MINORITY SHAREHOLDER'SREMEDIES IN CORPORATE LAW

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ABSTRACT

Investment in the corporate venture may sometimes be a risky venture for the minority shareholders. Apart from the business risk of the undertaking, there is also the risk of disagreement within the corporate organization. The interests of minority shareholders has often been made virtually worthless by the machinations of those in control of the corporation. They are often deprived of any income from the corporation either in the form of dividends or salary, they are not allowed any effective voice in the business decisions and they are denied any information about corporate affairs. Often, they are eventually eliminated from the corporation at a fraction of the real value of their interests.

Conflicts of interests which exist or develop among *the* shareholders constitute a threat to the success of the venture. In the absence of protective mechanisms, control is in the hands of the holders of the majority of the corporation's voting shares. While remedies do exist in the law for problems which arise unexpectedly, much could be done at the inception of the business venture to reduce the possibility of conflicts of interests arising. Careful planning in the initial periods of the incorporation of the corporate organization will do-much to reduce the risk to investors and provide them with a structure for their relationships.

However, even detailed planned and constructed contractual mechanisms do not always take care of the wide variety and forms which the suppression of minority interests may take. The contractual arrangements may be inadequate to take care of unforeseen future contingencies. Corporate law and the statutory provisions play active role roles here. By providing the statutory remedies, the law enables minority shareholders to either prevent the threat or rectify the abuse of corporate power. But

most of these corporate law remedies are surrounded with procedural requirements and other technicalities which may diminish their utility as protective weapons available to the minority shareholders.

The purpose of this work is to examine the adequacy of the statutory protections available to the minority shareholders vis-a-vis the private contractual mechanisms which also protect their interests. This study will develop its lines of enquiry by considering the leading schools of thought in corporate law. These schools are the traditional legal view and the economic approach to corporate law. While the traditional approach supports state intervention in the corporate affairs either by regulation or the facilitation of shareholder litigation, the economic approach views the corporation as founded on private contract where the role of the state is limited to enforcing contracts entered into by the participants in the intra corporate contract.

Notwithstanding the adoption of contractual mechanisms by the shareholders and the development of the economic approach to corporate law with emphasis on the dynamics of the market forces which align the interests of management with that of shareholders, this study suggests that minority shareholders still need the protection afforded by the statutes.

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INTRODUCTION

The corporation is one of the most successful inventions in history and this is evident by its widespread adoption and survival as a primary vehicle of capitalism over the past century. It provides the forum for the complex economic transactions which take place among the participants in the corporate organization. These participants include the management team represented by the board of directors and senior managers; employees: suppliers and investors (comprising the creditors and the shareholders).

The relationship which exists among these actors in the corporate setting presents an interesting picture because each group struggles to realize its expectations and objectives which often times conflict with the interest of another group. The creditors' and suppliers' interests are to ensure that the capital of the corporation is not diminished either by the payment of dividends if the Corporation by so doing, would be unable to meet its debts as they fall due or by engaging in unauthorized reduction of capital to their detriment. The shareholders' interest basically consists in the first place, that the corporation should be made to earn the maximum profit compatible with a reasonable degree of risk. Secondly, a proportion of these profits should be distributed whenever the best interests of the business permit while the corporation at the same time, retains a proportion of the profits to ensure an increase in share value. Thirdly, nothing should happen to impair his right to receive his equitable share of the profits which are distributed and finally that his shares should, (in the case of the widely-held corporation) remain freely marketable at a fair price. The interests of the management are not easily discernible. Is the management likely to want to run the corporation to produce the maximum profit at the minimum risk? Is it likely to want to distribute those profits generously and equitably among the shareholders? Is it likely to want to maintain market conditions-favourable to the investors? Their interests are varied but included in their objectives are monetary compensation and the desire for personal power and prestige with its attendant desire for security of position. The management may even engage in self-opportunistic conduct and take to excessive leisure to the detriment of the investors. This situation is more predominant in the widely-held corporation[1] where the management team is usually appointed and have little or no stake by way of investment in the corporation. Even in the closely-held[2] corporations where there is manifest duality of ownership and control, there is evidence from case law of directors engaging in conduct which is inconsistent and detrimental to the other shareholders.[3] Within the class of shareholders, problems and conflicts of interests may often arise as the majority shareholders may use their voting power in an oppressive and fraudulent manner to achieve their aim, without any consideration of the plight of the minority.

The employees' interests may be identified as ensuring that the corporation continues as a going concern on a profitable basis, thereby making it possible for the continuous payment of salaries and wages. Secondly, that favourable conditions for prospect of rise and promotion on the job exists. Many participants-protect their

1 The concepts of the widely-held corporation and separation of ownership from control is discussed in Chapter Two.

2 The meaning and characteristics of the closely-held corpoiation is discussed hereunder.

3 For example, in Nolan v. Parsons [1942] O.R. 358 (C.A.) the corporation had five shareholders. Four of them were directors, the fifth, who was the plaintiff, was not, In each of the years 1939 and 1940, the corporation had profits before the disputed payments in the neighbourhood of $20,000 and in each year the defendants voted and caused the corporation to pay to each of themselves director's fees of $2,000. At this time the defendants had apparently been seeking without success to purchase the plaintiffs shares "at a bargain price". The plaintiff sued to recover the director's fees for the corporation. He succeeded at the trial and on appeal. Master J.A. held that "the time, attention and services of the individual appellants as directors . . . was wholly incommensurate with the fees which they appropriated to themselves" and that the defendants' action was "fraudulently oppressive . . . as against the plaintiff. Id. at 362. See also National Building Maintenance Ltd. v. Dove [1972] 5 W.W.R 410 (B.C.C.A.).

interests by contractual agreements which define and regulate the conduct of each party. The position of the creditors is often secured by the debenture deeds which contain clauses restricting and sometimes prohibiting the corporation from certain acts considered detrimental to their interests and which also ensures security against property. This contractual protection is in addition to statutory protection accorded to them by certain sections of the Corporations' Act.[4] Employees are protected by their contracts of employment and union contracts.

Shareholders are not in the same position with the other participants since they have different interests from that of the other participants they assume a contractual relationship quite distinct from that. entered into by the other participants in the corporation. They are considered the residual claimants to the corporation's assets because they reap the benefits of the corporation if it is successful and bear the burden if it fails. For this reason, their position merits special consideration. In jurisdictions where the process of incorporation involves the filing of the Articles and Memorandum of Association, the shareholders enter into agreement inter se and with the corporation and this is reflected in the Articles and Memorandum of Association![5] The articles regulate the internal affairs of the corporation and define the scope of management powers vis-a-vis the corporation and the shareholders. In addition, in the closely-held

4 For example, S.258 British Columbia Company's Act 1985, S.42 Canada Corporations Business Act M89.

5 For example, Section 13 of the British Columbia Companies Act 1985 provides that "subject to this Act, the Memorandum and Articles, when registered, bind the company and its members to the same extent as if each had been signed and sealed by the company and by every member and contained covenants on the part of every member, his heirs, executors and administrators to observe the Memorandum and Articles". A "member" is defined in Section 1 of the same Act to include a subscriber of the Memorandum of the company and every other person who agrees tu become a member of the company and whose name is entered in its register of members or a branch register of members. This definition invariably includ[illegible] he class of shareholders. For judicial decision on the effect of the Memorandum and Artic[illegible] of Association, see, Hickman v. Kent or Romney Marsh Sheepbreeders Assoc. [1915] 1 Ch. 881 - An Article providing for a reference to arbitration of disputes between members and the company was held to be contractually binding.

corporations, the members often device contractual mechanisms such as the shareholders' agreement which define and regulate the conduct of the management and other members of the corporation. In the widely-held corporation, there has been in recent times, emphasis on contractual mechanisms which exist within and outside the corporation and serve as protective devices.

Corporate law statutory provisions afford protection to the shareholders by providing them with remedies against management abuse of power. Similarly, the minority shareholders are enabled under the remedies provided by the statutes to seek the enforcement of the remedies against the majority shareholders where the latter's conduct unfairly prejudice or affect the former. However, most of these corporate law remedies are surrounded with procedural requirements and other technicalities which may diminish their utility and efficiency as protective weapons available to the minority shareholders.

The aim of this work is therefore to examine the adequacy of the statutory protections available to the shareholders in the modem corporation. Ways of reducing the technical and procedural impairments in the remedies provided by the statutes are desirables for adequate protection of the shareholders. Notwithstanding the adoption of contractual mechanisms by the shareholders of small corporations as protective devices against management misconduct and the development of the economic approach to corporate law with emphasis on the dynamics of the market forces which align the interests of management of all corporations with that of the shareholders; it is the thesis of this work that shareholders still need the protection afforded by the statutes. For one, the utility of most contractual mechanisms in the corporation is impaired because of the inherent inability of the human mind to foresee every future contingency. Secondly, the market forces do not work without costs and may be inadequate to deal with one time divergence or other corporate management misconduct.

The smaller corporations often represent the life time work of the members and constitute a major part of their investments. If the business does not serve their needs adequately, the result may amount to a virtual loss of all sources of income. Similarly, if shareholders of the widely-held corporations are not ensured of adequate protection of their investment interests then shareholding in the widely-held corporation as a form of economic investment may generally decline with the consequent negative effects on the economies of most jurisdictions: In essence, the purpose of this work is to contribute to the fashioning of an improved and realistic means of protecting the shareholders in the corporation. In the course of the discussion, the contractual mechanisms which enable the shareholders of small corporations to evolve a corporate structure that takes care of areas likely to give rise to disputes in the course of the operation of the enterprise shali be examined. hi larger corporations, the impact of extra-legal market forces on shareholder protection shall be considered.

The thesis will develop its lines of argument by considering the leading schools of thought in corporate law. These schools are the traditional (corporate) legal view and the economic approach to corporate law. The traditional corporate legal theory views the corporation essentially as a legal fiction which comes into existence by virtue of a grant from the State This view holds that a corporation is a distinct legal entity different from the members who constitute it and can only exercise those powers conferred-on it by its charter of-incorporation. This traditional view of the corporation known as "the concession or entity theory" which has long dominated corporate legal thinking and scholarship dates back to the early nineteenth century and has held sway in many corporate law jurisdictions.[6]

6 For example, the United States; this theory was exemplified by Chief Justice Marshall's description of the corporation when he stated that "a corporation is an artificial being, invisible, intangible and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence". Trustees of Darthmouth College v. Woodward [1810] 17 U.S. (4 Wheat.) 518, 636. In Britain, the House of Lords expressed a similar view in Salomon v. Salomon & Co. [1897] A.C. 22, H.L.

