of the Society of Upper Canada, Recent Developments in Estate Planning and Administration, Toronto: Richard De Boo Publishers, 1980, 297.
- Campbell, Ian R., "Fair Market Value and The Notional Market", in J.C. McDonald, S. Cole and R.M. Wise, eds., Valuing Shares In a Private Company, Toronto: Department of Education, The Law Society Of Upper Canada, 1986, D1-D5.
- Cole, Stephen, Freidman, Andrew, and Brent, Linda, "Valuation Concepts and Terminology", in J.C. McDonald, S. Cole and R.M. Wise, eds., Valuing Shares In a Private Company, Toronto: Department of Education, The Law Society Of Upper Canada, 1986, J1-J60.
- Corbette, William A., "Buy-Sell Agreements", in Edited Lectures, Shareholders and Shareholders Agreements, Toronto: Department of Continuing Legal Education of the Law Society of Upper Canada, 1976.
- Drinkwalter, Donald E., "The Uses of Life Insurance Since the Repeal of the Ontario Succession Duty Act and the Gift Tax Act", in Special Lectures of the Law Society of Upper Canada, Recent Developments In Estate Planning and Administration, Toronto: Richard De Boo Publishers, 1980, 229.
- Fraser, Harvey M.S., and Francis, Glen C., "Problem Areas In Valuing Closely-Held Companies", in J.C. McDonald, S. Cole and R.M. Wise, eds., Valuing Shares In a Private Company, Toronto: Department of Education, The Law Society Of Upper Canada, 1986, E1-E12.
- Gauthier, Andre P., "The Appraisal Remedy", in J.C. McDonald, S. Cole and R.M. Wise, eds., Valuing Shares In a Private Company, Toronto: Department of Education, The Law Society Of Upper Canada, 1986, F1-F13.
- Hansen, B.G., "Corporate Law", in The Legal Education Society of Alberta, ed., Alberta Law for the 80's, Vancouver: Butterworths, 1978, Vol. II, 89.

- Iacubucci, Frank, and Johnston, David L., "The Private or Closely-Held Corporation", in Jacob S. Zeigel, ed, Studies in Canadian Company Law, Toronto: Butterworths, 1967.
- Kennedy, J.F., "Shareholder Agreements", in Special Lectures of the Law Society of Upper Canada, Recent Developments In Estate Planning and Administration, Toronto: Richard De Boo Publishers, 1980, 317.
- Kerr, Robert W., "Fraudulent Conveyances and Unjust Preferences", in Springman, M.A. and Gertner, E., eds., Debtor - Creditor: Law and Practice, Toronto: Butterworths, 1985, 191.
- Nixon, Apple B., " Shareholders' Agreements", in Special Lectures of the Law Society of Upper Canada, Developments in Company Law, Toronto: Richard De Boo Publishers, 1968, 159.
- Ross, Donald C., "Shareholder Agreements" in Law Society of Upper Canada, Bar Admission Course Materials, Business Law 1986/87, Toronto: Carswell 1986, 197.
- Ward, David A., "The Appraisal Remedy" in J.C. McDonald, S. Cole and R.M. Wise, eds., Valuing Shares in a Private Company, Toronto: Dept. of Continuing Education, The Law Society of Upper Canada, 1986, F-15-F30.
- Wilson, James R., and Bollerfer, Stuart F., "Taxation of Corporations and Their Shareholders" Business Law 1986/87, Law Society of Upper Canada, Bar Admission Course Materials, Toronto: Carswell 1986, 75.

CONFERENCE MATERIALS

- Report of the Proceedings of the Thirty-First Tax Conference, 1979 Conference Report, Toronto: Canadian Tax Foundation, 1980.
- Smith, David W., "Buy-Sell Agreements", p.665.
- Legal Problems Relating to Shareholder's Agreements, Vancouver: The Continuing Legal Education Society of British Columbia, June 1982.
- Horsey, E.F., "Control and Restrictions on Ownership of Shares".

Levine, Risa E., "Income Tax Implications of Shareholders' Agreements".

Report of the Proceedings of the Thirty-Third Tax Conference, Revenue Canada Round Table, Toronto: Canadian Tax Foundation, 1982.

How to Structure Major Business Agreements, Toronto: Insight Press, January 1983.

Grover, Warren, "Shareholder Agreements".

Selected Income Tax Aspects of the Purchase and Sale of a Business, Corporate Management Tax Conference 1984, Toronto: Canadian Tax Foundation, 1984.

Anderson, William D., "Purchase and Sale of Shares", p.203.

Reid, Robert J., "Tax Implications of a Change in Control", p.84.

Critical Issues Inside Major Business Agreements, Toronto: Insight Press, March 1984.

Robinson, Sidney, P.H., "Shareholder Agreements: Control and Divorce Provisions".

The New Ontario Business Corporations Act: Responding to the Proclamation, Toronto: Insight Press, May 1984.

Elder, John S. and Ash Stewart H., "Shareholder Rights, Obligations and Procedures".

Report of Proceedings of the Thirty-Sixth Tax Conference, 1984 Conference Report, Toronto: Canadian Tax Foundation, 1985.

Bernstein, Jack, "Life Insured Corporate Buy-Sell Arrangements", pp.957-1013.

Vesley, George J., "Some Inter Vivos Aspects of Buy-Sell Agreements", pp.925-956.

Wise, Richard M., "Valuation Aspects of Shareholders' Buy-Sell Agreements", pp.1013-1035.

**Shareholders' Rights and Agreements, Toronto: Insight Press,
December 1985.**

Bies, William J. "Certain Tax Aspects of Shareholder Agreements".

Fosbery, Peter, "The Use and Importance fo Insurance in Shareholder Agreements".

Blainey, Ronald B., "Shareholders' Agreements - Valuation Considerations".

Levine, Jonathan A., "Cases and Precedents in Shareholders Agreements".

Linkinski, Ester L., "The Equalizer - The Family Law Act, 1985".

Ross, Donald C., "Preparation and Enforcement of Shareholders' Agreements".

**Shareholders Agreements and Disagreements, Toronto: Canadian Bar Association - Ontario Continuing Legal Education,
January 1986.**

Campbell, Ian R., "Business Valuation Aspects of Shareholders' Agreements".

Drinkwalter, Donald, R., "Funding of Shareholder's Agreements".

Little, David T., "It's Time to Sue".

Lockyer, Peter R., "Shareholders' Agreements: Dispute Avoidance and Resolution (Or An Ounce of Prevention is Worth A Pound of Cure!)".

Mooney, Marguerite P., Wright, Lawrence A., "Buy-Sell Clauses".

Sweeney, Terrence A. and Tetreault, David T., "Income Tax Considerations in Shareholders' Agreements In Context of The Budget Proposals of May 23, 1985".

Wright, Lawrence A., "Shareholders' Agreements In Today's Context".

Report of Proceedings of the Thirty-Ninth Tax Conference, 1987
Conference Report, Toronto: Canadian Tax Foundation,
1988.

Wilson, Brian T., "Buy-Sell Agreements".

Report of Proceedings of the Fortieth Tax Conference, 1988
Conference Report, Toronto: Canadian Tax Foundation,
November 1989.

Beach, Wayne G. and Wheeler, Mark F., "Associated
Corporations".

Eng, Susan, "The Arm's-Length Rule".

Hiseler, Gregory R., "Corporate Control".

Kirby, F.P., "The Capital Gains Exemption: Other Than
Qualifying Small Business Corporation Shares".

Truster, Perry, "Associated Corporations: The New Rules".

Witterick, Robert G., "Buy-Sell Agreements".

TABLE OF STATUTES

Arbitrations Act, R.S.O. 1980, c.25 as amended 1984, c.11.

Arbitrations Act, S.A. 1986, c.A-43.

Bankruptcy Act, R.S.C. 1980, c.B3.

Business Corporations Act, S.A. 1981, c.B-15.

Business Corporations Act, S.O. 1982, c.4.

Canada Business Corporations Act S.C. 1974-75-76, c.33, as
amended by S.C. 1978-79, c.9, as amended (1980-81-82-83),
c.115.

Execution Act, R.S.O. 1980, c.146.

Income Tax (Canada) Act, S.C. 1970-71-72, c.63 as amended.

Insurance Act, R.S.O. 1980 c.218, as amended 1987 S.O. c.8.

Mental Health Act S.A. 1985, c.M-13.

Mental Incompetency Act, R.S.O. 1980, c.264.

Partnership Act R.S.O. 1980, c.370.

Perpetuities Act, S.A. 1972, c.P-4.

Perpetuities Act, R.S.O. 1980, c.374 as amended 1986 c.64.

Securities Act, R.S.O. 1980, c.466 as amended.

Securities Act, S.A. 1988, c.S-61.

INTERPRETATION BULLETINS

Interpretation Bulletin IT-64R2, "Corporations: Association and Control", December 20, 1983.

