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FAMILY-HELD BUSINESS SUMMIT
EXIT AND SUCCESSION STRATEGIES
APRIL 20, 2007 — TORONTO, ONTARIO

**“FAIR VALUE” AND
THE OPPRESSION REMEDY**

by

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MINORITY SHAREHOLDER APPRAISAL RIGHTS

A. Shareholder Dissent

1. Fundamental corporate change
2. Squeeze-out (e.g., via amalgamation)

- *versus* -

B. Oppression

1. Disregard of shareholder interests, reasonable expectations
2. Prejudicial conduct

DISSENT RIGHTS TRIGGERED BY FUNDAMENTAL CORPORATE CHANGE

- ✚ Amendment of articles to add, change or remove provisions restricting issue or transfer of shares
- ✚ Amendment of articles to add, change or remove restrictions on business corporation may carry on
- ✚ Amalgamation
- ✚ Continuance under laws of another jurisdiction
- ✚ Sale, lease or exchange of all or substantially all of corporation's property

CONDUCT

"Oppressive"

Conduct entailing a lack of probity or fair dealing in the affairs of a corporation; conduct that is burdensome, harsh or wrongful.

"Unfairly prejudicial"

Unjust or inequitable — in sense that it is detrimental or damaging to applicant's rights or *interests*.

"Unfairly disregard"

To unjustly and without cause pay no attention to, ignore or treat as of no importance, the *interests* of the complainant.

MAPLE LEAF FOODS INC. v. SCHNEIDER CORP.

ONTARIO SUPERIOR COURT OF JUSTICE

(1998), 42 OR (3d) 177 (Ont. CA)

“Conduct which disregards the ***interests*** of any shareholder and ***not simply a shareholder’s legal rights*** will infringe section 248 of the OBCA. This is because the oppression remedy is basically an equitable remedy and the court has jurisdiction to find an action is oppressive, unfairly prejudicial or unfairly taken ***in disregard of the interests*** of a security holder if it is wrongful, ***even if it is not actually unlawful.***”

OPPRESSION: POSSIBLE REMEDIES

- ① Purchase of shares by company (or by other persons) at **FAIR VALUE** (value on a *going-concern* basis rather than *liquidation* basis)

- CBCA, s.241(3)(f)

OR

- ② Liquidate company (*liquidation value*)

- CBCA, s. 214(a)

*PHILIPPE MONTEL ET AL v.
GROUPE DE CONSULTANTS P.G.L. INC. ET AL*
QUEBEC SUPERIOR COURT
(ROTHMAN, J)

“I can see no reason why the valuation should be any less just and equitable in the case of a shareholder who has been expelled or *oppressed* under [section 241 of the CBCA] than it would be for a *dissenting* shareholder under [section 190].”

WESTFAIR FOODS LTD.

INTERESTS OF CLASS A SHAREHOLDERS BEING UNFAIRLY DISREGARDED — PROCEDURAL CONFLICTS

- ✚ Unfairness based on dividend policy — rejected
- ✚ Auditors ignored existence of Class A shares in describing Westfair as “*wholly-owned* subsidiary” of its parent, in annual report
- ✚ Westfair permitted Toronto Stock Exchange to de-list Class A shares without protest
- ✚ Westfair and its parent company considered Class A shareholders to be a nuisance

WESTFAIR FOODS LTD. COURT OF APPEAL OF ALBERTA

- Q. Why would shareholders of a public company ask Court to order company to purchase shares when they could easily be sold on the public market?**
- A. [They] obviously consider public-market grossly under-valued [and] believe that [judge] had uncovered valuable right of which the market has been unaware: the right to force purchase at break-up value.**

WESTFAIR FOODS LTD.

Alberta Court of Appeal:

“If [Westfair] liquidated itself in the future [because of being] unsuccessful, then ... the assets [presumably] would be worth little. It is true that there is a *metaphysical possibility* that this company might liquidate itself while possessing significant assets ... *such metaphysical possibilities can have almost no weight whatever.*”
(Emphasis added.)

FORMAL JUDGMENT OF COURT OF APPEAL OF ALBERTA

**IN VALUING WESTFAIR'S CLASS A SHARES,
COURT-APPOINTED VALUATOR MUST NOT
CONSIDER:**

- ✚ Westfair's income (beyond the fixed \$2 annual dividend, which was paid continuously for 35 years)
- ✚ Westair's retained earnings
- ✚ Value of Westfair's assets
- ✚ Market or trading prices of the shares

FORMAL JUDGMENT OF COURT OF APPEAL OF ALBERTA (CONT'D)

- ✚ Value to Westfair (the acquisition or extinguishment of the shares)
- ✚ Future business plans of Westfair or its affiliates
- ✚ Any allowance or premium for compulsory taking of the shares
- ✚ Possible synergies
- ✚ Possible nuisance value.

WESTFAIR FOODS LTD.