In the late 70's and early 80's, a new thinking in corporate law evolved which in essence sought to explain the benefits of carrying out economic activities through the firm rather than the market. This movement stressed the economic reality behind the corporate organization and applied economic tools to the understanding of corporate law. The starting point of these corporate law scholars was to explain how, if at all, economic activity can be efficiently carried out by means of the firm rather than by simply contracting in the market. A range of answers were given to this question, most being complimentary and they all started with the economic theory of the firm put forward by Coase.[7] He pointed out that the firm and trading in the market were essentially devices for co-ordinating economic activity with the distinguishing characteristics of the firm being the suppression of the price mechanism within its area of activity. For him, the principal justification for the use of the firm was that it avoided or substantially reduced the transaction costs of using the market to effect an exchange.

Within the last two decades, the economic theory of the firm advanced from a struggle with the identification of the economic conditions that led to the formation of firms to a discourse on more sophisticated issues concerning intra firm relationships. This period saw the emergence of a group of economic-oriented corporate law-scholars called the "contractarians"[8] who challenge the orthodoxy of the traditional legal view of the corporation as a mere concession from the State. While the concession/entity theory of the corporation supports state intervention in the form of either direct

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7 Coase, "The Nature of the Firm" (1937) 4 Economica 386.

8 Prominent among the major contributions of this group include; Alchian & Demsetz, "Production, Information Costs and Economic Organization" (1972) 62 Am. Econ. Rev. 777; Baysinger & Butler, "The Role of Corporate Law in the Theory of the Firm" (1985) 28 J. Law & Econ. 179; Cheung, 'The Contractual Nature of the Firm' (1983) 26 J. Law & Econ. 1; Butler, "The Contractual Theory of the Corporation" (1989) 11 George Mason Univ. L. Rev. 99; Easterbrook & Fischel, "The Corporate Contract" (1989) 89 Col. Law Rev. 1416.

regulation or the facilitation of shareholder litigation in the corporation on the 'oasis that the'state created the corporation-'by granting it a charter, this movement views the corporation as founded on private contract where the role of the state is limited to enforcing contracts entered into by the participants in the intra corporate contract. Applying an economic approach to corporate law, these corporate law economists viewed the corporation as a complex nexus of contracts among the participants, With this movement came the evolution of the "contractual theory" of the corporation. They assert that one of the more important reasons why firms arise is to reduce transaction costs and self-interested post contractual behaviour among' persons who otherwise would be engaged in market transactions. They further argue that the essence of the contractual nexus within the corporation is that the participants should be free to mold a corporate form that best maximizes their probable expectations.

To them, corporate law provisions should be optimal and not mandatory on the participants who should be free to adopt or opt out of such provisions. A strong basis of the contractarians' view is the recognition of free market forces which they assert, act as effective constraints on corporate management and should therefore play a more significant role in protecting the shareholders against the directors' misconduct.

The application of economics to corporate law began in the United States, where it has gained enormous popularity and support. It has also started to attract attention in Canada.[9] However, it has not been expressly adopted in either United States or Canada although an argument could be made that economic forces shape corporate law in both jurisdictions. In any event, the greatest contribution of corporate law and economics has been the study of the relationships which exist among the participants in the corporate setting. In this study, attention shall be focussed on the

9 See for example, Cheffins, 'An Economic Analysis of the Oppression Remedy: Working Towards a More Coherent Picture of Corporate Law' (1990) 40 Univ. of T. Law J. 775; MacIntosh, "The Shareholders' Appraisal Right in Canada: A Critical Reappraisal" (1983) 24 Osgoode Hall L. J. 201.

examination of the impact of the economic approach to corporate law with emphasis on the market constraints and its effects on shareholder protection.[10]

One question which shall also be examined in this study is whether the corporate law rules regulating the conduct of the participants in the corporation should be optional (as the contractariane argue) or mandatory. Law and economic analysts support the enforcement of express articulated terms in intra corporate contract but they do not focus solely on express agreements. They recognize that intra corporate bargains are not fully articulated because at some point, the cost of setting out a bargain in writing will exceed the benefits. Corporate law then plays an important role here. Consistent with the "expanded choice thesis",[11] corporate law can act as a standard form of contract that provides the participants with ready made terms.

Finally, it is intended in this work to examine how intra corporate disputes should be resolved. Two kinds of corporations shall be distinguished: the closely-held and the widely-held corporations. The former is characterized by a relatively small

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10 That is, to examine whether the free market constraints on corporate management which is one of the postulates of the contractarians have helped to ensure more adequate protection for the shareholders.

11 The "expanded choice thesis" was formulated by Goetz and Scott in their seminal article, 'The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms', (1985) 73 Col. Law Rev. 261, 262, 265-6. With the aim of defining the extent to which implied and express terms, and standardized and individualized forms of agreement function in complementary ways, they assert that complaints about the misinterpretation of an agreement are rooted in tensions between implied and express terms and between standard and non-conventional forms of expressions. A major attempt to harmonize these tensions relies on the expanded choice postulate. The postulate maintains that implied terms expand contractors' choices by providing standardized and widely suitable preformulations, thus eliminating the cost of negotiating every detail of the proposed arrangement. The postulate presumes a neutral policy toward individualized agreements: atypical parties lose nothing, since they remain unrestrained from designing customized provisions to replace the state-supplied terms. Two key suppositions underlie the notion of expanded choice; (1) that state-supplied terms are mere facilitators, specifying terms that the parties could formulate themselves if unrestrained by time and effort costs; (2) that the availability of state-supplied terms is neutral in that it raises no barriers beyond the existing resource costs to the use of alternative terms by atypical parties.

Butler has applied this reasoning to corporate law. See, H. Butler, 'The Contractual Theory of the Corporation' (1989) 11 Geo. Mason ULR 99; 119-20.

number of shareholders (usually not more than 50). This small body of owners frequently share in the operation and management of the business - there is hardly separation of ownership from control. Since the shareholders are few in number and the business is usually quite small and unknown to the general public, there is usually no active market for the purchase and sale of its securities. This type of corporation is also typified by restrictions on the transfer of shares. The corporate firms that dominate the economic structure of most countries, however, are the widely-held corporations. Their shareholders number in the thousands or hundreds and most times comprise institutional investors. In these corporations, the shareholders are usually passive stakeholders who do not take part in any sense in the management of the corporation. There is widespread separation of ownership from control and this separation phenomenon has become the traditional mode of picturing the fundamental problem of corporate law and economics.[12] It will be advanced that the nature and structure of the corporation should provide guidance as to how intra corporate disputes shall be resolved. Legal rules governing internal affairs of the firm should be supplementary in nature and courts should interpret the provisions in the light of the shareholders' probable expectations. In addition, for the widely-held corporations, free market constraints regulating corporate management should be considered where compliance with statutory - protective remedies would cause hardship and entail extreme technicalities on the part of the participants.

12 It should be noted that many corporations do not fit either mold described above. However, the more dominant ones fit into the above analysis and attention will be focused on them in this study.

PLAN OF STUDY

The thesis shall be structured into three parts. The first part shall deal with an overview of the traditional concepts of corporate law relating to the modern corporation. The structures of the closely and widely-held corporations shall be examined. The position of the shareholders in the closely-held corporation and some of the various techniques by which the minority shareholders'are frozen out of the corporation shall be examined. Preventive mechanisms to solve the freeze-out problems are proposed and the curative remedies provided by corporation law shall be highlighted. In the widely-held corporation, the separation of ownership from control analysis and its consequent implication on shareholder protection shall be discussed. In addition, an economic analysis of both kinds of corporations shall be undertaken in this part.

The idea of corporation law as a kind of standard form contract which economizes on negotiation costs between managers and shareholders is a recurrent one in the economic analysis of the corporation. Corporate law and economic analysts support the enforcement of express terms in the intra corporate contract but they also recognize that such bargains are not fully articulated because at some point the cost of setting out a bargain in writing will exceed the benefits. Even the market mechanisms which economists see as important constraints on corporate management do not operate without cost and may be unable to deal with one time divergence by the managers. Corporate law plays an important role here. The second part shall examine the role of corporate law as standard form contracts. Given the assumption by economic analysts of corporate law that the participants in the intra corporate contract shall be free to choose a corporate firm that maximizes their probable expectations, this part of the study shall also evaluate the arguments for making corporate law provisions optimal.

The third part shall in the first instance be devoted to the economic analysis of selected shareholder remedies. These remedies include the oppressive remedy, derivative action, appraisal remedy and winding-up. Because economic factors often affect and shape the conduct of corporate affairs, it is intended to examine whether the presence of these remedies can be justified in economic terms. Also to be examined in this part are the practical considerations and problems arising from the operation of the current form of these remedies in Canadian corporate law. Suggestions for improvements in the law will be offered where adequate. This part also incorporates some concluding comments.

PART ONE

CHAPTER ONE

THE TRADITIONAL STRUCTURE OF CLOSELY-HELD CORPORATIONS

Introduction:

Investment in the closely-held corporation may sometimes be a risky venture. Apart from the business risk of the undertaking there is the risk of disagreement within the corporate organization. And due to the peculiar nature of the closely-held corporation, these risks pose a threat to the security of investment. Shareholders in closely-held corporations usually have personal involvement in, and expect commensurate degree of control over decision-making in the corporations. But under corporate law, control over decision making is primarily vested in the holders of the majority of the voting shares. This may have some consequences. It may lead to managerial efficiency. Share values would probably go up and all members of the corporation would benefit. On the other hand, it may be used as an instrument of oppression. The majority shareholders elect the directors who appoint officers of the corporation. Minority shareholders seldom have any say in this.

Traditional corporate legal view depicts the position of the minority shareholders as one which is vulnerable to oppression and other forms of abuse by the majority shareholders. Accordingly, if a significant different of opinion arises between the majority and minority group, the position of the minority may be a precarious one, which may eventually lead to a squeeze-out. There is much emphasis on legal control mechanisms to check the majority and protect the minority.

On the other hand, modem economic approach to corporate law asserts that the position of the minority shareholders is not as precarious as the traditional law depicts, otherwise no person would like to invest in the closely-held corporation. Basing their argument on the premise that the corporation is essentially founded on private contract, the corporate law and economic analysts recognize the efficacy of internal contractual monitoring mechanisms which take care of areas likely to give rise to disputes in the course of the business. These contractual arrangements generally enable the shareholders to depart from the traditional corporate management framework and agree among themselves on how control of the corporation shall be allocated.