Interpretation Bulletin IT-66R5, "Capital Dividends and Life Insurance Capital Dividends", June 22, 1985.

Interpretation Bulletin IT-73R4, "Small Business Deduction", September 13, 1988.

Interpretation Bulletin IT-140R3, "Buy-Sell Agreements", April, 14, 1989.

Interpretation Bulletin IT-169, "Price Adjustment Clauses", August 6, 1974.

Interpretation Bulletin IT-309R, "Expense of Borrowing Money-Life Insurance Premiums", January 10, 1979.

Interpretation Bulletin IT-416R3, "Valuation of Shares of Deceased Shareholders of a Corporation Receiving A Life Insurance Policy", July 10, 1987.

Interpretation Bulletin IT-419, "Meaning of Arm's Length", July 10, 1978.

Interpretation Bulletin IT-430R, "Life Insurance Proceeds Received by a Corporation or Partnership", May 21, 1985.

Interpretation Bulletin IT-449R, "Meaning of 'Vested Indefeasibly'", September 25, 1987.

Interpretation Bulletin IT-458, "Canadian-Controlled Private Corporation", September 8, 1980.

Interpretation Bulletin IT-484R, "Business Investment Losses", May 5, 1989.

Interpretation Bulletin IT-486R, "Intergenerational Transfers of Shares of a Small Business Corporation ", December 31, 1987.

NOTES (no author noted)

"A Closer Look at Disability Buy-Outs for the Close Corporation" (1967) 52 Minn. L.R. 483.

OTHER MATERIALS

Proposals for a New Alberta Business Corporations Act, Report No. 36, Edmonton: Institute of Law Research and Reform, 1980, Vols. I and II.

Report on The Rule Against Accumulations and Perpetuities, Report No. 49, Manitoba: Manitoba Law Reform Commission, 1982.

Canadian Master Tax Guide, 44th ed., Don Mills Ontario: CCH Canadian Ltd., 1989.

APPENDICES

The appendices are selected from a variety of sources and are presented as practical illustrations of the material presented in the dissertation. They may also serve as a useful guide for drafting buy-sell agreements. However it is recommended that buy-sell agreement should always be individually drafted to fit the facts and circumstances of the particular case.

- APPENDIX I** Buy-Sell Agreement -- Two Shareholders-- Shotgun provision operational during the lifetime of the parties -- Compulsory purchase after the death of either party -- Insurance funding on death -- Valuation fixed in advance.
- APPENDIX II** Buy-sell agreement between two parties-- funded by insurance -- right of first refusal-- right to purchase provision -- Provision covering incapacity of the shareholder-- includes schedule covering price determination.
- APPENDIX III** Buy-sell agreement between two shareholders-- stipulated value -- compulsory purchase after death.
- APPENDIX IV** Alternative or additional "shotgun" clause.
- APPENDIX V** Alternative or additional "piggy-back" clause.
1. Two shareholders -- Third party offer to A -- Right of B to dispose of an equivalent amount of share to the third party purchaser.
2. Third party offer to A to purchase all of the corporation's shares -- B to purchase or sell his entire shareholding.
- APPENDIX VI** Alternative or additional right to purchase clause.
- APPENDIX VII** Alternative or additional right of first refusal clause.
- APPENDIX VIII** Alternative or additional restricted auction clause.
- APPENDIX IX** Alternative or Additional valuation clauses.
1. Valuation by an auditor.
2. Valuation by an auditor -- method of determining value.
3. Book value -- capitalization of fixed assets.
4. Value stipulated annually or adjusted.
5. Valuation by an auditor after death-- method of valuing assets.

APPENDIX I

**Buy-Sell Agreement -- Two Shareholders--
Shotgun provision operational during the
lifetime of the parties -- Compulsory
purchase after the death of either party--
Insurance funding on death --Valuation fixed
in advance.**

BUY-SELL AGREEMENT made the day of , 19 ,
between A, of the [city], in the province of
[province] and B of the said city.

Whereas:

- (1) The parties own or control all the issued and outstanding shares in C Corporation Limited (herein called "the Corporation") as follows:

[set out shareholdings]

- (2) The parties desire to provide for their mutual protection if either dies or wishes to withdraw from the Corporation:

THIS AGREEMENT WITNESSES that the parties covenant and agree as follows:

1. The parties shall not transfer, encumber or in any way deal with any of their shares in the Corporation except as provided for in this agreement.

DURING THE LIFETIME OF THE PARTIES

2. If either A or B wishes to dispose of his shares in the Corporation, the (herein called the "Offeror") shall first offer in writing to sell all his shares to the other party (herein called the "Offeree") on the following terms and conditions.

3. The offer shall contain:

- (a) an offer to sell all the shares of the Corporation owned or controlled by the Offeror (herein called "all his shares" or "the shares") at the arbitrary price stipulated in the offer;

- (b) an offer to purchase all the shares

Appendix I (cont.)

of the Corporation owned or controlled by the Offeree (herein called "all his shares" or "the shares") at the same price;

(c) an undertaking to close the purchase or sale on a date fixed not less than [eighty (80)] days and not more than [one hundred (100)] days from the service of the offer on the Offeree at the time and place fixed in the offer;

4. If the Offeree accepts the offer to sell under paragraph 3(a), the Offeror (herein called "the Vendor") shall sell and transfer all his shares to the Offeree (herein called the "Purchaser") who shall purchase and pay for them on the date and at the place stated in the offer for the arbitrary price stipulated in the offer.

5. If the Offeree accepts the offer to purchase under paragraph 3(b), the Offeree (herein call "the Vendor") shall sell all his shares to the Offeror (herein called "the Purchaser") who shall purchase and pay for them on the date and at the place stated in the offer for the arbitrary price stipulated in the offer.

6. If the Offeree does not accept either of the alternatives in the offer in accordance with the provisions herein, he shall be deemed to have accepted the Offeror's offer to sell all his shares to the Offeree, and the Offeree (herein called "the Purchaser") shall purchase and pay for them on the date and at the place stated in the offer for the arbitrary price stipulated in the offer.

7. At the time set for closing, the Vendor shall deliver to the Purchaser in exchange for the items set out in paragraph 8:

(a) certificates for all his shares duly endorsed in blank for transfer;

(b) his resignation from the board and that of his wife and nominees, if applicable;

(c) his resignation as an employee and that of his wife and members of his family who may be in the employ of the Corporation;

Appendix I (cont.)

(d) an assignment to the Purchaser of all debts, if any owing by the Corporation to the Vendor;

(e) a release of all claims the Vendor has or may have against the Corporation and the Purchaser;

(f) assignment of all insurance policies on the life of the Purchaser as set out Annex "B";

(g) a certified cheque payable to the Purchaser for an amount equal to the aggregate of the cash surrender value of all policies on the life of the Vendor as set out in Annex "B";

(h) all other documents necessary or desirable in order to carry out the true intent of this agreement.

8. At the time set for closing, the Purchaser shall deliver to the Vendor in exchange for the items set out in paragraph 7 above:

(a) a certified cheque payable to the Vendor for the full amount of the arbitrary purchase price of the shares;

(b) a certified cheque payable to the Vendor for the full amount of any indebtedness owing by the Corporation to the Vendor as recorded on the books of the Corporation and verified by the Corporation's accountant;

(c) a certified cheque payable to the Vendor for an amount equal to the aggregate of the cash surrender value of all policies on the life of the Purchaser as set out in Annex "B";

(d) a release by the Corporation of all debts, if any, owing by the Vendor to the Corporation;

(e) a release of all claims the Corporation and the Purchaser have or may have against the Vendor;

(f) a release of all guarantees given by the

Appendix I (cont.)

Vendor on behalf of the Corporation;

(g) all securities, free and clear of all claims, which belong to the Vendor and are lodged with any person (including the Corporation's banks) to secure any indebtedness or credit of the Corporation;

(h) assignments of all insurance policies on the life of the Vendor as set out in Annex "B";

(i) All other documents necessary or desirable in order to carry out the true intent of this agreement.

9. If on the closing date the Vendor neglects or refuses to complete the transfer or does not comply with the procedures herein set out, the Purchaser has the right upon such default (without prejudice to any other right that he may have), upon payment by him of the purchase price (plus or minus any adjustments herein provided) to the credit of the Vendor in any chartered bank in the city of [city] (or to the solicitor for the Corporation in trust for, on behalf of and in the name of the Vendor), to complete the transaction as above. The Vendor hereby irrevocably constitutes the Purchaser his true and lawful attorney to complete the said transaction and execute on behalf of the Vendor every document necessary or desirable in that behalf. [If there is more than one vendor, this power of attorney shall apply to both vendors.]

