



SHAREHOLDER | PARTNER COUNSEL

WHEN NEW BLOOD LEADS TO BAD BLOOD

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“If you are making a change you must know how the law will affect your new relationship.”

The difference between a public and a closely-held corporation is this: a public company is typically adversarial, and involves self-interested parties controlled by an altruistic board. A closely-held firm, on the other hand, involves parties with common interests and objectives attempting to achieve consensus in their operations.

This fundamental difference is the reason closely-held corporations are more at risk than large corporations from “bad blood” difficulties. Being closely-held means fewer players and no overseer board. Corporate “divorces”, the addition of new players, or oppressive activity are felt much more strongly in closely-held firms where the balance is more delicate. That is why, in previous issues, we have outlined various ways in which the players in a closely-held corporation can protect themselves - for instance, with shotgun provisions - should the relationship no longer be viable.

This issue is the first in a multi-part series on problems that can arise in a closely-held corporation during times of change - when it’s time to say goodbye to an old player or welcome a new one. The topic of this issue deals with the effect that “new blood” may have on an existing unanimous shareholders’ agreement (a “USA”).

The legislation

If you are making a change by allowing new people into a closely-held corporate “partnership” or buying into one, you

must know how the law will affect your new relationship. The *Business Corporations Act* says that, where a unanimous shareholder agreement is in effect, and new shares are issued or existing shares are transferred to an incoming shareholder:

1. A new shareholder is deemed to be a party to the agreement whether or not he had actual knowledge of it when the share certificate was issued;
2. The fact that new shares have been issued does not terminate an existing USA;
3. If a new shareholder doesn’t know that the USA exists, he can rescind the contract under which the shares were acquired. The result is an entitlement to sell the shares back to the corporation at fair market value.

The questions

Parties to USAs should consider these questions when allowing new shareholders into a closely-held corporate partnership:

1. Is there a valid agreement in place between shareholders?
2. If yes, is it really a “unanimous shareholder agreement” as defined and affected by the legislation?
3. Who are the parties to that agreement? Are they still involved with the corporation? If not, does the agreement provide a means for their release from its terms?

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

“ The moral of this story? Review your USA periodically to ensure that it will continue to work for you as contemplated”.

4. Does the agreement continue to protect the original parties?
5. If not, what additional provisions are required, given the passage of time and given the addition of new shareholders?
6. Do incoming shareholders know about the agreement and what it contains?

A scenario

Suppose that shareholders in a closely-held corporation enter into an agreement naming only themselves as parties. Suppose they make no provision for termination of the agreement, or for eventualities like retirement or death.

Suppose the agreement provides that only the initial shareholders can ever be voted in as directors of the company. Suppose it contains no provisions for new blood coming into the “partnership”.

Suppose the agreement is forgotten, and by the time it is unearthed, most of the original parties to the agreement are no longer involved with the company, having either retired or expired. In the meantime, suppose that shares have been sold to a new shareholder who knows nothing about the agreement. To complicate things further, suppose the remaining shareholders have entered into a second shareholder agreement with an incoming shareholder, involving promises

and protective clauses different from those in the initial agreement.

A scenario like this can, and in the case of one of our clients, did result in a major problem. How can a corporation keep the new shareholder from using the governing legislation to take advantage of the first, forgotten agreement, which contained contractual rights that the initial shareholders anticipated would be for their benefit only?

Needless to say, untangling a mess like this is counterproductive and expensive. The moral of this story? Review your USA periodically to ensure that it will continue to work for you as contemplated.

Did you know ...

The legislation governing federal corporations has had a face-lift – the first revision to the Act since it came into force in 1975. Bill S-11, **An Act to amend the Canada Business Corporations Act and Canada Cooperatives Act and to amend other Acts in consequence** came into force November 24, 2001. Among other things, the Act amends the law surrounding directors’ liability by expanding defences open to directors.



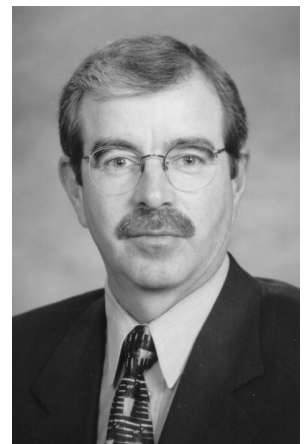
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J. Cameron Prowse, Q.C., a managing partner in Prowse Chowne LLP, offers over 25 years of legal expertise to the Alberta and N.W.T. business communities. A recognized and practiced litigator, Cameron has a special interest in business law.



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