An examination of the structure of the closely-held corporation and the position of the shareholders both from the traditional and economic perspectives is therefore necessary to enable us to appreciate the value and efficacy of the legal remedies and contractual devices which serve as protective mechanisms available to the shareholders.

As a prelude to the main focus of this work, this chapter examines the traditional, non-economic structure of the closely-held corporation. It starts with an attempt to define and identify the characteristics of most closely-held corporations. Thereafter, the position of the shareholders and some of the methods used to effect a squeeze-out are examined. Finally, the corporate law remedies available to the minority shareholders are highlighted leaving a detailed examination of these remedies for a later part of the work. The chapter ends with some concluding comments.[13]

13 Economic analysis of the structure of the closely-held corporation is undertaken in Chapter Three below.

Definition of Closely-held Corporation:

There is no universally accepted definition of a closely-held - or simply "close" - corporations. When "private corporation" was defined in Canadian corporation statutes, a private company was defined as a company that by its memorandum or articles restricted the right to transfer its shares, limited the number of its members to fifty or less and prohibited any invitation to the public to subscribe for any shares or debentures of the company. A "public" company was any company that was not a private company.[14] This distinction was primarily introduced and designed to enable small business concerns and its shareholders to operate the business with the flexibility of a proprietorship or a partnership and simultaneously to enjoy the benefits of incorporation without having to comply with the regulatory requirements applicable to widely-held corporations.[15]

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14 Most countries still adopt the traditional classification of corporations. Notable among them are Britain - 1985 British Companies Act; Nigeria - S.22 Company and Allied Matters Decree 1990; Australia, New Zealand - S.3 Draft Companies Act, 1990. In Canada, under the British Columbia Companies Act (hereinafter cited as B.C.C.A.) 1985, the classification is between reporting and non-reporting companies. Section 1 defines a reporting company to include a corporation that has any of its securities listed for trading on any stock exchange wheresoever situate or that was deemed to be a public company immediately before October 1, 1973. Under the Canada Business Corporations Act (hereinafter cited as C.B.C.A.) 1989, corporations are distinguished on functional rather than on doctrinal grounds. For example, some insider trading companies (S.130(1)) apply only to insiders of "distributing corporations" which are defined as corporations any of whose issued securities are or were part of a distribution to the public; remain outstanding and are held by more than one person - Section 126(1)(C.B.C.A.). Similarly, corporations any of whose securities have been distributed to the public must, unless exempted by the Director, appoint an audit committee - Section 171 (C.B.C.A.).

The British Columbia Securities Act 1985 makes a distinction between reporting issuers and private issuers. Under Section 1, a reporting issuer is defined to include an issuer that has filed a prospectus or Statement of Material Fact and obtained a receipt for it or has any securities which have been at any time listed and posted for trading on any stock exchange.

15 For example, Section 175-181 of the British Columbia Companies Act 1985 are designed to ameliorate possible abuses of the proxy system. Directors of reporting companies only must enclose the information circular to proxy forms required to be sent to every member pursuant to Section 177. In addition, although all corporations must file annual financial reports, but under Section 197 B.C.C.A., reporting companies must, in addition, file interim financial reports.

The term sometimes seem to be used to imply an incorporated enterprise in which the participants consider themselves partners inter se and have tried by shareholders' agreement or otherwise to obtain for the enterprise one or more partnership advantages or attributes. Hence, close corporation has been described as a "chartered partnership";[16] "incorporated partnership"[17] and it has been said to be functionally more closely related to the partnership than to the corporation.[18]

Appreciative of one of the most significant characteristics of many corporations with a small number of shareholders, a leading writer[19] has defined the close corporation as "one wherein all the outstanding stock is owned by the persons (or members of their immediate families) who are active in management and conduct of the business". A case in point is Ebrahimi v. Westbourne Galleries Ltd.[20] in which the appellant was one of the three shareholders; the personal respondents being the other two. The company was a private one which carried on business as dealers in Persian and other carpets. It was formed in 1958 to take over a business founded by the second respondent (Mr. Nazar) and since about 1945, the business had been carried on by the appellant and Mr. Nazar as partners, equally sharing the management and profits. When the company was formed, the signatories to its memorandum were the appellant and Mr. Nazar and they were appointed its first directors. Soon after the company's formation the third respondent (Mr. Nazar's son) was made a director and each of the

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Furthermore, reporting companies under the B.C.C.A. shall have at least three directors - (S. 132 B.C.C.A.)

16 Cullen, C.J. in Ripin v. United States Woven Label Co. (1912) 205 N.Y. 442, 447, 98 N.E. 855.

17 Ebrahimi v. Wesbourne Galleries Ltd. [1973] A.C. 360.

18 Rohrlich, Organizing Corporate and Other Business Enterprises (Rev. ed. 1953).

19 Supra, note 18.

20 [1973] A.C. 360.

two original shareholders transferred to him one hundred shares each. The court found as an indisputable fact that the appellant and Mr. Nazar had formed the company on the basis that the character of the association would as a matter of personal relation and good faith remain the same.

However, this definition seems to exclude from the category of close corporations that large group of corporations in which one or more of several shareholders put up the larger portion of the capital for the enterprise but leave the active management of the business to other shareholders, who may have relatively small shareholdings.

Thus, one may state that the apparent difficulty in formulating an all encompassing definition of the closely-held corporation is reminiscent of the dilemma faced by Justice Potter Stewart in deciding an obscenity case. After struggling with the definition of obscenity, he concluded that while perhaps he could not define it, "I know it when I see it."[21] In the same way, the closely-held corporation is difficult to define, but we all know it when we see it. It is the form of business organization with which we are probably most familiar.

The "closest" variety of the closely-held corporations is the one man corporation in which all the shares are owned or controlled by a single shareholder and family corporations in which the shares are owned or controlled by members of one family group. Although it is true that the corporate device was not originally designed for use by individual entrepreneurs or by family businesses in which substantially all the shares are owned or controlled by the head of the family, but in the United States, England and in this country, one-man companies and family corporations have received judicial and statutory sanctions.[22]

21 Holmes, Closely-Held Corporations in Michigan (1973).

22 See, for example, Sayers v. Navillus Oil Co. (1931) 41 S.W. 2d 506; Salomon v. Salomon & Co. [1897] A.C. 22; In Commissioners of Inland Revenue v. Sansoon [1921] 2 K.B. 492, Younger L.J. stated, "I . . . deprecate in connection with what are called one-man companies the

Characteristics of Closely-Held Corporations

Since "closely-held corporations" defies any precise definition, an alternative method of approach will be to identify the characteristics common to the various attempts made so far at defining the term. Some of the common threads running through all the definitions and terms relating to "closely-held corporations" constitute the normal attributes of such corporations. Before delving into these attributes, it is worth pointing out that the amount of a corporation's assets, the scope of its operations, the number of persons it employs or the volume of its sales does not determine whether it is "close". Many closely-held corporations have tremendous assets and operate all over the universe. Until 1955, the Ford Motor Company was a close corporation. The T. Eaton Company (Canada) is anything but small and yet is closely-held by members of the Eaton family and the family trust.

Most definitions stress some obvious characteristics of the closely-held corporation. These include the following:

(1) the number of shareholders is relatively small;

(2) most of the members of the closely-held corporation take an active part in the business.[23] Frequently, the shareholders, besides being directors are also the

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too indiscriminate use of such words as . . . simulacrum, sham or cloak . . . or indeed any other term of polite invective. Not only do these companies exist under the sanction, even with the encouragement of the legislature, but I have no reason whatever to doubt that the great majority of them are as bona fide and genuine as in a business sense they are convenient and suitable media for the provision and application of capital to industry". See also Constitution Ins. Co. v. Kosmopoulos [1987] 1 S.C.R. 2.

23 There is usually no division between the shareholder-owner and the director-manager. Either the shareholders themselves are the directors, or they so closely dominate and control the directors that the latter are in fact little more than their agents. Katcher v. Ohhsman (Ch. 1953) 26 N.J. Super. 28, 97 A-2d 180, illustrates the identity between ownership and management that typically prevails in a close corporation. In that case, the three persons each owned one third of the stock, the three constituted the board of directors and each was also an officer.

officers and executives of the company. In any case, either through serving as the directors and officers themselves or through detailed provisions in the Articles of Association or by-laws or shareholder agreements, the shareholders **personally** manage and control the business directly or else perform these functions through others who in reality, simply act as their agents.[24] The shareholders usually expect a voice in management as well as financial returns from the corporation commensurate with their investment;

(3) there is no established market for the shares of the closely-held corporation. The shares are usually not listed in any stock exchange and very little or no trading on the shares takes place.

From these principal characteristics, other attributes which distinguish the closely-held corporation from the widely-held corporation follow. The shareholders in a closely-held corporation are greatly concerned about the identity of the other members of the corporation. They have an inclination to hold the power to choose future shareholders or to veto prospective purchasers of shares whom they consider undesirable. This desire for control over the selection of future members and associates are often met by the use of carefully prepared clauses in shareholders' agreements, articles or by-laws. Participants forming a close corporation consider a corporate form to obtain-limited liability or other corporate advantage, but usually among themselves, they are "partners".[25]

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24 Notwithstanding the traditional Anglo-Canadian rule that absent special facts; directors are not agents of shareholders and do not owe any fiduciary duties to them; (Percival v. Wright [1902] 2 Ch. 421), the reality of the situation in most closely-held corporations is that majority shareholders by the use of their voting power are able to manipulate and control the directors who are usually appointed by them. Directors who act contrary to their wishes risk the chance of being removed or not being re-elected.

25 This does not imply that close corporation participants do not appreciate the significance of possessing majority shareholdings in the corporation. They consider themselves "partners" with respect to the harmony and balance of their business. However, in terms of control or division of assets or declaration of dividends, each "partner" is entitled to whatever is commensurate with the amount of his investment or as may be provided in any agreement. The notion of majority interest is still applicable in such corporations.