10. If on the closing date the Purchaser neglects or refuses to complete the transaction, or does not comply with the procedures herein set out the Vendor has the right upon such default (without prejudice to any other rights that he may have) to give to the Purchaser, within ten (10) days after such default, notice that on the twenty-first day after the original closing date, he (herein called "the New Purchaser") will purchase from the Purchaser (herein called "the New Vendor") all the shares of the Corporation owned or controlled by the New Vendor, for an amount equal to seventy-five percent (75%) of the purchase price set out in paragraph 8(a) and at the same time fix a new date within thirty (30) days and a time and place for closing; whereupon, on the new date for closing, the New

Appendix I (cont.)

Vendor shall sell all his shares to the New Purchaser who shall purchase the same for the new purchase price, and it is expressly agreed that all the terms of this agreement applicable to the closing of the sale and purchase of shares and to the adjustment of purchase price, if any, shall be applicable to the said closing. The New Vendor hereby constitutes the New Purchaser his true and lawful attorney to complete the said transaction and execute on behalf. [If there is more than one vendor, this power of attorney shall apply to both vendors.]

11. No offer hereunder shall be given while another offer is outstanding or a sale pending or until [one hundred (100) days after any sale is aborted.

AFTER THE DEATH OF A PARTY

12. Within [one hundred (100)] days of the death of either A or B (provided the survivor is alive on the thirtieth day after the death of the first deceased) the survivor (Purchaser) shall purchase and the estate of the deceased (Vendor) shall sell to the survivor all his shares owned or controlled by the deceased at the time of his death for the most recent price stipulated in Annex "A".

13. The legal representatives of the deceased shall in writing fix a date not more than [one hundred (100)] days from the date of death a time and place for the closing of the sale of its shares.

14. At the time set for closing, the Purchaser shall deliver to the Vendor/Estate in exchange for the items set out in paragraph 14:

(a) a certified cheque payable to the Vendor/Estate for the full amount of the purchase price as set out in Annex "A";

(b) a certified cheque payable to the Vendor/Estate for the full amount of any indebtedness owing by the Corporation to the deceased;

(c) a certified cheque payable to the Vendor/Estate for the amount of the cash surrender value on all insurance policies on the life of the Purchase listed in Annex "B";

Appendix I (cont.)

(d) a certified cheque payable to the Vendor/Estate for the amount, in any, by which the aggregate net proceeds received by the Purchaser from the insurers in Annex "B" exceeds the aggregate of (a), (b) and (c) above;

(e) a release by the Corporation and the Purchaser of all debts and to the claims that they have or may have against the Vendor/Estate;

(f) a release of all guarantees given by the deceased Vendor on behalf of the Corporation;

(g) all securities, free and clear of all claims, belonging to the deceased Vendor which are lodged with any person (including the Corporation's banks) to secure any indebtedness or credit of the Corporation;

(h) all other documents necessary or desirable in order to carry out the true intent of this agreement.

15. At the time set for closing, the Vendor/Estate shall deliver to the Purchaser in exchange for the items set out in paragraph 14:

(a) certificates for all the Vendor's shares duly endorsed for transfer in blank with signature guaranteed by a bank or trust company;

(b) evidence of authority of executors to sign;

(c) succession duty release for the shares if applicable;

(d) resignations from the board and employment of all members of the deceased's family and nominees;

(e) an assignment to the Purchaser of all debts, if any, owing by the corporation to the Vendor;

(f) a release of all claims the deceased Vendor or his estate has or may have against

Appendix I (cont.)

the Corporation or the Purchaser;

(g) an assignment to the Purchaser of all insurance policies on the life of the Purchaser listed in Annex "B";

(h) all other documents necessary or desirable in order to carry out the true intent of this agreement.

INSURANCE

16. In order to ensure that all or a substantial part of the purchase price for the shares of the deceased party will be available immediately in cash upon his death, each of the parties hereto has procured insurance on the other's life as set out in Annex "B". Additional policies may be taken out for the purpose of this agreement and they shall be added to Annex "B".

17. Each of the parties hereto agrees, throughout the term of this agreement, to maintain and pay the premiums as they fall due on all life insurance policies listed in Annex "B" owned by him.

18. The insurers set out in Annex "B" are hereby authorized and directed to give any party hereto, upon written request, all information concerning the status of the said policies.

19. If any premium on any insurance policy is not paid within [twenty (20) days] after its due date, the party insured shall have the right to pay such premium and be reimbursed therefor by the owner thereof together with interest at the rate of [two] percent per month on the amount so paid in respect of such premium from the date of payment until the date of reimbursement.

20. Immediately upon the death of one of the parties hereto the survivor shall proceed as expeditiously as possible to collect the proceeds of the policies on the deceased party, and the legal representatives of the estate of the deceased party shall apply and expedite the application for letters of administration or letters probate, as may be required.

21. The parties shall not assign, encumber,

Appendix I (cont.)

GENERAL

22. The parties shall not throughout the term of this agreement and until a valid sale of the shares is completed under this agreement do or cause or permit to be done anything out of the normal course of business of the Corporation.

23. Time shall be of the essence of this agreement and everything that relates thereto.

24. The parties agree to execute and deliver any documents necessary or desirable to carry out the true purpose and intent of this agreement.

25. This agreement shall be binding upon and enure to the benefit of the parties hereto and their respective heirs, executors, administrators and assigns.

IN WITNESS, etc.

SIGNED, SEALED AND DELIVERED, etc.

[Signatures and seals]

Annex "A" /9.

Appendix I (cont.)

Annex "A"

C CORPORATION LIMITED

BUY-SELL AGREEMENT

ANNEX "A"

{Date} Pursuant to the buy-sell agreement, the price for all my shares in the Corporation is \$.

.....

Pursuant to the buy-sell agreement, the price for all my shares in the Corporation is \$.

.....

Annex "B"

C CORPORATION LIMITED

BUY-SELL AGREEMENT

ANNEX "B"

Life insurance policies on the life of A owned by B:

Insurer	Number	Amount
---------	--------	--------

Life insurance policies on the life of B owned by A:

Insurer	Number	Amount
---------	--------	--------

(J.D. Honsberger, and J.M. Wainberg, eds., O'Brein's Encyclopedia of Forms, 10th ed., Vol. VI, Agincourt, Ontario: Canada Law Book Ltd., 1980).

APPENDIX II

Buy-sell agreement between two parties--
funded by insurance -- right of first refusal
-- right to purchase provision -- Provision
covering incapacity of the shareholder--
includes schedule covering price
determination.

MEMORANDUM OF AGREEMENT made the day of _____, 19 .

Between:

[name] of the City of [city]
in the Province of [province]
OF THE FIRST PART,
-and-

[name] of the City of [city]
in the Province of [province]
OF THE SECOND PART.

WHEREAS C Limited (the "Corporation") is a corporation incorporated under the laws of the province of [province] with an authorized capital of [] common shares without par value ("common shares"), of which [] common shares have been issued and are now outstanding;

AND WHEREAS each of the parties hereto is the beneficial owner of common shares of the Corporation;

NOW THEREFORE THIS AGREEMENT WITNESSETH that in consideration of the respective covenants and agreements herein contained and of the sum of \$[5] now paid by each of the parties hereto to the other (the receipt and sufficiency of which is hereby acknowledged by each of the parties hereto), it is agreed by and between the parties hereto as follows:

1. GENERAL COVENANT.

1.1 Neither party hereto, without the prior written consent of the other, will sell, assign, transfer, dispose of, donate, mortgage, pledge, hypothecate, charge or otherwise encumber or deal with any common shares of the corporation now or

Appendix II (cont.)

hereafter owned by such party except in accordance with the terms and conditions hereof.

2. PURCHASE AND SALE OF COMMON SHARES

2.1 If either party desires to terminate the arrangements with respect to the ownership of common shares of the Corporation referred to herein, the party wishing to so terminate such arrangements (hereinafter sometimes referred to as the "Offering Party") shall offer in writing to the other party (hereinafter sometime referred to as the "Notified Party") to purchase:

(a) all but not less than all the common shares of the Corporation beneficially owned by the Notified Party; and

(b) all of the indebtedness of the Corporation (if any) to the Notified Party

(which common shares and indebtedness (if any), or the corresponding common shares and indebtedness (if any) owned by the Offering Party, as the case may be, are hereinafter sometimes referred to as the "Offered Securities"). The Offering Party shall specify in such offer the terms of the purchase and sale and the price to be paid for the Offered Securities, provided that the price for the indebtedness (if any) of the Corporation to the Notified Party constituting part of the Offered Securities shall be the face value thereof [plus accrued and unpaid interest thereon (if any)] as shown on the books of account of the Company. The price so specified in the offer for the Offered Securities is hereinafter referred to as the "Designated Price".

2.2 Within [30] days after the receipt by the Notified Party of the offer from the Offering Party pursuant to section 2.1 hereof, the Notified Party shall advise the Offering Party pursuant to section 2.1, the Notified Party shall advise the Offering Party in writing either:

(a) that the Notified Party accepts the offer made by the Offering Party to purchase the Offered Securities owned by the Notified Party on the terms and at the Designated Price set out in the offer; or

Appendix II (cont.)

