



# SHAREHOLDER | PARTNER COUNSEL

MAY/JUNE 2000

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## WHEN BINDING CONTRACTS AREN'T: *JUDICIAL MEDDLING IN USAs AND PARTNERSHIP AGREEMENTS\**

### *Binding contracts are The Law*

A partners' or shareholders' agreement is a binding contract, and part of the legal make-up of any corporation or partnership. That goes for all of the components of the agreement, including the buy-sell or shotgun provisions. The law looks upon contracts freely entered into as hallowed territory. However...

### *The Law v. Equity*

Sometimes reasons will exist for a Court to take a closer look at a partners' or shareholders' agreement – including the dispute resolution mechanisms agreed to by the parties. Situations crying out for a dose of fairness can prompt a judge to apply equity instead of the common law<sup>1</sup>. The difference is this: In law, a binding contract must be enforced; but in equity, a Court has the latitude to look for reasons to deny one party his contractual rights. Depending upon which camp they are in, the parties will see this equitable remedy as either meddlesome or miraculous.

### *Some practical reasons for judicial override*

A review of the cases from the past decade yields up several scenarios where the Court has exercised its equitable discretion to override a contract entered into between businesspeople. No matter what the label placed on the parties' conduct – either “corporate wrongdoing”, “unfair conduct” or “manifest unreasonableness” – the common denominator is the same: a finding of breach of the duty of good faith.

For instance, an Alberta Court exercised its equitable discretion in these circumstances<sup>2</sup>: The parties to a USA agreed not to apply for a Court order either winding up or liquidating the corporation under the *Alberta Business Corporations Act*. However, when the parties' relationship disintegrated, Party A made such an application to the Court. Party B, relying on the agreement, contested the application. The Court held that it can invoke its equitable jurisdiction

and override a contract where it finds “corporate wrongdoing”. Although the Court found no corporate wrongdoing in this case – and no need to meddle with the agreement – the message was clear.

A few years later, an Alberta Court dealt with the opposite situation<sup>3</sup>. The USA provided that either party could force the company's voluntary liquidation and dissolution. When one party attempted to do just that, the other applied to the Court for help. The Court noted that, alongside other equitable considerations, manifest unreasonableness by one party can open the door to a Court override. In this case, the Court found such unreasonableness, ignored the USA and refused to wind up the company.

Manifest unreasonableness, according to this Court, can be found where one party attempts to frustrate the goal of doing business – that is, the protection of assets and maximization of returns to shareholders. In its decision, the Court gave two scenarios that demonstrate unreasonableness. They are:

- Where the contractual remedy to which one party is entitled will jeopardize the interests of other shareholders, and another, more reasonable alternative is available, or
- If the implied intent of one of the parties is to “punish” the other for a perceived misconduct by choosing a remedy most likely to reduce asset value and return.

<sup>1</sup>Many years ago, the Courts recognized that the law can be, well, an ass. Stemming from that recognition, the Courts created an arsenal of “equitable” principles to supplement the “legal” ones. These principles recognize that, notwithstanding the legalities, some situations require an examination of what is fair as opposed to what is legal.

<sup>2</sup> *Koroganas v. Andrew et al* (1992) 128 A.R. 381 (Q.B.).

<sup>3</sup> *Re Cavendish Investing Ltd.* (1996) 190 A.R. 3 (Q.B.).

\*Mr. Prowse acknowledges the research and editorial assistance of Karen M. McDougall, BA, LLB in the publication of this newsletter.

*“...conduct which is oppressive or unfairly prejudicial, ... ‘strikes at the very underpinning of the contractual mechanism’ ....”*

One further case of note stemmed from a bad deal made between an unsophisticated employee/ shareholder and others in a closely-held corporation<sup>4</sup>. The USA provided that the unsophisticate would be bought out only upon his death and for no other reason. Inevitably, due to self-dealing by the managing shareholders, the unsophisticate resigned as an employee of the corporation and attempted to sell his shares only to find that, under the agreement, he was not entitled to do that. As a last resort, he applied to an Ontario Court for an order for the mandatory sale of his shares, based upon the company's alleged oppressive conduct.

The issue before the Court boiled down to whether it should enforce the USA disentitling the shareholder to a buy-out. The Court decided that this equitable “underlying premise” favoured a buy-out, which it ordered:

**“No shareholder is entitled to have his shares purchased by the others when the company is being operated in a proper and fair manner. However, where there is conduct which is oppressive or unfairly prejudicial, that conduct ‘strikes at the very underpinning of the contractual mechanism itself’.... In those circumstances, the oppression remedy section has application...”**

These are a few examples of Court override of agreements freely entered into between parties. As is the way with judge-made law, more examples will come only when the Court is called upon to consider them. In the meantime, there are many issues left open in this area of the law. Included in those unanswered questions is whether the Courts will consider the seriousness of the consequences

before deciding to override a contract. The ultimate consequence is, of course, the destruction of the business. Although one Court has raised this issue, it was left open for another day<sup>5</sup>.

<sup>4</sup> *Neri v. Finch Hardware (1976) Ltd. (c.o.b. Union Hardware Wholesale) (1995) 20 B.L.R. (2d) 216 (Ont. Gen. Div.)*.

<sup>5</sup> *ibid*

In the next issue of *Shareholder/Partner Counsel*...

Watch for the surprising story of how one judge resolved a shareholders' dispute by imposing a “game show” buy-sell mechanism – complete with buzzers!

The legal professionals at Prowse & Chowne bring you *Shareholder/Partner Counsel*, dedicated to the discussion of issues particularly important to the small businessperson. Look for it bi-monthly for information and insight into the various legal remedies available to shareholders or partners with grievances; means available to resolve inter-shareholder disputes, including mediation; the oppression and derivative action remedies available through the Alberta *Business Corporations Act*; conflicts of interest; issues related to shareholder loans and shareholder agreements; and much more.



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