Unlike a shareholder in the widely-held corporation who is a passive stakeholder and does not expect any management responsibilities, the shareholder in a closely-held corporation usually has personal involvement in, and expect some degree of control over decision-making which is commensurate with his investment. His participation in the corporation may often turn out to be his principal source of income. In a widely-held corporation, power to control the corporation is relatively unimportant to the investor save in take over situations where majority shareholdings may sell at a premium. But the widespread nature of shareholdings in the widely-held corporations makes it difficult for an individual investor to possess a majority shareholding. The reverse is the case in the closely-held corporation where the power to control or at least to veto fundamental changes is vital to the member. Luna in his commentary summarised the position succintly when he said:

> "it is for the protection of these interests that an individual director or shareholder should be permitted to have a voice in corporate affairs larger than that which comes with the right to cast a lonely minority vote against a majority. Actively participating in the running of the corporation and thus situated as to know and understand the problems of the corporation, the veto power should be safe with him."[26]

With respect to the juridical nature of closely-held corporations, consistent with the entity or concession theory,[27] the closely-held corporation is generally viewed as a legal entity having in law an existence separate and apart from its shareholders. As in a widely-held corporation, the shareholders in a closely-held corporation have in theory only an indirect interest in the business and assets of the corporation, their right being to share in the profits and distribution of corporate assets on liquidation. The closely-held corporation, just as any other corporation, holds property,[28] enters into contracts,

26 Luna, "Protection of Minority Interests through Shareholders' Agreements: A Commentary on Section 9 of the New York Stock Corporation Law", (1953) 28 Phil. L.J. 506, 535.

27 Supra, note 6.

28 Macaura v. Northern Assurance Co. [1925] A.C. 619.

executes conveyances and conducts litigation in a capacity separate and distinct from its shareholders.[29] The mere fact that one person owns all the shares of a corporation does not make corporate assets subject to payment of his debts.[30]

Notwithstanding the separate personality accorded to close corporations, confusion as to the exact juridical nature of close corporations often arises by the court's attribution of the corporation's property to the individual owner of the business. An example of the legal confusion this can cause is illustrated by the case of Constitution Insurance Co. v. Kosmopoulos.[31] Prior to this case, the corporate law proposition has been that the assets of a corporation are not the assets of its shareholders and that a shareholder's interest is merely the right to receive a dividend, if and when declared by the corporation or otherwise due, and to receive a pro rata share of the proceeds of the net assets on a winding up of the corporation. The Ontario Court of Appeal held in this case that this principle does not apply to a one-person corporation. The learned judge distinguished the present came from Macaura v. Northern Assurance Co.[32] when he said;

> "I am of the opinion that Macaura can be properly distinguished, and that on the facts of this case, it would be unfair to permit the insurers to succeed in their defence. I conclude that Mr. Kosmopoulos did have an insurable interest. The defence rests its argument upon a legal fiction; a fiction that has been created for purposes relating to the conduct of the business of the corporation, its management and control, and the limited liability of its shareholders, and it has nothing to do in the circumstances of this case with the risk that was underwritten.[33]

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29 Foss v. Harbottle (1843) 2 Hare 461, 67 E.R. 189.

30 Star Brewing Co. v. Flynn (1921) 237 Mass. 213, 129, N.E. 438.

31 [1987] 1 S.C.R. 2; [1981] I.C.R. 5315.

32 [1925] A.C. 619. This case had been the leading authority for the corporate law proposition enunciated above.

33 Supra, note 31, at p. 5518.

It is difficult to appreciate the reasoning of the courts in this case. A person who incorporates his business must abide by the consequences of his decision. Furthermore, there seems to be no reason of public policy which should allow the shareholder of a one person corporation to ignore the separate legal personality of his creation whenever he deems it convenient to do so.

Position of Shareholders in Closely-Held Corporations

The dominant shareholders in the closely-held corporations usually act as managers and directors. The traditional view of the closely-held corporation depicts the position of the minority interests as unique. According to this view, their interest in close corporations are often made worthless by the conduct of the majority who are in control of the corporation. The minority shareholders are deprived of any income from the corporation either in the form of dividends or salary; they are not allowed any effective voice in the business and control of the corporation; they are denied any information about corporate affairs and often, they are finally freezed out from the corporation at a fraction of the real value of their interests.[34] Participants in the general partnership form of business are not in a similar predicament if they are excluded by their associates from full participation in their enterprise.[35] According to Dean O'Neal;

> "The inherent characteristic of the (general) partnership form of business preclude many of the popular corporate squeeze-out techniques. Partners ordinarily do not depend on salaries or dividends for a return on their investments but receive a share of the profits of the enterprise. Additionally, a partner, as a co-owner of the business, is entitled to

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34 Hodge O'Neal, "Oppression of Minority Shareholders: Protecting Minority Shareholders" [1987] 35 Clev S.L.R. 121.

35 An analogy is drawn here between the shareholders in the closely-held corporation and their counterpart in the general partnership because of the marked resemblance in the structure of the two forms of business organizations.

> continued employment by the firm. In consequence, there is no partnership counterpart of the corporate squeeze-technique of terminating a shareholder's employment and withholding of dividends."[36]

The shareholder in a widely-held corporation enjoys a similar position. The stock market provides substantial forces which ensure that managers operate corporations in a manner that maximizes the shareholders' expectations.[37] The availability of a liquid market for shares offers the shareholder an opportunity to liquidate his investment and re-invest in another corporation that meets his expectations. On the alternative, shareholders' derivative actions are available to enable shareholders to recover indirectly any loss, but the transaction costs associated with such suits usually prevent shareholders from relying on that remedy.

The market forces which align management interests with that of the shareholders in widely-held corporations do not exist in closely-held corporations. Because of the inherent difficulties in obtaining control of the closely-held corporation, corporate raiders are discouraged from bidding for the shares of closely-held corporations.[38]

In addition, an unhappy minority shareholder in the closely-held corporation has difficulty in disposing of his interest. Usually, the only prospective purchasers of a minority interest in a closely-held corporation are the majority shareholders.[39] If they

36 F. O'Neal & Desuri, "Expulsion or Oppression of Business Associates: Squeeze-outs in Small Enterprises" (1961) 143. Even in the limited partnership form of business, the position of the limited partners is not as precarious as that of an oppressed minority shareholder in a closely-held corporation because his rights and circumstances under which he may be expelled from the business are often well defined in the partnership agreement. In the closely-held corporation, it is a well known principle of corporate law that there is no fundamental right to remain a shareholder and the majority shareholders may use one squeeze-out technique or the other to eliminate an unwanted member. See Re: Saltdean Estate Co. Ltd. [1968] 1 W.L.R. 1844.

37 See Posner, Economic Analysis of the Law, 383 (3d. ed.) (1986).

38 See Manne, "Our Two Corporation System; Law and Economics", (1967) 53 Va. L. Rev. 259, 280. Corporate raiders do not usually have access to the information about a closely-held corporation with which to assess a potential takeover.

39 Bahls in his article, "Resolving Shareholder Dissension: Selection of an Appropriate Equitable Remedy", (1990) J. Corp. Law, 285 described this condition as "monopsony". Commenting on the difficulty encountered by the minority in disposing their shares, the court in Re: Block's

refuse to buy or offer a token purchase price, the unhappy shareholder is locked into the corporation. Generally, the minority shareholders seeking to sell their shares are not able to find other bidders when the majority shareholders hold out for an unreasonably low purchase price. Because the majority shareholders already control management, they desire no additional benefit from purchasing an additional control. The discounted value of the shares are therefore relatively low.[40]

Most problems in the closely-held corporation revolve around the conflict of interest and disagreements over the business policy of the corporation between the shareholder-directorsor managers and the ordinary shareholders who don't participate in the management of the corporation. This last group usually constitutes the minority.

An uncooperative minority shareholder may often be the cause of dispute in the corporation. The frequency with which the uncomprising attitude of the minority shareholder occurs and the problem arising from such is put succintly by O'Neal in the following words:

> "Time and again, when questioned about squeeze-out problems, lawyers and other business advisers comment on the problem of the minority shareholder who 'throws his weight around', and makes life miserable for management. An unreasonable and obstreperous shareholder . . . often gives company managers a 'rough time'. Some corporate officers say they have to spend more time and thought in keeping minority shareholders pacified than in operating the business".[41]

Will (1946) 60 N.Y.S. 2d. 639, stated at page 642: "In view of the nature of the shares themselves, being those of a closely-held corporation, having no general market and not saleable to the general public in the usual manner, it would be extremely difficult if not impossible to obtain a ready buyer for the shares".

40 This notwithstanding, economic analysis suggests that the shareholders in the closely-held corporations are not that badly off, otherwise no one would invest in them. Restriction on alienability of shares is justified to ensure that those who are investors are also compatible as managers. Further, when the corporation begins as a familial venture, the restrictions also ensure that control remains in the family, which may aid in reducing opportunistic conduct. See, Easterbrook and Fischel, "Close Corporations and Agency Costs", (1986) 38 Stan. L. Rev. 271.

41 Hodge O'Neal, supra, note 34 at 122.

Friction also arises when a minority shareholder enters with a competing business. An unhappy shareholder who have acquired skill in the particular kind of business operated by the corporation may establish a similar business or go to work for another company in a similar business.

Disregard of corporate law provisions and requirements and inability of the participants to distinguish in what capacities they act also cause friction. Due to the close nature of the corporation and interwoven nature of the status of members either as shareholders, directors or officers, there may be sometimes no avenue of establishing "who took what action when".[42]

Although the law plays a role in ensuring managerial efficiency,[43] the Majority Rule doctrine may pose as an impediment to the protection of the minority interest in the corporation. Under corporate law, the general rule is that the will of the majority members shall prevail. This is usually achieved in general meetings where some decisions are taken by a simple majority of members and other more important decisions are taken by special resolutions. The doctrine could be a double-edged sword for the minority shareholders. Apparently, where it increases managerial efficiency, this may lead to an increase in share value. Minority shareholders benefit if this happens. However, the majority shareholders might also use the doctrine as an instrument of oppression. Majority shareholders select the board, thereby choosing management and the minority shareholders seldom have substantial input in the process.[44]

42 Ibid.

43 By providing fiduciary standards and enabling shareholders to seek remedy for the enforcement of fiduciary duties and other personal rights.

44 Another principle which impedes the protection of minority interest in the corporation is the Business Judgment Rule. Although this principle is of American origin and not part of Canadian corporate law, it states that courts will not second guess or inquire into the adequacy of decisions of management if it is reasonable to believe that management is acting in good faith with a reasonable basis and within the scope of the power conferred on them. This rule creates problems of proof for the minority shareholder - bringing a suit for breach of a director's duty

Minority shareholders encounter a number of practical difficulties when seeking monetary compensation to remedy damages caused by dishonest management. They must invest large sums of money to sustain a litigation. Most times, the dissatisfied shareholder is unable to afford the legal cost of remedying a wrong. Even if he eventually succeeds in obtaining monetary compensation, the incompetent or dishonest controlling shareholder remains.