(b) that the Notified Party elects to purchase the Offered Securities owned by the Offering Party on the terms and at the Designated Price set forth in the offer referred to in section 2.1 hereof, mutatis mutandis.

If the Notified Party so elects to purchase the Offered Securities owned by the Offering Party, the Notified Party shall thereupon be conclusively deemed to have made an offer to purchase the Offered Securities owned by the Offering Party on the terms and at the Designated Price set out in the offer referred to in section 2.1 hereof, mutatis mutandis, and the Offering Party shall be conclusively deemed to have accepted such offer. If the Notified Party fails to advise the Offering Party in writing within [30] days after the receipt of the offer from the Offering Party pursuant to section 2.1 hereof, the Notified Party shall be conclusively deemed to have accepted the offer made by the Offering Party to purchase the Offered Securities owned by the Notified Party on the terms and at the Designated Price set forth in such offer.

2.3 The purchase and sale of the Offered Securities resulting from the acceptance or deemed acceptance of an offer pursuant to section 2.2 hereof shall be completed at the principal office of the Corporation in the city of [city] at [city time] on the [10th] business day after such offer has been accepted or deemed to have been accepted pursuant to section 2.2 hereof. Such place and time are sometimes hereinafter referred to as the "Place of Closing" and "Time of Closing", respectively. At the Time of Closing the payment of the Designated Price for the Offered Securities shall be made by the purchasing shareholder against delivery by the selling shareholder of a certificate or certificates representing the common shares of the Corporation to be purchased, duly endorsed in blank for transfer (with signatures guaranteed by a Canadian chartered bank) together with duly executed assignments of the indebtedness of the Corporation to the selling shareholder.

2.4 If the selling shareholder is not present at the Place of Closing at the Time of Closing, or is present but fails for any reason whatsoever to produce and deliver to the purchasing shareholder the

Appendix II (cont.)

said certificate or certificates duly endorsed in blank for transfer (with signatures guaranteed by a Canadian chartered bank) and duly executed assignments of the indebtedness of the Corporation to the selling shareholder, then the Designated Price for the Offered Securities shall be deposited by the purchasing shareholder into a special account at a branch of the Corporation's bankers in the name of the selling shareholder. Such deposit shall constitute valid and effective payment of the Designated Price for the Offered Securities to the selling shareholder even though the selling shareholder has voluntarily encumbered or disposed of any of the common shares of the Corporation and/or indebtedness (if any) constituting all or part of the Offered Securities and notwithstanding the fact that a certificate or certificates or assignment or assignments for any of the said common shares and/or indebtedness may have been delivered to any pledgee, transferee or other person.

2.5 If the Designated Price for the Offered Securities is deposited pursuant to section 2.4 into a special account at a branch of the Corporation's bankers in the name of the selling shareholder, then from and after the date of such deposit, and even though the certificates and assignments evidencing the Offered Securities have not been delivered to the purchasing shareholder, the purchase of the Offered Securities shall be deemed to have been fully completed and all right, title, benefit and interest, both at law and in equity, in and to the Offered Securities shall be conclusively deemed to have been transferred and assigned to and become vested in the purchasing shareholder and all right, title, benefit and interest, both at law and in equity, of the selling shareholder, or of any transferee, assignee or any other person having any interest, legal or equitable, therein or thereto, whether as a shareholder or creditor of the Corporation or otherwise, shall cease and determine, provided, however, that the selling shareholder shall be entitled to receive, the Designated Price so deposited, without interest.

The selling shareholder hereby irrevocably constitutes and appoints the purchasing shareholder as his true and lawful attorney-in-fact and agent, for, in the name of and on behalf of the selling shareholder to execute and deliver in the name of the

Appendix II (cont.)

selling shareholder all such assignments, transfers, deeds and instruments as may be necessary to effectively transfer and assign the Offered Securities, or any part thereof, to the purchasing shareholder, or his nominee or nominees, on the books of the Corporation. Such appointment and power of attorney, being coupled with an interest, shall not be revoked by the insolvency, bankruptcy, death or incapacity of the selling shareholder and the selling shareholder hereby ratifies and confirms and agrees to ratify and confirm all that the purchasing shareholder may lawfully do or cause to be done by virtue of the provisions hereof.

The selling shareholder hereby irrevocably consents to any transfer of the Offered Securities or any part thereof made pursuant to the provisions of this section 2.5.

The selling shareholder shall be entitled to receive the Designated Price deposited with the bankers of the Corporation upon delivery to the Corporation of certificates evidencing the common shares so purchased duly endorsed in blank for transfer (with signatures guaranteed by a Canadian Chartered bank), together with duly executed assignments of the indebtedness of the Corporation to the selling shareholder constituting part of the Offered Securities.

3. INCAPACITY ETC.

3.1 If either party hereto is declared bankrupt or adjudged unable to manage his own affairs, makes an assignment for the benefit of creditors, suffers his common shares to be liable to seizure, or becomes, by reason of illness, disease, mental or physical disability or otherwise, unable for a period of [12] consecutive months to discharge the duties of his employment with the Corporation or accepts full time employment with any person, firm or corporation other than with the Corporation (other than compulsory service in the armed forces during peace time or voluntary or compulsory service during time of war) or is not actively engaged with the Corporation for a period of [12] consecutive months (such party being in this section 3.1 referred to as the "Inactive Party"), the remaining party shall have the exclusive right (but not the obligation) to purchase all but not less than all common shares

Appendix II (cont.)

owned by the Inactive Party at the purchase price and on the terms set out in Schedule A hereto. Such right may be exercised by notice in writing to the Inactive Party within [30] days from the bankruptcy, assignment, incapacity or inactivity in question, which notice shall be given in accordance with section 2 Schedule A.

4. DEATH

4.1 Upon the death of either party hereto, the surviving party shall purchase all of the common shares held by the decedent from the legal personal representatives of the decedent within [30] days of:

(a) such legal personal representative or representatives receiving all necessary succession duty and other tax releases and consents to such sale; and

(b) the surviving party receiving the proceeds of the policy or policies of insurance on the life of the decedent held by him pursuant to Part 5 hereof.

The purchase price for such common shares shall be calculated in accordance with and the purchase shall be made on the terms set forth in Schedule A hereto. If no executor or administrator is appointed for the estate of the decedent within [90] days after his death, the surviving party shall be considered a creditor of the estate of the decedent with all of the rights conferred upon a creditor of the estate of a decedent by the place of his domicile, including the right to cause an executor or administrator to be appointed.

4.2 For the purposes of this agreement, if either party becomes missing such party shall be conclusively presumed dead after he has been missing for [12] months.

4.3 For the purposes of this agreement, in the event that both parties die within a period of [30] days of each other, all rights and obligations of purchase accruing to and imposed upon the surviving party shall thereupon be terminated and have no further force or effect.

Appendix II (cont.)

5. LIFE INSURANCE POLICIES.

5.1 Each party covenants and agrees to maintain in full force and effect until the death of the other party or the prior sale of the common shares owned by such other party, the policies of life insurance on the life of the other party as described below:

<u>Policy Owner</u>	<u>Insurer and Policy No.</u>	<u>Life Insured</u>	<u>Face of Policy</u>	<u>Amount</u>
---------------------	-------------------------------	---------------------	-----------------------	---------------

[insert policy details]

5.2 Each party shall pay the premiums as they fall due on the policy or policies of life insurance on the other party shall from time to time produce proof of the payment of such premiums. The insurers noted in section 5.1. are hereby authorized and directed to supply to each life insured, upon his request, any information respecting the status of any policy or policies on his life.

5.3 If at any time either party shall be advised that the other has failed to maintain in full force and effect the policy or policies of insurance which such other party has covenanted to maintain, the party whose life is insured by such policy or policies, the premiums on which have not been paid, shall have the right, exercisable by notice in writing to the defaulting party, given within [30] days of being advised of such default, either:

(a) to terminate this agreement and all obligations arising hereunder, in which event this agreement shall be deemed to have been terminated by mutual agreement, except sections 5.5. and 5.6 hereof; or

(b) to make such payments as may from time to time be necessary to restore the said policy or policies to full force and effect, in which case this agreement shall continue in full force and effect.

In default of such election, the party whose life is insured shall be deemed to have elected not to terminate this agreement. All payments made by the party whose life is insured to restore to full force and effect a policy or policies in default shall be deemed to have been made for the account of the

Appendix II (cont.)

defaulting party. If such defaulting party becomes obligated to sell his common shares hereunder, the aggregate amount of such payments made to restore to full force and effect and to maintain in full force and effect such life insurance policy or policies shall be deducted from the purchase price which the purchasing party is required to pay in respect of the purchase of such common shares. If the defaulting party becomes obligated to purchase any shares hereunder, the aggregate amount of such payments shall be added to the purchase price which such defaulting party is required to pay for the common shares.