1998 ABCA 337

“It is unlikely that [the trial judge] intended to impose an obligation on the victims of the unfair treatment to sell their shares at an uncertain value while ... conferring a benefit on Westfair ... by satisfying [the Westfair group’s] long-standing desire to acquire the remaining publicly-held Class A shares”.

...

“Compelling Westfair to purchase *at fair value* ... was an appropriate remedy in the circumstances.

...”

HALL v. ATTO
ONTARIO SUPERIOR COURT OF JUSTICE
[2001] O.J. No. 3068

■ **Oppressive acts**

- Excess compensation taken by Defendants
- Personal racehorse paid for by corporation

■ **Fair value must consider “monies inappropriately taken”**

■ **Court:**

“Purpose of oppression remedy is to put Plaintiff in the position in which he would have been, but for the oppressive act or to compensate him therefor.”

HALL v. ATTO
ONTARIO SUPERIOR COURT OF JUSTICE
[2001] O.J. No. 3068

- Interest should be added to compensate for funds inappropriately removed from company.
- Other factors:
 - Valuator may not resort to hindsight to assist in performing valuation.
 - However, valuator may “look to events and information arising after valuation date for purpose of testing his/her assumptions”.

THE FORD CANADA CASE

[2006] O.J. 27 (C.A.)

- ✚ What is oppressive and unfairly prejudicial in one case may not necessarily be so in slightly different setting of another
- ✚ Onus of proof of oppression is on applicant
- ✚ **OPPRESSION**: The conduct, or absence of conduct, that effects a result that is oppressive or unfairly prejudicial to, or that unfairly disregards, the interests of a shareholder

THE FORD CANADA CASE

- ✚ Intercompany transfer pricing between Ford Canada and Ford U.S.
- ✚ Court commented that transfer pricing system that runs afoul of income tax laws “might well not be oppressive to shareholders” (of Canadian subsidiary):

“Indeed, a transfer pricing system that meets with tax problems is usually to the benefit of the narrow, private self-interest of all the shareholders while being at the expense of the public interest through the loss of tax revenues. Conversely, a transfer pricing system that meets the criteria of the tax authorities does not in itself necessarily establish that there cannot be a finding of oppression in respect of shareholders.”

THE FORD CANADA CASE

(CONT'D)

- ✚ Any oppression will only be established on evidence of corporate operations of Ford Canada
- ✚ A factual finding of structural flaws ... in transfer pricing system may nevertheless possibly impact upon determination of fair value as of valuation date
- ✚ Arm's length purchaser of Ford Canada would consider inherent values dependent upon transfer pricing adjustments, just as a purchaser would in respect of any other asset or liability not recognized on company's books

THE FORD CANADA CASE

(CONT'D)

- ✚ An unrelated, independent Ford Canada would have wanted to renegotiate historical arrangements with Ford U.S.
- ✚ Court held that transfer pricing system is relevant to a claim for oppression, i.e., transfer pricing system may be oppressive or unfairly prejudicial to, or unfairly disregards, interests of shareholders, *even though it meets requirements of tax law*

VALUATION CONSIDERATIONS RE OPPRESSION

- ✚ Courts generally value shares as if oppression had not occurred (if oppressive acts have had negative effect on value of shares, such negative effects are ignored)
- ✚ Courts generally will not order premium because of oppressive conduct. However, minority discount may apply where conduct of *minority* was sufficiently grave that minority deserved to be excluded
- ✚ Valuation date is typically date of petition filed seeking relief — but if intervening events make earlier date appropriate, earlier date may be used



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**SHAREHOLDERS'
BUY-SELL AGREEMENTS**

by

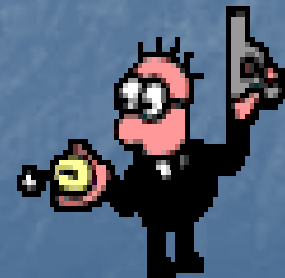
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BUY-SELL AGREEMENTS TRIGGERING EVENTS

- ✚ Death
- ✚ Mental or physical disability
- ✚ Bankruptcy
- ✚ Voluntary cessation of employment (retirement)
- ✚ Involuntary cessation of employment (dismissal)



BUY-SELL AGREEMENTS TRIGGERING EVENTS (CON'TD)

- ✚ Dissension or deadlock among shareholders
- ✚ Criminal conviction
- ✚ Matrimonial property claim
- ✚ Desire to sell the shares and withdraw from company in order to start one's own business.



BUY-SELL CLAUSE OBJECTIVES

- ✦ Increased certainty as to (a) quantum and (b) liquidity with respect to deceased's shares
- ✦ Assured market for shareholding
- ✦ Fair *selling* price for terminating shareholder as a result of death, incapacity, retirement, withdrawal or inability to continue in the business
- ✦ Fair *purchase* price
- ✦ Price-setting mechanism for shareholding acquired by continuing shareholder(s)

BUY-SELL CLAUSE OBJECTIVES

(CONT'D)

- In case of death, to provide vehicle to assist in timely administration of deceased shareholder's estate
- Increased certainty for estate planning purposes as to *quantum* and *liquidity* with respect to deceased's shares

BUY-SELL AGREEMENT OBJECTIVES

(CONT'D)

- ✚ Control of corporation by remaining shareholders is assured
- ✚ Avoids involvement and possible interference of outsiders who might otherwise acquire terminating shareholder's shares.