Coroorate Squeeze-Out of Minority Shareholders

Compounding the problems of minority shareholders in a closely-held corporation is the potential or actual threat of squeeze-out. Most times, the majority shareholders and the directors (elected by the majority) try to freeze-out the minority. This pressuring of the minority into eventual exit from the corporation has been defined as; " . . . the manipulative use by some of the owners or participants in the business of corporate control, strategic position, inside information or powers of control or the utilization of some legal device or technique to eliminate minority shareholders from the enterprise or to reduce to relative insignificance their voting power or claims on corporate earnings and assets or propose to deprive them of corporate income or advantages to which they are otherwise entitled.[45] "

The majority shareholders through their voting power to elect and control a majority of the directors have extensive powers to benefit themselves at the expense of minority shareholders. 'Directors may refuse to declare dividends and may drain off the corporation's earnings in a number of ways. Exorbitant salaries and bonuses to the majority shareholder - officers and perhaps to their relatives, high rentals for property

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of care. See, for example, Auerbach v. Bennett (1979) 393 N.E. 2d 994 New York Court of Appeals.

45 O'Neal & Desuri, supra, note 36, at page 143.

the corporation leases from majority shareholders, and unreasonable payments to majority shareholders under contracts between the corporation and majority shareholders or companies the majority shareholders own are three major ways. Directors appoint officers and may deprive minority shareholders of corporate offices and of employment by the company or may cause the corporation to sell its assets at an inadequate price to the majority shareholders or to companies in which the majority are interested. Majority shareholders may also organize a new company in which the minority will have no interest, transfer the corporations' assets or business to it and perhaps then dissolve the old corporation, or they may bring about a merger under a plan unfair to the minority'.[46]

There exists no limit to the various forms that a squeeze-out might take. The Majority Rule Doctrine has enabled some Canadian courts to maintain a policy of non-interference in the internal management of the corporation except where there is excessive manifestation of fraud, or oppression.[47] Certain forms of squeeze-outs which are most prevalent include the following:

(a) Fundamental Corporate Changes

This technique involves an alteration of the structure of the business. While most fundamental corporate changes accord with the dictates of good business and thus beneficial to the corporation as a whole, the majority shareholders may nevertheless, use this device in a manner that is obviously disadvantageous to the minority shareholders with the sole purpose of effecting a squeeze-out. The provisions of some

46 Hodge O'Neal, supra, note 34, at page 125.

47 Brant Investments Ltd. v. Keeprite Inc. (1987) 37 BLR 65 (Ont. HC). However, most judges have adopted a liberal approach to the doctrine and this has enabled them to grant reliefs even in situations where the conduct of the majority falls short of excessive manifestation of fraud or oppression. See Sparling v. Javelin Int. Ltd. (1986) RJQ 1073 (Que. SC); Re Ferguson and Imax Systems Corp. (1983) 43 OR 2d. 128; Keho Holdings Ltd. v. Noble (1987) 53 Alta. LR 195 (Alt. CA).

corporation law statutes authorizing the alteration of the Articles or by-laws and other fundamental corporate changes give considerable opportunities to directors and majority shareholders to take unfair advantage of minority shareholders. For instance, the Canada Business Corporations Act 1975 and the British Columbia Company Act 1973 (as amended) permit fundamental corporate changes by a special resolution of the members.[48] The amendment of the Articles of Association may be used, either alone or in conjunction with other techniques to eliminate unwanted shareholders or alter their rights. Sections 248 and **249** of the British Columbia Company Act (B.C.C.A.) authorize a great variety of changes in the rights of shareholders to be effected by an amendment of the Articles through special resolution. However, the statute gives some protection to minority shareholders by providing that an alteration which affects the rights of preferences of any class of shares is subject to the right of the class affected to vote thereon as a class.[49]

In British Columbia, a corporation's article can be amended to make a non-redeemable class of shares redeemable. A minority shareholder can then be eliminated from the corporation by making his shares redeemable and then redeeming his shares.[50]

Provisions permitting voluntary dissolution of a corporation on the vote of the specified percentage of its shareholders, especially if dissolution is not required to be

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48 The same position also applies in Nigeria. "Special Resolution" is defined under Section 1 B.C.C.A. 1985 as including a resolution passed by a majority of not less than 3/4 of the votes cast by those members of a company who, being entitled to do so, vote in person or by proxy at a general meeting of the company. Under Section 2 C.B.C.A, 1989, 2/3 majority is required instead. Nigeria has a similar definition contained in Section 1 of the B.C.C.A. (see Section 236(2) Company and Allied Matters Decree 1990).

49 Section 250(1) B.C.C.A. 1985.

50 Of course, this may not be possible under the provisions of the Canada Business Corporations Act (C.B.C.A.) because Section 176(c)(ii) specifically requires a separate class vote of the affected shares before the alteration becomes valid. In contrast, the addition, removal or change in the redemption rights of the shareholder is not mentioned as a triggering event for a class vote in British Columbia

under judicial supervision,[51] may open the way for majority shareholders to bring about the dissolution of a company, the liquidation of its assets and the acquisition of the assets by a concern which they own. To quote Professor George Hornstein,[52] "voluntary dissolution can be used to squeeze out small shareholders where the corporation is obviously earning money and prospering in every way, and it is proposed, not to discontinue the business, but to turn it over to a new corporation with a slightly different name but with the same powers and some of the original owners".

(b) Share Issue to Effect Dilution of Interests

Essentially this technique consists in the shareholder-director-executives causing the corporation to allot a large number of new shares, which they take at a grossly inadequate price, thus increasing their proportionate control and claims on earnings and assets and diminishing the minority's proportionate voting rights and proportionate claim on earnings and assets. The creation of pre-emptive rights[53] is an attempt to limit the occurrence of this dilution by requiring a pro-rata offering to the members. But the utility of the shareholders pre-emptive rights as a shield against squeeze-outs is considerably impaired by the number of exceptions to those rights. For example, the rights do not attach to shares issued in exchange for property the corporation needs.[54] Similarly, the minority shareholders may not have sufficient funds available to exercise their pre-emptive rights when the new shares are issued. Majority shareholders and the

51 For example, Sections 291-292 B.C.C.A. 1985; Sections 211 and 137 C.B.C.A. 1989; Section 457 Company and Allied Matters Decree of Nigeria 1990.

52 Hornstein, "Voluntary Dissolution - A New Development in Intracorporate Abuse" (1945) 51 Yale L.J. 64, 67.

53 S. 41 B.C.C.A.; S.28 C.B.C.A. (while the pre-emptive right is mandatory in B.C.C.A. jurisdictions, it is made optional under the C.B.C.A. The discussion paper on Company Act 1990 (B.C.C.A.) recommends the adoption of an optional pre-emptive right, with appraisal rights to shareholders who might dissent during the transitional period.

54 S. 28(2)(a) C.B.C.A.: This exemption is not applicable under the B.C.C.A. 1985.

directors and officers under their control may deliberately issue the additional shares at a time when it will be financially difficult or impossible for the minority shareholders to finance the purchase of their part of the shares. In Browning v. C&C Plywood Corporation[55] for example, an issue of shares which reduced the plaintiff's interest from 32% to 1% was set aside. The issued share capital was increased from 1,000 to 500,000 shares and the plaintiff was given thirty days to take up 152,000 shares at $1 each. Management knew that the plaintiff could not afford this, and the sole purpose of the increase of stock was found to be to eliminate Browning's interest.

(c) ~~Withholding Dividends~~

In corporations that use dividends as profit distribution mechanism, this technique is the most common method of effecting a squeeze-out. To squeeze-out a minority, the executives may refuse to declare dividends but they provide high compensation for themselves and otherwise enjoy to the fullest, the patronage which corporate control entails, leaving the minority shareholders who do not have corporate office with the choice of obtaining little or no return on their investments for a long period of time or of selling out to the majority at whatever price they will offer.

A minority shareholder who challenges the directors' failure to declare dividends faces many obstacles in obtaining relief from the courts. The first obstacle is the court's view that whether or not dividends are to be declared and, if so, when, how and in what amount they are to be paid are primarily matters for the sound discretion of the directors.[56] The second obstacle which necessarily flows from the first consists in the court's relucntance to interfere in the internal management of the company absent

55 [1967] Supreme Court of Oregon, 434 P. 2d 339.

56 Devall v. Wainwright Gas Co. Ltd. [1932] 1 W.W.R. 281; Miles v. Sydney Meat Preserving Corp. [1913] 16 CLR 50.

fraud or dishonesty, This reluctance to intrude on internal corporate affairs very nearly hardened into an absolute rule of law. In Burland v. Earle[57] Lord Davey stated that:

> "Their lordships are not aware of any principle which compels a joint stock company while a going concern to divide the whole of its profits amongst its shareholders. Wether the whole or any part should be divided, or what portion should be divided and what portion retained are entirely questions of internal management which the shareholders must decide for themselves and the court has no jurisdiction to control or review their decision, or to say what is a "fair" or "reasonable" sum to retain undivided, or what reserve fund may be "properly" required.[58]

However, there are limits to the director's privilege to retain earnings in the business and the courts, particularly in cases involving close corporations, will grant relief where the minority can prove the directors have abused their discretion by acting arbitrarily, fraudulently or in bad faith. Re Ferguson and Imax Systems[59] illustrates this point. There was a marital breakup and the husband attempted to squeeze-out his wife who was a minority preferred shareholder in the corporation. To achieve this, no dividends were declared even through funds were available. A special resolution was passed converting the preferred shares into ones which could be redeemed. The wife applied under the oppression remedy to compel the payment of dividends and an injunction to invalidate the special resolution. The court held that the corporation must pay dividends because they were withheld for improper purposes. The special resolution was also invalidated.[60]

57 [1902] A.C. 83.

58 At-page 85.

59 [1983] 150 D.L.R. 3d 718.

60 See also, Dodge v. Ford Motors Co. (1919) 204 Mich. 459, 170 N.W. 668; Patton v. Nicholas (1955) 154 Tex. 385, 279 S.W. 2d. 848. In Von An v. Magenheimer (1908) 126 App. Div. 257, 110 N.Y. Supp. 629, a minority shareholder alleged that majority shareholders conspired to obtain her stock and that in order to induce her to sell they; (1) refrained from declaring a fair dividend; (2) increased their salaries as corporate officers, and (3) represented that the company had suffered reverses to such an extent that it could not pay a dividend larger than three percent and that it probably would never be able to pay more. The minority shareholder having sold her shares, the court permitted her to maintain an individual action against the majority shareholders for the losses that she suffered from the sale. As was said by the Supreme Court of Indiana in Star Pub. Co. v. Ball (1922) 192 Ind. 158, 171, "the courts will not allow

(d) Excessive Compensation

A typical squeeze-out technique is for the majority shareholders to acquire corporate wealth by causing the Corporation to pay them high and excessive compensation for services rendered as directors, officers or senior employees. They usually compensate themselves not only by huge salaries, but also by 'bonuses, pensions, profit-sharing, generous expense accounts, medical and health programs, company-purchased insurance and various other so-called "fringe benefits". A minority shareholder often watches the majority shareholders and their families live on compensation from the corporation and enjoy the prestige, privileges and patronage that accompany control of the corporation, while he and his family receive no financial return or any other benefit from his investment in the company.'[61] Payment of excessive compensation over a 'long period of time may be to the minority shareholder's detriment when the corporation sells its business and assets or merges with another corporation, because its earning power may be reflected in the price the corporation receives for its assets or in terms of the merger agreement.