5.4 All amounts received by a party as proceeds of the policy or policies of insurance referred to above, or so much thereof as may be necessary, shall be paid and applied on account of the purchase price to be paid by the survivor pursuant to section 4.1 hereof.

5.5 Upon the death of one of the parties to this agreement, his legal personal representatives shall forthwith offer to assign, transfer and set over to the surviving party hereto the right, title and interest of the decedent in and to the insurance policy or policies insuring the life of the survivor for a price equal to the aggregate of the cash surrender value (if any) and any accumulated dividends or the distributions of such insurance policy or policies plus the unused portion of the last premium paid thereon as determined by the insurer, or the sum of \$1, whichever is greater, as of a date immediately prior to the death of the decedent and, upon payment of such price by the survivor to the legal personal representatives of the decedent, such legal personal representative shall forthwith assign, transfer and set over unto survivor all such right, title and interest in and to the said insurance policy and policies, and shall deliver the same to the survivor. Should the survivor not decide within a period of [60] days from the date of the aforesaid offer by the legal personal representatives to acquire the said insurance policy or policies, the said offer shall lapse and be null and void and the legal personal representatives shall forthwith surrender the policy or policies to the insurer for the cash surrender value thereof, together with the amount of any accumulated dividends or other distributions thereon, which when received shall be

Appendix II (cont.)

paid to the survivor.

5.6 Upon termination of this agreement for any reason, each party shall have the right to purchase from the other the policy or policies of insurance upon his life upon payment to the other of a purchase price calculated in the manner described in section 5.5 hereof. If either party fails or refuses to purchase the said policy or policies within [30] days after such termination, such policy or policies may be surrendered for its cash surrender value and accumulated dividends or other distributions thereon.

6. LEGEND ON SHARE CERTIFICATES

6.1 The certificates representing the common shares of the Corporation shall have typed or otherwise written thereon the following legend:

"The common shares represented by this certificate are subject to the provisions of an agreement made the day of , 19 between and which agreement contains restrictions on the right of such persons to sell, assign, transfer, dispose of, donate, mortgage, pledge, hypothecate, charge or otherwise encumber or deal with the common shares represented hereby and notice of the terms and conditions of such agreement is hereby given."

7. GENERAL

7.1 The parties hereto agree to do all acts and things as directors and shareholders of the Corporation to effect compliance with or waiver of the restrictions on the transfer of shares contained in the [articles or by-laws] of the corporation to give effect to any transfer or intended transfer of common shares required or permitted to be made and recorded as the result of the application of the provisions of this agreement in order that, notwithstanding such restrictions, the terms and conditions of this agreement may be carried out.

7.2 The parties hereto agree that the provisions of this agreement relating to common shares of the Corporation shall apply mutatis mutandis to any shares or securities into which such common shares may be converted, changed, reclassified, redivided,

Appendix II (cont.)

redesignated, subdivided, or consolidated, to any shares or securities which are received by the parties hereto as a stock dividend or distribution payable in shares or securities of the Corporation or of any successor or continuing company or corporation to the Corporation which may be received by the parties hereto on a reorganization, amalgamation, consolidation or merger, statutory or otherwise.

7.3 Any notice or other document required or permitted to be given to either party hereunder (including under the provisions of Schedule A) shall be validly given if delivered personally or if mailed be prepaid registered mail to the party at the following address:

[insert address]

Any such notice or other document delivered personally shall be deemed to have been received by and given to the addressees on the day of delivery and any such notice or other document mailed as aforesaid shall be deemed to have been received by and given to the other party on the [second] business day following the date of mailing. Either party may at any time give notice of any change of address.

7.4 Time shall be of the essence of this agreement.

7.5 The agreement shall be subject to and be construed in accordance with the laws of the Province of [province].

7.6 This agreement shall enure to the benefit of and be binding upon the parties hereto and their respective heirs, executors, administrators, legal personal representatives, successors and assigns.

In WITNESS WHEREOF the parties hereto have executed this agreement.

SIGNED, SEALED & DELIVERED
in the presence of

[execution by the parties]

Schedule A/11.

Appendix II (cont.)

SCHEDULE A

This is Schedule A to the agreement (the "Agreement") made the day of , 19 between and .

DETERMINATION OF PURCHASE PRICE

1. The purchase price to be paid for any common shares purchased pursuant to section 3.1 or 4.1 of the Agreement shall be the adjusted net book value of such common shares determined by [chartered accountants] [city] (the "Auditors") as at the date the obligation to purchase such shares arose (the "Effective Date"), on the following bases:

(a) The Auditors shall determine, in accordance with generally accepted accounting principles, the amount which in their opinion represents the fair value of the assets of the Corporation and the amount which in their opinion represents the face amount of the liabilities of the Corporation (other than liabilities to capital stock referable to the outstanding common shares of the Corporation) as at the Effective Date;

(b) The net book value of the Corporation shall be equal to the amount by which the fair value of the assets exceeds the face amount of the liabilities of the Corporation determined in accordance with sub-section (a); and

(c) The adjusted book value per common share of the Corporation shall be the amount obtained by dividing the adjusted net book value of the Corporation by the total number of common shares of the Corporation issued and outstanding.

DATE AND TIME OF CLOSING UNDER SECTION 3.1

2. The party electing to purchase common shares pursuant to section 3.1 of the Agreement shall, at the same time as electing to purchase such shares, notify the vendor in writing of the date and time for closing (which date shall be within the period of [30] days after the giving of such notice, on which

Appendix II (cont.)

date the purchase and sale shall take place (which time and date are hereinafter respectively called the "Time of Closing" and the "Date of Closing").

DATE AND TIME OF CLOSING UNDER SECTION 4.1.

3. The surviving party, on becoming obligated to purchase common shares pursuant to section 4.1 of the Agreement shall notify the vendor in writing of the date and time for closing (which date shall be within the period of [30] days referred to in section 4.1 of the Agreement), on which date the purchase and sale shall take place (which time and date are hereinafter respectively called the "Time of Closing" and the "Date of Closing").

CLOSING OF PURCHASE AND SALE

4. The closing of any purchase and sale to be effected pursuant to section 3.1 or 4.1 of the Agreement shall be at the principal office of the Corporation in [city, province] at [city time] or at such other place as may be agreeable to the purchaser and the vendor.

5. In respect of a purchase made pursuant to section 3.1 of the Agreement, the purchase price shall be payable as follows:

(a) a sum equal to [10]% of the purchase price at the Time of Closing;

(b) a further sum equal to [10]% of the purchase price within [three] months from the Date of Closing; and

(c) the balance in [20] equal [half-yearly] installments with interest on the amount owing from time to time at the rate of [9]% per annum, the first such payment to be due and owing [six] months after the Date of Closing provided that the purchaser shall have the privilege of prepaying all or any part of any of such installments before maturity at any time and from time to time without notice or bonus.

6. The purchase price payable in respect of a purchase pursuant to section 4.1 of the Agreement shall be paid as follows:

Appendix II (cont.)

(a) the full purchase price or the proceeds of the policies of insurance maintained on the life of the deceased vendor pursuant to section 5.1 of the Agreement (whichever amount is the lesser shall be paid at the Time of Closing; and

(b) in the event that the purchase price exceeds the proceeds of the said policies of insurance, the said excess shall be paid by the purchaser to the vendor in [20] equal [half-yearly] installments with interest on the amount owing from time to time at the rate of [9]% per annum; provided that the purchaser shall have the privilege of prepaying any or all such payments before maturity at any time and from time to time without notice or bonus. The first instalment shall become due and payable [six] months following the Date of Closing.

7. All amounts payable on account of any such purchase price shall be paid by certified cheque made payable to the order of the vendor.

8. If there is any default in payment of any instalment owing on the payment of any purchase price hereunder and such default continues for a period of [30] days the remaining installments shall, if the vendor so elects, forthwith become due and payable.

SIGNED, SEALED & DELIVERED
in the presence of

[execution by the parties]

(G.H. Emerson, ed., Canadian Corporation Precedents, 3d ed., Vol. III, Toronto: Carswell, 1989).

APPENDIX III

**Buy-sell agreement between two shareholders-
- stipulated value -- compulsory purchase
after death.**

We, the undersigned, A and B, shareholders in C Corporation Limited, agree to the following:

1. Upon the death of the first one of us to die, his estate shall sell and the survivor shall buy all the shares of the deceased in the corporation.

2. The purchase price of these shares shall be determined by the value set out in the attached Schedule "A". This valuation shall be reviewed at the end of each financial year, or at any other time at the request of either one of us.

3. Each one of us shall own, keep in force and be the beneficiary of a life insurance policy on the life of the other listed in the annexed Schedule "B". Neither of us shall assign surrender or borrow against any such policy without the consent of the other.

