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Have you ever asked yourself – “Is this the right person for me? Are we compatible with each other? Are we interested in the same outcomes in this relationship?”

Why not begin every business relationship in your life with these questions? The relationship between shareholders in a closely held corporation is like a marriage. The shareholders have to interact with each other, for better or for worse. Acrimonious situations cannot only harm the relationships between the shareholders; they can result in corporate instability, loss of revenue and even dissolution of the corporation. So why put yourself through such instability? You can take steps at the beginning of the relationship to avoid unrest and protect yourself in the event of a corporate divorce.

In marriage, relationships can start in a mature manner and endure without disputes. However, at some point in the relationship you may encounter a situation that cannot be resolved easily. This is when you wish you had done

something differently at the outset. In business, the excitement of a new venture and the need for capital can lead to accepting shareholders that may not be entirely compatible with the other shareholders. This can create problems and disputes down the road. These occurrences could be avoided, or at least minimized, with proper planning and due diligence prior to committing to the relationship.

This series of articles provide insight into 1) what a corporation and an investor should consider when deciding to enter into their “corporate marriage”, 2) possible mechanisms to avoid a “corporate divorce” and 3) if corporate divorce is inevitable, how can it be best resolved.

The following are some of the primary considerations and protective mechanisms you should implement when becoming partners/shareholders/co-founders with other individuals:

1. Conduct Business, Legal and Interpersonal

Due Diligence: Whether you are a corporation looking for investors or the investor looking to become a shareholder of a corporation, due diligence should be done by both parties before the corporate marriage is consummated. Due diligence should focus both on the interpersonal aspects between the shareholders, the goals of the corporation vis-à-vis the investor, and whether the investment in the corporation will satisfy these goals.

2. Enter into Shareholder's Agreement: A shareholder's agreement is the best way to protect both the corporation and the shareholders in a corporate marriage from possible situations where disputes may arise. It is akin to a prenuptial agreement in a marriage. This agreement can provide for resolutions to possible disputes or situations such as the death of a shareholder, how shares can be transferred or sold, resolving a deadlock at a shareholder's meeting, and how a shareholder can be bought out.

3. Implement Dispute Resolution Provisions in Shareholder's Agreement: A dispute resolution provision can be invaluable for resolving disputes and disagreements in an effective and efficient manner. Like any relationship, a business relationship may have its ups and downs. A dispute resolution provision can provide for mediation or arbitration in the event of a disagreement and a guideline to resolving disputes which may result in corporate divorce.

This article, being the first in a series, focuses on the first mechanism described above. The following are a number of due diligence items that should be considered by both the shareholders and the corporation contemplating the possibility of a "corporate marriage":

Shareholders:

Interpersonal

- Are the shareholders' personalities compatible? For example, are they risk takers, aggressive, socially conscious, etc.?
- What is the management structure of the corporation? Who will make the decisions? What level of input will each shareholder possess?
- What skills does each shareholder contribute to the relationship?
- Are the shareholders trustworthy?
- Are shareholders willing/able to put in the required time to fulfill their responsibilities?
- How is the business of the corporation conducted?
- Are people in the corporation happy?
- Are the investors sophisticated / Does each shareholder truly understand what they are getting into?

Goals

- How will the investment funds be spent?
- What is the expected return on capital and associated timeline?
- What are the terms of the investment? For example, what will be received in exchange for the investment and how will this be delivered and over what timeframe?
- How long will it take for the investment funds to be exhausted?
- Will there be a need for additional investment?
- What are the reasons for investing in the corporation?
- Will shareholdings be diluted in the near future?
- Is there an exit strategy? What are the corporation's short term and long term goals with respect to this strategy?
- What are the respective visions for the corporation? Are they diverse or united?

- What are the material business relationships of the corporation?
- Do the investors/shareholders understand the operational aspects of the business?
- What are each individual's detailed responsibilities?

Investors

If you are the investor looking for the right corporation to invest in, there are additional items which you should consider before making the final commitment:

- Do you understand the financial situation of the corporation?
- What is your level of understanding of the market in which the corporation operates and the competitive advantage of the corporation?
- Identify the projected profit of the corporation and on what basis and assumptions these projections are based on.
- Identify what your expectation for return is on your investment.
- Are there any shareholder's agreements which you will be bound by?
- What are the major assets of the corporation?
- Are there any liabilities of the corporation and would you become liable for anything if you become a shareholder?
- Does the corporation rely on certain "key" employees and are these individuals happy in their current roles?
- Identify the debts and liabilities of the corporation.
- Acquire an organizational chart of the corporation.
- Request copies of the constating documents and by-laws.
- Review the financial statement (including interim reports) of the corporation and a summary of the business activities.
- Ascertain whether the corporation is involved in any litigation or is facing any potential litigation.

It is unlikely that you will be able to get answers to all the items outlined above. It also may not be appropriate in your situation to request all the information. However, every situation is unique. Possibly, your values and personal situation will give you the ability to proceed with the relationship regardless of whether these points are all covered. The key is that you give considerable thought at the beginning of your relationship and you seriously consider the interests, goals and motivations of all the parties involved. The initial stages may in fact be the most significant in establishing a long and prosperous corporate marriage.

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When Good Isn't Good Enough: The Onus on "Best Efforts"

When negotiating a lease, tenants and landlords often argue over the standard that must be met by the parties when fulfilling various obligations. Typically, tenants bargain for the inclusion of reasonableness requirements or a blanket reasonability clause. If the tenant has adequate bargaining power they may insist on even more onerous undertakings by the landlord such as "best efforts", "reasonable best efforts" or other variants of the kind. Before a landlord agrees to such an undertaking, they must take into consideration what obligations and requirements these words engender.