(e) Non-Disclosure

An effective technique of squeeze-out by the majority shareholders usually consists in adopting a method of active non-disclosure of corporate information. This can be the preface to either a purchase by the majority of the minority interests or to a new issue of shares in the company. The effect is to conceal corporate information which might cause the ignorant party to value the shares more highly; thus resulting in

the directors to use their power oppressively by refusing to declare dividends where the net profits and the condition and character of the business clearly warrant it". The ultimate test resolves itself into an examination of the good faith and reasonableness of the policy of retaining that which otherwise is available for dividends.

61 Hodge O'Neal, supra note 34, at 129.

a sale of his shares at a bargain price, or in his failing to subscribe to a share issue which would result in the dilution effects. The position of the minority shareholder becomes more endangered when it is realized that reporting and disclosure requirements of the Securities Act[62] do not apply to close corporations (which by their very structure, cannot be classified as "reporting issuers"). Shareholders in a close corporation do not have access to sources of information available to securities holders in a widely-held corporation.

Protecting the Shareholders in a Closely-Held Corporation

It has been illustrated in the foregoing pages the problems and difficulties which may confront the shareholders in a closely-held corporation. Closely-held corporations account for most of Canadian business. Even in the United States, it is estimated that family-owned businesses alone represent ninety-five percent of all United States' business and are responsible for nearly fifty percent of the jobs in the United States.[63]

The legal principles applicable to several of the practices by which the minority shareholders are deprived of their interests in the corporation raise basic questions as to the nature and extent of the duties owed by controlling shareholders. From the attributes common to all attempted definitions of the closely-held corporation enunciated above,[64] it may be justifiable to assert that the closely-held corporation

62 For example, Section 67 of the British Columbia Securities Act 1985 makes provision for the publication of any 'material change' occurring in the affairs of a "reporting issuer". Section 1 of the Act defines what constitutes a material change. See supra, note 13 for definition of "Reporting Issuer".

63 J. Ward, Keeping the Family Business Healthy (1987).

64 See supra, pages 17-19.

bears a striking resemblance to the partnership.[65] Therefore, the relationship among the shareholders in the closely-held-Corporation shall be one of trust, confidence and absolute loyalty. Closely-held corporations with substantial assets and with more numerous shareholders are no different from smaller closely-held corporations in this regard. All participants rely on the fidelity and abilities of those shareholders who hold office. "Disloyalty and self-seeking conduct on the part of any shareholder will engender bickering; corporate stalemate and perhaps, efforts to achieve dissolution".[66]

Costs associated with the frictions and consequent litigations in the closely-held corporation may result in the ineffective use of management time; diminished confidence of banks, suppliers and customers in the corporate enterprise; inability to obtain necessary financing;[67] reduced efficiency of the management, as well as the increased risk of business failure. , .reholder disputes within the corporation also give rise to non-economic losses. If allowed to go on, it can destroy sound family relationship and lead to acrimony and vindictiveness.[68]

To ensure a more realistic and harmonious environment for the operation of the business within the closely-held corporation, an atmosphere of good feeling amongst the shareholders is an essential pre-requisite. Where an event or conduct by the majority shareholders gives rise to a dispute, resort may be had to one or other of the corporate legal remedies. Most of the problems encountered in the closely-held corporation which lead to corporate squeeze-out of minority shareholders could be resolved through the application of the legal remedies. However, the adequacy of the

65 There are however significant dissimilarities between them; the most prominent being the separate legal status accorded the closely-held corporation which is non-existent in partnership business.

66 Per. Tauro, C.J. in Donahue v. Rodd Electrotype Co. of New England, (1975) 328 N.E. 2d 505 at 514.

67 F. O'Neal and Thompson, Oppression of Minority Shareholders (2d. ed. 1985).

68 Bahls, supra note 40; at page 287.

corporate law remedies is another question which shall be looked at in one of the subsequent chapters.

In addition to the statutory remedies, corporate law and economic analysts assert that certain contractual monitoring mechanisms designed to minimize the conflict of interest problem also exist in the closely-held corporation. Beginning from the premise that the closely-held corporation is essentially founded on private contract among the participants to the nexus of contract within the corporation, they point out that these contractual devices take care of areas likely to give rise to problems in the future and further that the minority shareholders in the closely-held corporation are not that badly off otherwise no one would invest in them.

While the statutory remedies available to the shareholders are merel highlighted here (leaving a detailed discussion for a later part of this work), the contractual monitoring mechanisms designed to minimize agency problems in closely-held corporations and the enforceability of such arrangements shall be taken up when the economic structure of the closely-held corporation is examined in Chapter Three. Suffice it to say at this point that the adoption of contractual arrangements enables the participants in the closely-held corporation to depart from the traditional corporate management framework and agree on how control of the corporation shall be allocated. Similarly, that adoption of the shareholders' agreements as planning device in dispute prevention or resolution may-be inevitable for assured corporate success.

Statutory Remedies

Preventive mechanisms against squeeze-outs and frictions may sometimes be ineffective because the variety of possible forms which a squeeze-out may take, virtually precludes any success at preventing every attack. Therefore, where a course of conduct pursued by the majority is not one covered by some form of preventive protection, the injured minority shareholder may have recourse to common law[69] and the statutes for relief. Some of the Corporate Law remedies which are readily available to an aggrieved shareholder include; the oppression remedy;[70] appraisal rights;[71] derivative action[72] and an action for winding up.[73]

Conclusion

Development of appropriate methods of protecting minority shareholders in the closely-held corporation requires an appreciation of the legal and business environment which will affect the enterprise. The ascertainment of the circumstances and attitudes of the parties who are to be members in the corporation is also important. O'Neal pointed out that an obvious fact that many persons who become minority shareholders in the closely-held corporation when it is being organized or who buy into the business later, have a trusting, almost child-like innocence, at the outset of their involvement.

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69 The Common Law rules are not always valuable to a minority shareholder because of the rule in Foss v. Harbottle (1843) 2 Hale 461. Attention will therefore be focused more on the protection offered by the Corporation Acts.

70 In British Columbia, the remedy is provided under Section 224 B.C.C.A. See also Section 241 C.B.C.A. for similar provision. In Britain, Sections 459-461 of the British Companies Act 1985; Nigeria - Sections 310 - 313 of the Company and Allied Matters Decree 1990. In the United States, some states do not have any direct equivalent of the oppression remedy but Rule 10b-5 of the U.S. Securities and Exchange Commissi[illegible] corporations to obtain a remedy for conduct that would arise under the oppression remedy in Canada.

The scope of potential applicants is more limited under the B.C.C.A. than in the C.B.C.A. However, the Company Law Discussion Paper 1990 (B.C.C.A.) has recommended for an increased scope of applicants to include previous members. For judicial recognition of the need to include past members as eligible applicants, see Buckley v. B.C.T.F. (1990) 44 B.C.L.R. 31 (2d).

71 See Sections 231 B.C.C.A.; 190 C.B.C.A.

72 Sections 225 B.C.C.A.; 238 C.B.C.A.

73 Sections 296-298 B.C.C.A.; 213-217 C.B.C.A.; 408(c)(e) C.A.M.D. 1990, Nigeria.

They are enthusiastic about going into business for themselves and they are optimistic about success in the business and the receipt of high profits.

Conflicts of interests which exist or develop among the shareholders constitute a threat to the success of the venture. In the absence of protective mechamisms, control is in the hands of the holders of the majority of the corporation's voting shares and the likelihood of abuse of this power of control may not be far. While remedies do exist in the law for problems which arise unexpectedly, much could be done at the inception of the business venture to reduce the possibility of conflicts of interests arising. Careful planning in the initial periods of the incorporation of the corporate organization will do much to reduce the risk to investors and provide them with a structure for their relationships which will allow them to devote their attention to the business of the corporation rather than to the security of their position within it.

However, it must be appreciated that even detailed planned and constructed contractual mechanisms do not always take care of the wide variety and forms which a squeeze-out may take. The technique of avoiding these contractual arrangements are numerous. Corporate law and the statutory provisions play an active role here. By providing the statutory remedies the law enables the minority shareholder to either enforce a breach of an agreement or to prevent or cure any abuse of power by the controlling shareholders. A combination of the contractual devices and the statutory remedies may ensure a more realistic protection for the shareholders in the closely-held corporation.

CHAPTER TWO

THE TRADITIONAL STRUCTURE OF THE WIDELY-HELD CORPORATION

Introduction:

While corporate law and judicial decisions in some jurisdictions have increasingly recognized the existence of the distinction between the two kinds of corporations termed the closely-held and widely-held corporations, an important change in Canadian corporate law in the late 70's and early 80's was to drop the public/private distinction. Emphasis was rather shifted to the reporting obligations of the corporation as a distinguishing factor. For instance, the British Columbia Companies Act makes a distinction between reporting and "non-reporting" companies.[74] However, the difference in terminology notwithstanding, most features of the non-reporting companies could be identified in the closely-held corporation while the reporting issuers more closely resemble the widely-held corporations.

The typical one-person or family enterprise and the small corporation in which all the shares are held by comparatively few persons who regard themselves as "partners" and who are active in the business are clearly closely-held corporations. The larger enterprises with securities publicly traded (usually on a recognized stock exchange or in an organized over-the-counter market) is no doubt a widely-held corporation. These widely-held corporations dominate the economic structure of most countries with shareholders numbering in the thousands and most times comprising institutional investors.

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74 See Section 1, B.C.C.A., 1973; similarly Section 67 of the British Columbia Securities Act 1985 imposes some disclosure obligations with respect to any "material change" occurring in the affairs of "reporting issuers". See supra, note 13, for definition of "reporting issuers".