4. The survivor shall pay the purchase price to the legal representatives of the deceased, using as much as necessary of the insurance proceeds payable under the policy on the life of the deceased as listed in Schedule "B" If the proceeds are less than the purchase price, the survivor shall pay the balance either in one sum or within two (2) years in equal monthly installments with interest at the rate of [eight per cent (8%)] per year. Such deferred payments shall be evidenced by a negotiable promissory note with the right at any time to prepay part or all of the balance.

5. The survivor shall have the option of purchasing, within sixty (60) days of the death of the deceased, the insurance policy on his own life owned by the estate of the deceased by paying to the legal representatives of the estate the cash surrender value of the policy.

6. Upon the termination of this agreement (otherwise than under section 8(b), or upon the disposal, by either one of us, of all his shares under section 7, each of us shall have the option of

Appendix III (cont.)

purchasing, within thirty days, the policy of insurance on his life owned by the other by paying to him the cash surrender value of the policy.

7. Neither of us shall dispose of all or any part of his shares in the corporation during his lifetime unless he has first offered in writing to sell such shares to the other at the lesser of:

(a) the purchase price specified in this agreement, and

(b) the price at which he proposes to sell such shares to any prospective purchaser who has made a bona fide offer to purchase such shares,

and the other shareholder has either rejected or has not accepted the offer in writing within thirty days.

8. This agreement shall terminate:

(a) upon the bankruptcy or dissolution of the corporation;

(b) if we both die within thirty (30) days of each other, or

(c) at the option of the other if one of us violates any provision of this agreement.

SIGNED, SEALED & DELIVERED
in the presence of

[execution of the parties]

Schedule A /3.

Appendix III (cont.)

SCHEDULE "A"

The following is the value of a share of C Corporation Limited as determined in respect of the annexed buy-sell agreement:

Value of one
share of C Corporation Limited:
\$ _____ Date: _____

{Signatures of shareholders}

SCHEDULE "B"

The following are the policies referred to in the annexed buy-sell agreement:

	Owner and beneficiary	Amount
On the life of A. [Corporation and Policy number]		
On the life of B. [Corporation and policy number]		

(J.D. Honsberger, and J. M. Wainberg, eds., O'Brein's Encyclopedia of Forms, 10th ed., Vol. VI, Ontario: Canada Law Book Ltd., 1980).

APPENDIX IV

Additional or Alternative "shotgun" clause.

NOTE: It is intended that the seven paragraphs in this form should be contained in one article in the buy-sell agreement.

1. If either A or B desires to terminate his association with the Corporation, the party wishing to terminate such arrangements (herein sometimes called "the Offering Party") shall notify the other party (herein sometimes called "the Notified Party") in writing under this section that the Offering Party is prepared to acquire at the Designated Price set out in this agreement all (but not less than all) the shares in the Corporation to the Notified Party (which shares and indebtedness owned by the Offering Party, as the case may be, are herein called "the Offered Securities").

2. The Designated Price shall be such amount as the Offering Party and the Notified Party agree upon and if they are unable to do so within [fifteen (15)] days after notification, the determination of the purchase price shall be submitted by the Offering Party to [valuator] (hereinafter called "the Valuator) who shall determine the Designated Price as follows:

(a) the shares shall be valued at the fair market price thereof; and

(b) the indebtedness shall be valued at the face value at the face value thereof as shown on the books of the Corporation plus interest at the rate mentioned below from the date of the original notification to the date of closing of the purchase and sale (herein called "the Closing Date").

Within thirty days after their appointment, the Valuator shall notify each party of its determination, and such determination shall be final and binding on both parties. Each party shall bear one-half the cost of the services of the Valuator.

3. Within [thirty (30)] days after the receipt

Appendix IV (cont.)

of the said determination by the Valuator under section (2) hereof, the Notified Party shall inform the Offering Party in writing that the Notified Party either elects to purchase the Offered Securities owned by the Offering Party, or in the alternative, elects to sell the Offered Securities owned by the Notified Party to the Offering Party. If the Notified Party fails inform the Offering Party within the said 30-day period whether it elects to sell or to purchase the Offered Securities, the Notified Party shall be conclusively deemed to have elected to sell to the Offering Party (herein called "the Purchaser") the Offered Securities owned by the Notified Party (herein called "the Seller") and the closing date shall be [fifteen (15)] days later.

4. The designated Price as agreed upon or determined as above shall be paid as follows:

(a) On the closing date the Purchaser shall pay to the Seller in cash or by certified cheque a sum equal to [twenty per cent (20%)] of the Designated Price; and

(b) The balance of the Designated Price shall be payable in [five (5)] equal annual installments (evidenced by five promissory notes), the first of such installments to be due and payable on the first anniversary of the closing date. The balance outstanding from time to time shall bear interest at a rate equal to [two per cent (2%)] above the prime bank rate on the closing date and shall be payable on each date on which an instalment payment is made.

(c) On default of payment of any instalment the balance outstanding shall at the option of the Seller become due and payable.

(d) As long as the Purchaser is not in default of any payment of principal or interest on the Designated Price, the Purchaser shall have the privilege of prepaying all or any part of the principal balance outstanding at any time or times without notice or bonus but with accrued interest to the date of payment.

5. The closing of the purchase and sale of the Offered Securities to be purchased and sold under the provisions hereof shall be made at the office of

Appendix IV (cont.)

the Corporation in [city], and if none then at the office of the Seller in [city] on the closing date, as herein determined. At the closing the Seller shall cause the same to be effectively and validly transferred to the Purchaser.

6. In the case of a purchase and sale of the shares, the following shall apply:

(a) If, on the closing date, the Seller has any guarantees or securities lodged with any purchaser or bank to secure an indebtedness of the Corporation, the Purchaser shall use its best efforts to deliver upon cause to be delivered up to the Seller and cancel or cause to be cancelled such guarantees and securities on the closing date;

(b) If, on the closing date, the Seller is indebted to the Corporation in an amount recorded on the books of the Corporation and verified in writing by the auditor of the Corporation, or if the Purchaser has any claims against the Seller which are liquidated demands acknowledged in writing, the Purchaser shall have the right out of the Designated Price to pay, satisfy and discharge all or any portion of such indebtedness or such claims and receive and take credit against the Designated Price for the amounts so paid on account of the indebtedness or claims;

(c) Until the unpaid balance of the Designated Price has been paid in full, the Purchaser agrees that he will not sell, transfer, assign, charge, hypothecate or otherwise dispose of, encumber or in any manner deal with the shares which have been acquired from the Seller. The Purchaser agree to pay to the Seller, forthwith upon receipt thereof, all dividends received by him on account of the shares purchased from the Seller and the amount of such dividends received by the Seller shall be applied in reduction of the unpaid balance of the Designated Price. If the Purchaser defaults in making the payments as herein agreed, the Seller shall have the option of either:

- (i) obtaining a judgment on the promissory note(s); or
- (ii) requesting the Purchaser to

Appendix IV (cont.)

re-assign the said shares to the Seller in which event the Purchaser covenants to re-assign the said shares to the Seller forthwith on demand.

The Purchaser shall have a further period of [three (3) months] from the date of such default to repay the balance owing on the note(s) plus the interest as above from the date of default plus all legal costs, and on payment of such amounts within such period the Seller agrees to re-assign the shares to the Purchaser. If the shares are assigned or re-assigned under the provisions of this paragraph, the Purchaser shall do all things that are required to be done to ensure that all corporate procedures have been complied with in order to properly vest the title to the shares in the Seller. During such time as the shares are registered in the name of the Purchaser and any balance remains owing pursuant to the promissory note, the Seller shall have a lien on the shares for the purposes of this paragraph.

7. If the Seller fails on the closing date to deliver the relevant certificates representing all the shares comprising part of the Offered Securities duly endorsed in blank for transfer with signatures guaranteed by a Canadian Bank or trust company, together with duly executed assignments of any indebtedness of the Corporation to the Seller representing part thereof, together with any evidence of such indebtedness which may exist, then the portion of the Designated Price for the Offered Securities due on the closing date may be paid by the Purchaser to the Corporation which shall deposit the same in a special bank account and hold the same in trust for the Seller and until such failure is cured the Purchaser shall make all future payments to the Corporation.

8. From and after the payment of the full balance of the Designated Price to the Corporation, the purchase of the Offered Securities shall be deemed to have been fully effected as between the Purchaser and the Seller and the Corporation, and all title and interest in and to the Offered Securities so purchased shall be deemed to have been vested in the Purchaser and all rights of the Seller or of any

Appendix IV (cont.)

transferee, assignee or any other person having any interest therein and claiming through the Seller shall cease and determine except only the right to receive the Designated Price from the Corporation. The Seller hereby appoints any nominee of the Purchaser as attorney for and in the name of the Seller to execute, deliver and effect the transfer to the Purchaser or nominees on the books or the Corporation of the Offered Securities or any part thereof. The Seller shall be entitled to receive the Designated Price or such portion thereof as is held in trust by the Corporation for the seller upon the delivery to the Corporation of all evidence or certificates representing the Offered Securities duly endorsed in blank for transfer together with such other documents, if any, as may be requisite in the premises.