SETTING THE BUY-SELL PRICE

- ✦ Fixed price negotiated in advance by parties, but updated periodically (e.g., annually) to be used when specified event subsequently occurs
- ✦ Price determined by independent third party, such as CBV
- ✦ Price established by formula
- ✦ Price determined by a shotgun clause
- ✦ Price established by right of first refusal

BUY-SELL PRICE: WHAT STANDARD OF VALUE?

- Book value?
- Adjusted book value?
- Fair market value?
- Fair value?
- Formula price?



PROBLEMS IN USING "BOOK VALUE"

A FEW POSSIBLE UNINTENDED RESULTS IN USING "BOOK VALUE"

Payment to withdrawing or deceased shareholder may be substantially below a fair and reasonable amount because of:

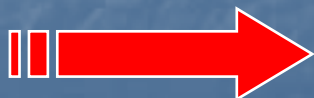
- a. Increases in values of fixed and certain other assets and existence of valuable intangibles, including IP;
- b. contingent assets (and liabilities) not reflected on balance sheet (only in notes to financial statements).



Not reflected in Book Value

A FEW POSSIBLE UNINTENDED RESULTS IN USING "BOOK VALUE" (CONT'D)

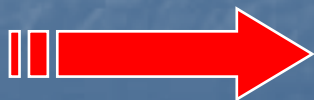
- ✚ Long-term debt owing to arm's-length creditors bears interest at rates substantially below current market rates on similar debt.



Not reflected in Book Value

A FEW POSSIBLE UNINTENDED RESULTS IN USING "BOOK VALUE" (CONT'D)

- ✚ "Special purchasers" for the business exist in marketplace.
- ✚ Triggering event is death, and life insurance proceeds are payable to company as beneficiary and owner of policy.



Not reflected in Book Value

A FEW POSSIBLE UNINTENDED RESULTS IN USING "BOOK VALUE" (CONT'D)

- ✚ *Contingent liabilities*
- ✚ At time of signing buy-sell, circumstances were very different from those prevailing when triggering event occurs.



Not reflected in Book Value

A FEW POSSIBLE UNINTENDED RESULTS IN USING "BOOK VALUE" (CONT'D)

- ✚ Pending lawsuits or substantial claims by or against company (referred to only in notes to financial statements).



Not reflected in Book Value

PROF. JAMES C. BONBRIGHT

“ ... an inference that ... ‘fair market value’ of a share is equal to its book value must be based on a whole series of assumptions, each of which is more likely than not to be unwarranted in a given case. ... ”

The Valuation of Property, 2 vols. New York: McGraw-Hill, 1937, 1058.

FAIR MARKET VALUE

Family-Held Business Summit
Exit and Succession Strategies
THE LAW SOCIETY OF UPPER CANADA

April 20, 2007
Toronto, Ontario

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USE OF "FAIR MARKET VALUE" QUESTIONS TO BE ADDRESSED BY VALUATOR

- ✚ Absent any specific instruction, does valuator apply Minority Discount in valuing terminating shareholder's shares?
- ✚ What about a Marketability Discount?
- ✚ If so, what size discount(s)?



BUY-SELL AGREEMENTS CONSIDERATIONS FOR VALUATOR

- ✚ Absent specific instructions, should valuator — in determining FMV of terminating shareholder's interest — consider loss to company of terminating shareholder's future services?

SHOTGUN PROVISION

"You cut the pie in two, and I will choose my half!"

SAFEGUARD:

- ✚ If offeror *asks too high a price*, offeree may respond by requiring *offeror* to pay that same price for offeree's shares
- ✚ If *too low a price offered*, offeree may respond by buying out *offeror* at that low price



ADVANTAGES OF SHOTGUN PROVISION

- If parties have equal financial backing and are equally informed as to future prospects of business, shotgun approach should establish a fair price, since offeror may be:
 - forced to sell if his/her valuation is too low; or
 - forced to buy if his/her valuation is too high

DISADVANTAGES OF SHOTGUN PROVISION

Assumes respective shareholdings are of similar size. However, if two shareholders (say, one with 85% and other 15%), it might be easier for 85% shareholder to buy; 15% shareholder might not have resources to acquire 85%.

VALUATION CONSIDERATIONS

- How will price/value be determined?
- As of what date?
 - Date of specified/triggering event?
 - End of immediately preceding month?
 - End of last completed fiscal year of the business?
 - End of last regular accounting/reporting period (e.g., fiscal quarter)?
- How often should buy-sell clause be reviewed/updated (changing circumstances, conditions)?