Between the extremes of the closely-held and widely-held corporations lies an important distinction which is besf-understood in terms of the degree of identity between ownership and management. Where the owners and the managers are identical or substantially so, the closely-held corporation feature is predominant. The dominant shareholders usually double as managers. In the widely-held corporation, the management team is usually appointed. Most often, the managers are either not shareholders in the corporation or they own a relatively little percentage of the stock. These corporations are marked by widespread share ownership structure. The shareholders are for the most times considered to be passive stakeholders who do not take any (active) part in the management of tha corporation. There is separation of ownership of shares from control of the corporation. It is this separation phenomenon that has become the traditional mode of picturing the fundamental problem of corporate law and economics.[75]

Due to the manifest widespread nature of shareholding and the separation of ownership from control, traditional corporate lawyers have asserted that the small group of managers are relatively free to manage the widely-held corporations for their own benefit, not that of the powerless and passive shareholders. They have called for more stringent legal rules to restrain the management group. However, as shall be shown later, corporate law economists argue that these traditional corporate law scholars fail to recognize the operational effects of some market forces on corporate management and their assertion becomes hallow when the value of the free market constraints on corporate management is examined.

There exists an available market for the sale or transfer of securities. Unlike in the closely-held corporation, the securities market affords powerful inducement to ensure that managers of widely-held corporations operate in a manner that maximizes

75 Economic analysis of the widely-held corporations is treated in the next chapter.

the shareholders' expectations. Although dissatisfied shareholders may remove dishonest and incompetent managers by the use of the proxy machinery, this process is rarely used because of the costs and delay inherent therein. Most times in the widely-held corporation, the dissatisfied shareholders simply sell their shares. While the sale of shares does not often lead to new management, it does offer the shareholder an opportunity to liquidate his investment, and re-invest in another corporation. But sometimes, the sale of shares may result in the sale of control usually at a premium with the consequent implication on the probability of the installation of a new management by the acquiring team.

Separation of Ownership from Control in the Widely-Held Corporation

The most dominant feature of widely-held corporations which distinguishes them from the closely-held corporations is the notion of the separation of ownership by shareholders from that of control by the management group. The shareholders are widespread and this makes it difficult, if not impossible for them to come together and device an organized contractual mechanism akin to the shareholders' agreements obtainable in the closely-held corporations. With no identifiable interest in the corporation other than profit maximization by the corporation, the shareholders are considered passive stakeholders without any interest in management responsibilities and duties.

The separation of ownership and control in the widely-held corporation was brought to the fore almost sixty years ago by Berle and Means.[76] This separation phenomenon has retained a central position in recent writings about the economic theory of the corporation. The problem created by the separation phenomena was

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76 Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).

recognized by Berle and Means when they stated that "the separation of bwnership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear . . ."[77] Thus, they asserted that ownership and control have been separated in the widely-held corporation and that this has large effects on the conduct of the corporate enterprise. The holder of corporate shares experiences a loss of control over his resources because ownership is so broadly dispersed across large numbers of shareholders that the typical shareholder cannot exercise real power to oversee managerial performance in modern corporations. Management exercises more freedom in the use of the corporation's resources than would exist if the corporation were managed by its owner(s).

The theme of their work could be gathered from the early pages of the book:

> "It has been assumed that, if the individual is protected in the right both to use his property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess. In the [quasi] public corporation, such an assumption no longer holds. . . , it is no longer the individual himself who uses his wealth. Those in control of that wealth, and therefore in a position to secure industrial efficiency and produce profits, are no longer, as owners, entitled to the bulk of such profits. Those who control the destinies often own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree. The stockholders, on the other hand, to whom the profit of the corporation go, cannot be motivated by those profits to a more efficient use of the property, since they have surrendered all disposition of it to those in control of the enterprise."[78]

The theme of the book rests on three propositions:[79]

1. The large corporation is owned by so many shareholders that no one or even no score of them typically owns a significant fraction of the outstanding shares.

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77 At p. 6.

78 Ibid, pp. 8-9.

79 See Stigler & Friedland, "The Literature of Economics: The Case of Berle And Means", (1983) 26 Journal of Law and Economics, 237, 238.

Berle and Means conducted an empirical study and examined the structure of control exercised over two hundred largest American corporations in 1930, including the Pennsylvania Railroad, the United States Steel and the American Telephone and Telegraph. They observed that "sixty-five percent of the companies and eighty percent of their combined wealth"[80] were controlled by the management or by a legal device involving a very small percentage of proportion of ownership. Since no one individual or group possessed a controlling block of shares in such corporations, they asserted that control over the conduct of the affairs of the widely-held corporations resided in the small group of directors and senior management that run the corporation;

2. Corporate officers in general own a very small fraction of the shares of their corporations;

3. The interests of management and shareholders diverge widely.

Berle made a study of the changing statute and case law with respect to the rights and duties of shareholders and corporate directors and officers.[81] The relaxation of incorporate statutes, the reduction in the rights not only of voting but of participation by the shareholders, and the growing prerogatives of the management to control investments, corporate structure and disbursement of profits and the like, were held to have eliminated most legal restraints on management prerogatives.

Berle and Means recognized the availability of the proxy machinery to the shareholders who may nominate their own directorial nominees and campaign for votes but they equally recognized that the process is so expensive that only wealthy groups can finance the effort. The cost of mailing proxy solicitation materials to shareholders is great when this is added the cost of the inevitable legal battle, printing fees for the

80 Berle and Means, supra, note 85, at p.94.

81 bk. 11.

solicitation materials, costs of retaining accountants and financial advisors, the aggregate costs are now and were in Berle and Means' time, immense.[82] Incumbent directors on the other hand, do not bear any of these costs - the corporate treasury does. The shareholder in reality is thus reduced to a mere passive stakeholder subject to the whims and caprice of the directors. Berle and Means concluded:

> ". . . for the most part, the stockholder is able to play only the part of the rubber stamp . . . the usual stockholder has little power . . .. The separation of ownership and control has become virtually complete. The bulk of the owners have in fact almost no control over the enterprise, while those in control hold only a negligible proportion of the total ownership."[83]

The authors contrasted the widely-held corporation to the Adam Smith[84] enterprise in which the owner managed as well as owned the business. By carrying on enterprise he would employ his energy and wealth in such a way as to obtain more wealth. In this effort, he would tend to make for profit those things which were in most demand. Thus, while the owner of the small enterprise is spurred on by the expectation of profits to risk his wealth; in the case of the widely-held corporation, the shareholders may hope to maximize profits by risking their capital, but the control group may seek to maximize salaries and easy executive life, Adam Smith recognized this fact when he wrote that

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82 Wolfson, The Modem Corporation: Free Markets versus Regulation, 14 (1984).

83 Berle and Means, supra, note 114 at p.89.

84 After two centuries, Adam Smith, an eighteenth century classical economist remains a towering figure in the history of economic thought. Known primarily for a single work, "An Inquiry into the Nature and Causes of the Wealth of Nations", (1776), the first comprehensive system of political economy, Smith is more properly regarded as a social philosopher whose economic writings constitute only the capstone to an overarching view of political and social evolution. The "Wealth of Nations" may be seen not merely as a treatise. on economics but as a partial exposition of a much larger scheme of historical evolution. In his book, Smith described the evolution through federalism into a stage of society requiring new institutions such as market-determined rather than guild-determined wages, and free rather than government constrained enterprise. This later became known as laissez-faire capitalism. Smith called it the system of perfect liberty.

". . . the directors of such companies[85] . . . being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or **less,** in the management of the affairs of such a company."[86]

Berle and Means stressed that the modern corporation is "so different from the privately owned enterprises of the past to make the concept of private enterprise an ineffective instrument of analysis."[87] They argued that the existence of the modern giant corporations cannot be integrated into the classical theory of capitalism. They further stated that: "when Adam Smith talked of "enterprise" he had in mind as the typical unit the small individual business in which the owner, perhaps with the aid of a few apprentices or workers, labored to produce goods for market or to carry on commerce. Very emphatically, he repudiated the stock corporation as a business mechanism, holding that dispersed ownership made efficient operation impossible . . .. Yet when [we] speak of business enterprise today, [we] must have in mind primarily these very units which seemed to Adam Smith not to fit into the principles . . . he was laying down for the conduct of economic activity".[88]

They concluded that the modern corporations, unlike the smaller units of Adam Smith's day operate in non-competitive markets dominated by a few great enterprises in which individual initiative has disappeared. Berle and Means viewed the modern corporation as an economic state. In their opinion, "the law of corporations was in

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85 Adam Smith was talking of joint stock companies, the 18th century equivalent of the widely-held corporations.

86 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, 700 (E. Cannan, ed. 1966).

87 Berle and Means, op. cit. p. 349.

88 Ibid, at 345-346.

reality a branch of constitutional law for the new economic state".[89] They advocated that a new corporate constitutional law and government officials rather than the free market would be used to force the corporation to serve not only the shareholders but also the society.[90]

Effects of the Berle and Means Thesis

For the last sixty years or thereabout, public discussion of corporations and public policy towards corporations have been dominated by the vision of Adolf Berle and Gardiner Means. The authors' analysis made two suggestions. One was for the courts to adopt the doctrine that corporate officers and directors are trustees for the shareholders, and to hold them to the highest standards of fiduciary responsibility. This suggestion was considered weak because it would require close monitoring of corporate affairs by the courts, a task for which the judges were not qualified and for which even the largest investors showed no soncern. The authors recognized this point when they conceded that the legal effort on monitoring corporate affairs has not been successful because the courts lack the "ability to handle the problems involved".[91]

Another suggestion was to restore active control to the shareholders. Berle and Means claimed that corporate officers were promoting their own financial interests at the expense of the shareholders and that to remedy the situation, the shareholders should be encouraged to play an active role in nominating and electing directors and thus influence the selection of the officers who run the corporation. This approach known as the "shareholder democracy" holds that shareholders are inactive or apathetic mainly because they lack easy access to corporate information. And presumably, they

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89 Ibid, at p. 357.

90 Ibid, at p. 356.

91 Ibid, at p. 357.

would be willing to play an active role in determining corporate goals and in designing a 'strategy to achieve these goals, if they posses the information needed to make informed policy decisions.