(J.D. Honsberger, and J.M. Wainberg, eds., O'Brein's Encyclopedia of Forms, 10th ed., Vol. VI, Agincourt, Ontario: Canada Law Book Ltd., 1980).

APPENDIX V

Additional or Alternative Piggy back Clauses

1. Two shareholders -- Third party offer to A--
Right of B to dispose of an equivalent amount of
share to the third party purchaser.

If A receives from a third party or third parties with which he is dealing at arm's length, a bona fide offer to purchase any of the common shares of the Corporation beneficially owned by him which A desires to accept then, and in every such event, A shall forthwith notify B of the receipt of such offer and his desire to accept the same and shall contemporaneously with the giving of such notice deliver to B full particulars of the offer to purchase. B shall then have the exclusive right, option and privilege, exercisable within thirty (30) days from the receipt of the aforesaid notice, to elect to sell to such third parties, at the same price and upon substantially the same terms and conditions, the same proportion of the common shares beneficially owned by him as would then be sold by A and the number of common shares to be sold to such third party or third parties by A shall be reduced accordingly. Upon the expiration of such action or upon receipt by A from B of a notice in writing declining to exercise the said option, A shall be at liberty, at any time within ninety days from the earlier date of the expiration of the option or the receipt of the notice declining to exercise the option, to accept and complete the sale to the third party or third parties at the purchase price and, without material alteration, upon the terms and provisions of this agreement and so on from time to time.

(W. Grover, "Shareholder Agreements" How to Structure Major Business Agreements, Toronto: Insight Press, 1983, at 28-29.)

Appendix V (cont.)

2. Third party offer to A to purchase all of the corporation's shares -- B to purchase or sell his entire shareholding.

If A receives from any third party or third parties with which he is dealing at arm's length, a bona fide offer to purchase all of the common shares of the corporation beneficially owned by him which A desires to accept then, and in every such event, A shall forthwith notify B of the receipt of such offer and his desire to accept the same and shall contemporaneously with the giving of such notice deliver to B full particulars of the offer to purchase. If such third party or third parties also desire to purchase the common shares of the Corporation beneficially owned by B then B shall have the exclusive right, option and privilege, exercisable within thirty (30) days from the receipt of the aforesaid notice either (i) to elect to sell all the common shares beneficially owned by him to such third party or third parties at the same price and upon the same conditions as are applicable to the sale of A's common shares or, in the alternative, (ii) to require A to purchase all of B's common shares at and for a purchase price that is equal to the consolidated book value of such common shares as at the end of the month next preceding the date when the transaction of sale and purchase is to be closed. Upon the giving by B to A of any such notice, B shall be bound to sell and A shall be bound to purchase all of the common shares of the Corporation beneficially owned by B. If B does not, within the time limited therefor, give notice to A requiring him to purchase all of B's common shares then B shall be conclusively deemed to have agreed to sell his common shares to such third party or third parties.

(W.A. Corbette, "Buy-Sell Agreements" in Edited Lectures Shareholder and Shareholder Agreements, Toronto: Department of Continuing Education of the Law Society of Upper Canada, 1976).

APPENDIX VI

Additional or Alternative Right to Purchase Provision

1. Subject to the provisions hereinafter contained, [name], (the "purchasing shareholder"), shall have the right to purchase from [name], (the "selling shareholder"), and the selling shareholder shall be required to sell, transfer and assign to the purchasing shareholder all, but not less than all, the common shares of the Corporation owned by him and all, but not less than all, the indebtedness of the Corporation to the selling shareholder (which shares and indebtedness are hereinafter sometimes referred to as the "Purchased Securities") if any of the following events shall occur:

[insert appropriate conditions]

2. The purchasing shareholder may exercise his right to purchase the Purchased Securities hereunder by mailing a notice in writing, by registered post, postage prepaid, addressed to the selling shareholder at the address referred to in this agreement or by delivering such notice in writing to the selling shareholder at such address. Upon the purchasing shareholder exercising his right to purchase the Purchased Securities as aforesaid, the selling shareholder shall then be required to sell, transfer and assign to the purchasing shareholder all, but not less than all, the Purchased Securities in accordance with the terms hereof.

3. In the event that the purchasing shareholder exercises his right to purchase the Purchased Securities upon the happening of any of the events referred to in section 1 hereof, then the aggregate purchase price for the Purchased Securities required to be sold by the selling shareholder to the purchasing shareholder shall be calculated as follows:

(a) the purchase price for the indebtedness of the Corporation forming part of the Purchased Securities shall be the principal amount thereof plus accrued and unpaid interest, if any, to the date of purchase by the purchasing shareholder; and

(b) the purchase price for each common

Appendix VI (cont.)

share of the Corporation shall be determined in accordance with the provisions of section 4 hereof.

4. The purchase price per share for the common shares of the Corporation required to be sold to the purchasing shareholder shall be the book value per common share (as hereinafter defined) as at the end of the month in which the purchasing shareholder exercises his right to purchase the Purchased Securities for the selling shareholder, as determined by the auditors of the Corporation in accordance with the provisions hereof and generally accepted accounting principles. For the purpose of determining the "book value per common share" of the common shares of the Corporation, the auditors of the Corporation shall cause an appraisal of the real property and fixed assets of the Corporation to be made at the expense of the Corporation by an independent appraiser appointed by the auditors who is a recognised licensed real estate appraiser. The independent appraiser so appointed shall appraise the real property and fixed assets of the Corporation at their fair market value as at the end of the month in which the notice of purchase is given. In addition, for the purposes of determining the book value per common share of the common shares of the Corporation, there shall be submitted to the auditors a balance sheet of the Corporation (excluding goodwill) made as of the end of the month in which the notice of purchase is given. Such balance sheet shall be signed by the Treasurer of the Corporation who shall certify that the same sets forth, fully and accurately, the financial condition of the Corporation as shown on its books of account and financial records. The auditors shall determine the book value per common share of the Corporation by using the values set forth in the independent appraisal referred to above for the real property and fixed assets of the Corporation and by using the book values for the remainder of the assets and for the liabilities of the Corporation as set forth in the balance sheet, without obligation of proving or verifying the existence of the items shown in such balance sheet. In determining the book value per common share of the common shares of the Corporation, the auditors shall not be required to make a special audit but may rely upon such independent appraisal and balance sheet made available to them. The auditors of the Corporation in determining the book

Appendix VI (cont.)

value per common share of the common shares of the Corporation shall be considered as acting as experts and not as auditors and the book value per common share so fixed by the auditors shall be conclusive and binding upon all parties in interest.

5. The purchase price for the Purchased Securities purchased by the purchasing shareholder in the event that he exercises his rights of purchase upon the happening of any of the event under section 1 hereof shall be paid by the purchasing shareholder as follows:

(a) as to an amount equal to [20]% of the purchase price, by certified cheque or bank draft payable at par in [city] to or to the order of the selling shareholder; and

(b) as to the balance of the purchase price, by a promissory note of the purchasing shareholder payable to or to the order of the selling shareholder in an amount equal to the balance of the purchase price bearing interest at the prime rate of interest charged by (name Canadian chartered bank) from time to time and payable in [five] equal annual blended installments of principal and interest.

6. The purchase and sale of the Purchased Securities shall be closed at the head office of the Corporation in [city] on the [10th] business day following the date of the determination for the purchase price for the Purchased Securities by the auditors under section 4 hereof. At the closing of the purchase and sale of the Purchased Securities, the selling shareholder shall deliver to the purchasing shareholder:

(a) a Certificate or certificates duly endorsed in blank for transfer (with signatures guaranteed by a Canadian chartered bank) and with all exigible security transfer tax paid, representing all of his common shares of the Corporation so agreed to be purchased and sold to the purchasing shareholder, with good and marketable title thereto, free and clear of all liens, charges, pledges, claims, demands, security interests, adverse claims and encumbrances of

Appendix VI (cont.)

any nature or kind whatsoever;

(b) an assignment or assignments (with signatures guaranteed by a Canadian chartered bank) representing all indebtedness of the Corporation to the selling shareholder constituting part of the Purchased Securities, free and clear of all liens, charges, pledges, claims, demands, security interests, adverse claims and encumbrances of any nature or kind whatsoever;

(c) a warranty duly executed under seal by the selling shareholder to the purchasing shareholder to the effect that:

(i) there are no contractual or other restrictions to the transfer and assignment of the Purchased Securities (other than the restrictions set out in the [articles] of the Corporation and in this agreement); and

(ii) the selling shareholder is the sole beneficial owner of the Purchased Securities with full right, title and authority to sell, transfer and assign the Purchased Securities to the purchasing shareholder, free and clear of all liens, charges, pledges, claims, demands, security interests, adverse claims and encumbrances of any nature or kind whatsoever; and

(d) the resignation of the selling shareholder as director and officer of the Corporation;

whereupon, subject to all other terms hereof being complied with, the purchasing shareholder shall make payment of the requisite purchase price in accordance with the provisions of section 5 hereof.