The "best efforts" provision was outlined in the case of *Atmospheric Diving Systems Inc. v. International Hard Suits Inc.*, ("Atomospheric"). Madam Justice Godan summarized the legal meaning and the principles of "best efforts" as, but not limited to:

1. ...a higher obligation than a "reasonable effort".
2. ...taking, in good faith, all reasonable steps to achieve the objective, carrying the process to its logical conclusion and leaving no stone unturned.
3. ...doing everything known to be usual, necessary and proper for ensuring the success of the endeavour.
4. ...must be approached in the light of the particular contract, the parties to it and the contract's overall purpose as reflected in its language.

In the recent case of *Diamond Robinson Building Ltd. v. Conn*, the Court examined the issue of a landlord's obligation to use its "best efforts" to fulfill a fundamental term of a lease within the context of an anticipatory breach claim.

In April 2006, Ronald Conn ("Conn") entered into negotiations for a commercial space with Diamond Robinson Building Ltd. ("Diamond"). Conn advised Diamond that twenty-two reserved parking stalls were required by its business. Diamond provided a verbal assurance that it would "not be a problem". However, the parking area was designed in a way that precluded the availability of twenty-two reserved stalls. In order to satisfy Conn's parking requirements Diamond had to obtain strata council approval. On May 9, 2006 both parties signed the Offer to Lease and the Lease Agreement (the "Lease") was finalized on May 31, 2006.

The Lease stated that Diamond would provide Conn with "up to twenty-two reserved parking stalls". In addition, the Lease contained a rider which stated:

"to the extent the Landlord is providing covenants regarding the Common Area... the Landlord is relying on the obligations of the strata corporation to perform same provided that the Landlord shall use its best efforts to cause the strata corporation to perform same."

Diamond failed to obtain the necessary strata council approval despite several months of effort. Conn informed Diamond on September 11, 2006 that it no longer intended to move forward with the Lease. Formal written notice of this intention was provided on November 3, 2006. Diamond accepted Conn's termination of the lease and claimed damages for the loss of the remainder of the Lease term.

The Court determined that the parking provisions were a fundamental term of the Lease but concluded that Conn's pre-emptive disclaiming of the Lease constituted anticipatory breach because Diamond had yet to do anything which would lead Conn to believe that the parking obligations would not be fulfilled. Despite this conclusion the Court did not award damages to Diamond.



The Court upheld the principles outlined in *Atmospheric* and concluded that where a contract includes the term “best efforts” the court will impute intent to the parties that is something more than “reasonable efforts”, which is an obligation to take every step through to its logical conclusion, “leaving no stone unturned”.

Diamond’s obligation was to make “best efforts” to obtain strata council approval by the November 1, 2006 commencement date. Diamond’s efforts from the time the Lease was signed to the date of Conn’s repudiation was considered by the Court to be those of “best efforts”. However Diamond treated the Lease as if it were still in force until December 15, 2006. Diamond could not recover damages since they did not continue to make “best efforts” to obtain strata council approval following Conn’s repudiation. This conclusion was based on a principle of contract law which states that where an innocent party treats a repudiated contract as if there was no repudiation and then fails to meet its obligations under the contract, it cannot bring an action for damages against the repudiating party.

Both landlords and tenants should pay attention to this British Columbia decision. In particular, the use of “best efforts” terminology will result in a much more onerous standard than one of reasonableness. Landlords must be aware and take into consideration what will be required of them when providing this type of assurance to a tenant and tenants should seek to impose “best efforts” obligations upon a landlord for performance of any fundamental terms of the lease

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Professional Notes

Follow **Irvin Schein** as he blogs about recent cases at www.irvinschein.com

Hartley R. Nathan Q.C. and **Phillip G. Bevans** presented *Top 10 Contentious Issues at Board and Shareholders Meetings* for CCH Canada (December 2011)

The **Honourable Jerry S. Grafstein, Q.C.** was installed as the Honourary Chairman Of The Board Of Governors of the Canadian Yeshiva & Rabbinical School (December 2011)

Glen Lewis was quoted in the article *Come Together, Right Now* in the Winter 2011 edition of Precedent Magazine

Hartley R. Nathan, Q.C. presented *The Preparation and Conduct of Board and Committee Meetings* to the Directors College: Chairs Forum (November 2011)

Steven I. Pearlstein was quoted in the following Law Times articles, *Should sellers have to disclose gruesome histories* and *Environmental problems can leave clients liable* (November 2011)

Joan E. Jung presented *Current Estate Planning Issues* to The Estate Planning Council - Toronto (November 2011)

Arnie Herschorn was quoted in the article *Caveat Realtor? Do vendors and real estate agents have a duty to alert potential buyers to the pedophile next door?* in the Canadian Bar Association National Magazine (November 2011)

Enzo Sallese will be participating in the *14th Tax Planning for Real Estate Transactions*

Reuben M. Rosenblatt, Q.C. spoke at The Law Society of Upper Canada's Civil Appeals: Year in Review on the topic New Property Matters for Consideration in Civil Litigation held on October 18, 2011 and December 6, 2011; and The Law Society of Upper Canada's Six Minute Real Estate Lawyer on the topic To Close or Not to Close? Conditions, Warranties and Condition Precedents held on November 22, 2011. He was also Co-chair for The Law Society of Upper Canada's Safeguarding Real Estate Transactions Conference held on November 22, 2011 and spoke on the topic Fraudulent Conveyances: A Continuing Problem - The Role of the Lawyer

In December 2011, **Reuben M. Rosenblatt, Q.C.** completed his 34th year teaching the Real Estate Transactions Course at Osgoode Hall Law School

Firm News

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The firm is pleased to announce **Enzo Sallese** and **Leah Silber** joined our Real Estate group and **Sepideh Nassabi** has joined the Litigation and Insolvency groups