7. At the closing of the purchase and sale of the Purchased Securities, the selling shareholder and the purchasing shareholder agree to hold and cause to be held all such meetings of the directors and shareholders of the Corporation and to deliver and execute all such documents, instruments and consents as may be necessary to give effect to the sale,

Appendix VI (cont.)

transfer and assignment of the Purchased Securities to the Purchasing shareholder in accordance with the terms hereof.

(G.H. Emerson, ed., Canadian Corporation Precedents, 3d ed., Vol. III, Toronto: Carswell, 1989).

APPENDIX VII

Additional or Alternative Right of First Refusal Provision

1. In the event that either party hereto desires to sell, transfer, assign or otherwise dispose of any [common] shares of the Corporation (the "Offeror"), the Offeror shall make an offer in writing to the other party hereto (the "Offeree") to sell such common shares to the Offeree and shall specify in such offer the price per share, the manner of payment and the place and time of closing. The Offeree may accept such offer within [30] days after the receipt thereof and in the event that no acceptance is received from the Offeree with such [30] day period, the offer shall be deemed to have been refused. If the offer is not accepted as to all of the common shares subject to the offer within such [30] days period, the Offeror shall be at liberty for a further period of [30] days commencing with the expiration of the first [30] day period to sell all but not less all of such common shares to any person, firm, or corporation at a price which is not less than the price and on terms which are not more favorable than the terms at which such common shares were offered to the Offeree. If no such sale is completed within such further period of [30] days the Offeror shall be required, before selling, transferring, assigning or otherwise disposing of any common shares of the Corporation, to offer such common shares to the Offeree in the manner hereinbefore provided, and such process shall be repeated so often as either party to this agreement desires to sell, transfer or otherwise dispose of any such common shares.

(G. H. Emerson, ed., Canadian Corporation Precedents, 3d ed., Vol. III, Toronto: Carswell, 1989).

APPENDIX VIII

Additional or Alternative Restricted Auction Clause

1. Each Shareholder shall have the right at any time, by notice in writing to the other Shareholders, to require a private auction (the "Auction" of all the Shares and in the event that such notice is sent, all the Shareholders shall attend and participate in the Auction in accordance with this section.

2. Each Shareholder hereby grants to each of the other Shareholders the right to purchase his Shares at an Auction conducted in accordance with this section and agrees to sell his Shares to the successful bidder at such Auction, whether or not the Shareholder attends the Auction.

3. The Auction shall be conducted under the following terms:

(a) The Shareholder calling the Auction shall do so by giving notice to the other Shareholders of the date of the Auction, which date shall not be earlier than 30 days nor later than 60 days after the date such notice is received by the other Shareholders.

(b) The Auction shall take place at [time], at the offices of the Corporation's solicitors.

(c) The Corporation's solicitors shall appoint an auctioneer.

(d) Each Shareholder shall be entitled to have two (2) persons attend the Auction.

(e) All bids shall be in writing on a bid form to be prepared by the auctioneer, and shall be signed by the Shareholder submitting the bid. Nothing shall be added to the bid form except the amount per Share bid and the signature of the Shareholder submitting the bid. A bid shall not be deemed to have been made until it is in the hands of the auctioneer, and shall not be deemed to be valid until the auctioneer declares that it complies with this agreement and announces to all present the amount of the bid.

(f) The order of the bidding shall be determined by lot and, once determined shall be

Appendix VIII (cont.)

followed. The initial bid may be in any amount. Each subsequent bid shall be made within 10 minutes of the immediately preceding bid. The amount per Share bid shall be greater than the immediately preceding bid by an amount no less than [amount] divided by the total number of Shares outstanding.

(g) The bidding shall be deemed to be terminated if 40 minutes have elapsed during which no valid bid had been made, in which case the last bid shall be deemed to be a valid offer by the Shareholder who submitted the last bid to purchase all of the Share of the corporation held by the other Shareholders for a price per share equal to the amount of the last bid and the other shareholders shall be deemed to have accepted such offer.

(h) If any dispute or disagreement arises respecting any matter pertaining to the Auction or the conduct thereof, the determination by the auctioneer with respect thereto shall be final and binding on the Shareholders, and there shall be no appeal or review therefrom.

(i) The fees of the auctioneer shall be borne by all the Shareholders equally.

4. The Shareholder making the last bid shall purchase all the Shares held by the other Shareholder for the price per Share indicated on the last bid. The purchase and sale of such Shares shall be completed on the 30th day following the date of the Auction.

(M. Mooney & L.A. Wright, "Buy-Sell Clauses" Shareholders Agreements and Disagreements, (Toronto: Canadian Bar Association - Ontario Continuing Legal Education, 1986).

APPENDIX IX

Additional or Alternative Valuation Clauses

1. Valuation by an auditor.

The survivor and executors or administrators of the deceased or the retiring shareholder shall cause a valuation of all other shares of common and preferred stock of the Corporation to be made by the auditor of the Corporation based on the book value of the Corporation on the first day of the month immediately preceding the deceased's death. If within thirty days the survivor and the executors or administrators of the deceased have not signified their approval of the valuation of the shares of the Corporation as determined by the auditors, the value of such shares shall be fixed by a board of three arbitrators selected as follows: In the case of death, the survivor shall select one arbitrator, the executors or administrators of the deceased shall select one arbitrator and the two so selected shall select the third arbitrator: In the case of inter vivos transfers or the shareholder should each select an arbitrator and the two so selected shall select the third arbitrator and the decision of a majority of the said arbitrators shall be final.

2. Valuation by an auditor; method of determining value

The survivor and the executors or administrators of the deceased or the retiring shareholder shall cause a valuation of the shares of the Corporation to be made by the auditors of the Corporation at the month end immediately following the death of the deceased based on the book value of the Corporation calculated as follows; goodwill shall not be carried on the books; equipment and inventory shall be included at the lower cost and market; land and buildings shall be included at the then determined market value as determined by the appraisal of a licensed appraiser chosen by the survivor and the executors or administrators of the deceased whose decision if not agreed upon by the parties shall be submitted to a board of arbitrators as herein described; and the usual reserve for bad debts shall be used.

If within thirty days the survivor and the executors or administrators of the deceased have not

Appendix IX (cont.)

signified their approval of the valuation of the shares of the Corporation as determined by the auditors, the value of such shares shall be fixed by a board of three arbitrators selected as follows: In the case of death, the survivor shall select one arbitrator, the executors or administrators of the deceased shall select one arbitrator and the two so selected shall select the third arbitrator: In the case of inter vivos transfers or the shareholder should each select an arbitrator and the two so selected shall select the third arbitrator and the decision of a majority of the said arbitrators shall be final.

3. Book Value -- Capitalization of Fixed Assets

To the book value if the shares of the corporation shall be added an amount equal to the [six] times the difference between the average net profit of the Corporation, after payment of all taxes thereon, for [three] complete fiscal years of the Corporation immediately preceding the deceased's death and [ten] per cent of the adjusted net asset value of the Corporation as above determined at the date of death of the deceased.

4. Value Stipulated Annually or Adjusted

The parties shall stipulate each year the value of the shares of the Corporation as of the date of the last financial statement of the Corporation and shall file such stipulation with each copy of this agreement and such stipulated valuation shall be the basis of determining the purchase price during the succeeding twelve-month period.

If no valuation is made for two successive fiscal years, the purchase price shall be the last stipulated valuation prior to the death of the deceased, increased or decreased, as the case may be, by the difference between the book value of the shares according to the financial statement for the year-end next preceding the last stipulated valuation and the book value according to the financial statement for the year-end preceding the date of death.

Appendix IX (cont.)

5. Valuation by Auditor After Death --Method of Valuing of Assets

The purchase price to be paid on the purchase of the deceased's shares shall be calculated by the auditor of the Corporation on the following basis:

- (a) Shares shall be valued at their market value as of the date of death or retirement;
- (b) Land and buildings shall be valued at the appraisal value fixed by an appraiser appointed by the vendor and the purchaser or in default of such appointment pursuant to the provisions of the [Arbitration Act];
- (c) Fixed assets other than land and buildings shall be valued at their book value as shown on the last financial statement of the Corporation;
- (d) Other business assets including inventory, accounts receivable, less accounts payable and other indebtedness, shall be valued at three times the average of the net profit after tax for the last three fiscal years.

(J.D. Honsberger and J.M. Wainberg, eds., O'Brein's Encyclopedia of Forms, 10th ed., Vol. VI, Agincourt, Ontario: Canada Law Book Ltd., 1980).