Most modern corporate law legislations are based on the fears of domination by the corporate directors and managers expressed by Berle and Means. The goal of public control animated many of those who wrote and adopted the United States Securities Act of 1933 and the Securities Exchange Act of 1934. For instance, the Chairman of the United States House Commerce Committee presented the 1933 bill in a language consistent with the analysis of Berle and Means:

> "Where the stock is widely distributed, as in the case of so many American corporations, the officers of the company, through the use of proxies and the advantage they have in obtaining proxies, are able to continue in office without much regard to their efficiency . . .. Two hundred companies own 75 percent of the total wealth of the United States. The management of these big corporations, as a rule, own an insignificant percentage of the outstanding voting stock."[92]

The Berle and Means' book was credited with the inspiration for the 1933 reform legislation, and *Time* magazine called it "the economic Bible of the Roosevelt administration".[93]

The reformative effects of the Berle and Means' thesis notwithstanding, the work has not been without criticism. In the first place, Berle and Means asserted that the interests of the management group and shareholders diverge widely in the widely-held corporations, but no attempt was made in the book to present any systematic divergence of interest between ownership and control. One writer has pointed out that organized empirical research would have been welcome; "even significant albeit anecdotal evidence of the misuse of control power would have aided the case".[94]

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92 (1973)4; The Economic Regulation of Business and Industry 2615-16 (Bernard Schwartz, ed.).

93 Time, April 24, 1933, at p. 14.

94 Wolfson, supra, note 82 at p. 17.

Secondly, economic analysts are highly critical of the Berle and Means thesis. A fundamental defect in their thesis is the failure to recognize the value of free market constraints on corporate management which help to align management interests with that of the shareholders in the widely-held corporations, Wolfson in unequivocal terms criticized the work of the authors in similar terms when he wrote:

> ". , . the book after development of data demonstrating the dispersion of stock ownership into many small shareholders devotes over a hundred pages to a demonstration that could not have been new even in 1932 that corporate directors and management have the potential power under the case and statutory law to dominate the financial and business affairs of the corporation . . .. None of the Rerlc and Means discussion with the literal exception of one or two isolated anecdotal examples ever proves that free market forces do not discipline management or that control systematically uses its power to harm shareholders or the public."[95]

Conclusion

No doubt, there is bound to be a high probability of divergence of interest between the management interest and that of the shareholders when control of the property[96] and the ownership thereof is not housed in the same individual. This summarizes the basic fact of most widely-held corporations. The position of the shareholders in the widely-held corporation is quite different from that of their counterparts in the closely-held corporations, where the existence of shareholders' agreements go a long way in preventing and taking care of areas or issues likely to give rise to difficulties. Shareholders' agreements are not possible in the widely-held corporations chiefly because of the widespread ownership structure. Similarly, the use of the proxy machinery as a control mechanism may be expensive.

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95 Wolfson, Ibid at 17-18.

96 As evidenced by the shares.

However, the shareholders are not totally without protection from management misconduct. Corporate law and economic analysts argue that the managers are constrained by an identifiable network of bonding and monitoring devices to exercise their discretion in the shareholders' interests and that an exploration of the economic reality of the corporate structure and the capital market in which is exists will reveal that the widely-held corporation is not a kind of institution free from the discipline of a free competitive market,

Moreover, resort may be had to corporate law provisions for the protection of the shareholders. The provision of the oppression remedy, appraisal remedy and for breach of fiduciary duties the derivative action serve to protect the shareholders where the market forces are unable to take care of one-time divergence by the managers. Similarly, the enactment of the Securities Acts[97] which require full disclosure of facts relevant to the value of corporate securities also serve an important function in shareholder protection. Derivative action for breach of fiduciary duties may lie where the directors or managers fail to disclose any material change in the affairs of the corporation and subsequently make use of the undisclosed information to their own benefit.[98]

97 For example, U.S.A. 1934, British Columbia 1985.

See, for example, Section 121 of the British Columbia Securities Act. 1985; See also Securities &Exchange Commission v. Texas Gulf Sulphur Co. (1968) 410 F. 2d. 833.

Personal action may lie for the breach of duty to disclose any material change occurring in the affairs of the corporation (as provided by Section 47 of the British Columbia Securities Act, 1985) if the plaintiff can rely on the corporate law rule which states that where a statutory provisipn is designed for the protection of a class to which the plaintiff belongs, then if he can show loss through damage caused by failure to observe the statutory provisions, he can rely on that provision to claim for personal relief. See Goldex Mines Ltd. v. Revill (1974) 7 O.R. (2d) 216 (C.A.)).

CHAPTER THREE

ECONOMIC ANALYSIS OF THE CLOSELY AND WIDELY-HELD CORPORATIONS

Tntroduction:

In the previous chapters, the traditional structures of the closely and widely-held corporations were examined. It was pointed out that there is a fundamental difference between the two corporate forms. Apart from the existence of share transfer restrictions in the closely-held only, it was noted that there is great diffusion of share ownership in the widely-held corporations. Furthermore, risk bearing and management are separated in widely-held but not in closely-held corporations. Two views exist on the consequences that follow from the diffusion of share ownership and the separation phenomenon in the widely-held corporation. The two views represent the assertions of the two leading schools of thought in corporate law - the traditional (corporate) legal view and the economic approach to corporate law.

The traditional legal view emphasizes that the position of the shareholders in the widely-held corporation has degenerated into a helpless one because of the separation phenomenon and the likelihood that the management may exploit the situation to their advantage. The view also holds that shareholders in the closely-held corporation face unique risks of exploitation; hence the need for state intervention in the form of imposing strict legal rules including the oppression remedy, fiduciary duties and appraisal remedies enabling exploited members to liquidate their investments.

The economic approach which represents a new thinking in corporate law applies economic tools to the understanding of corporate law problems. The view holds that shareholders in the widely-held corporation are not worse off because of either the separation phenomenon or the diffusion of share ownership. The view asserts that the modern corporation is an entity which exists in a competitive market and that the effective constraints which the free market imposes on management force them to act for the welfare of shareholders. According to this view, the coalescence of ownership and control is not a necessary condition for managerial efficiency. The essence of this view is that the modern corporation is based on private contractual foundation among the participants. Reliance is placed by the corporate law economists on contractual and market constraints on corporate management as opposed to state intervention for the protection of shareholders.

Although economic analysis of corporate law is controversial[98] and the application of economics to corporate law has not been expressly adopted either in the United States (where the idea started) or in Canada, the greatest contribution of corporate law and economics has been the study of the relationships which exist among the participants in the corporate organization. This chapter examines the relationship existing between the shareholders and the management[99] in both the widely and closely-held corporations in the light of the economic approach to corporate law. Section 1 sets the stage for the discussion by presenting a summary of the two leading schools of thought in corporate law - the Traditional (Corporate) Legal View and the Economic Approach to corporate law. Section II presents the theory of the firm which

98 Not many corporate law commentators have accepted the economic approach to corporate law. Thus, it has been criticized at different levels. See, for example, L. Dallas, "Two Models of Corporate Governance: Beyond Berle and Means", (1988) 22 J. of L. Reform 19 (rejects the mode of analysis entirely saying that a corporation is better understood as a power coalition than as a nexus of contract); V. Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract", (1985) 85 Col. L.R. 1403 (attacks particular element of the contractual analysis by arguing that a shareholder does not enter into a conventional contract since there is little bargain over details or alternatives). Coleman, Heckathorn and S. Maser, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law", (1989) 12 Harv. J. of Law & Pub. Pol. 639 at 640-50 (attacks the ethical foundations of the economic approach).

99 Other participants in the corporate organization include the employees and creditors. However, the focus of this work is how the shareholders could be protected against management misconduct, hence the limitation of the discussion to the two groups.

is one of the several fundamental economic issues in corporate law. Section III analyzes the structures of the widely and closely-held corporations from an economic perspective. When the closely-held corporation is looked at, the economic structure of the corporation will be considered first. The governance and contractual mechanisms which align the interests of those in control with that of minority shareholders are also considered. The discussion on the closely-held corporation concludes with an examination of the validity of these contractual arrangements.

When the widely-held corporation is examined, the agency problems inherent in the separation phenomenon will be identified. Furthermore, the contractual and free market constraints on corporate management are discussed. Section IV offers some concluding remarks and comments.

I: The Traditional (Corporate) Legal Theory

The traditional legal theory views the corporation essentially as a legal fiction which comes into existence by virtue of a grant from the state. This view holds that a corporation is a distinct legal entity different from the members who constitute it and can only exercise those powers conferred on it by its charter of incorporation.[100] The essence of this view is that the corporation constitutes a separate juridical unit created by state action; an artificial creature of the state possessing in addition to its essential "core" attributes only such limited powers as are granted by the state. While a separate legal entity, its legal capacity beyond its "core rights" depends on its charter and thereby differs from the fuller panoply of legal rights possessed by natural persons. This theory of the corporation supports state intervention in the form of either direct

100 See supra, note 6.

regulation or the facilitation of shareholder litigation in the corporation on the basis that the state created the corporation by granting it a charter.

In 1932, Berle and Means further enhanced this view in their thesis when they observed that dispersed shareholders of the modern corporation do not have the incentive to effectively control corporate management and that managers often act in their own interests rather than in the shareholders' interests. Their thesis provided the basis for many calls for more stringent legal controls on managerial behavior and has fostered the view among some legal commentators that corporate law is the only meaningful constraint on managerial behavior. Corporate law, according to this view, plays a pre-eminent role in maintaining balance in the widely-held corporation characterized by the separation of ownership and control.

The Economic Approach to Corporate Law

The economic approach represents a new thinking in corporate law and consists in the use by economists and economic oriented corporate law scholars of the theoretical and empirical methods of economics to illuminate a variety of issues and problems in corporate law. Today, it occupies a central role in corporate law theory.

The approach began in the United States but has extended to many other jurisdictions including Canada and other Commonwealth countries.[101] The starting point of these corporate law scholars was to explain how economic activity can be efficiently carried out by means of firm rather than by contracting in the market. They assert that firms arise to reduce transaction costs and self interested post-contractual

101 An example of law and economics corporate scholarship in Canada is F.H. Buckley and M.Q. Connelly; Corporations: Principles and Policies, 2d. ed. (Toronto: Edmond Montgomery Publications, Inc. 1988). Other examples include; Cheffins, supra, note 9; J. MacIntosh, supra, note 9. For Commonwealth position, see D.D. Prentice, "The Theory of the Firm: Minority Shareholder Oppression: Sections 459-461 of the British Companies Act 1985", (1988) 8 Oxford J. of Legal Studies 55.

behavior among persons who otherwise would be engaged in market transactions.[102] The economic approach is in stark opposition of, and challenges the orthodoxy of the traditional legal view of the corporation as a mere concession from the state. The approach views the corporation as founded on private contract where the role of the state is limited to enforcing contracts entered into by the participants to the intracorporate contract.

Thus, according to this view, the corporation is a complex nexus of contracts that are different from and presumably more efficient than those which would arise in the market.[103] With this approach came the evolution of the "contractual theory" of the corporation. Proponents of the economic approach to corporate law argue that the essence of the contractual nexus within the corporation is that the participants should be free to mold a corporate form of their choice. A strong basis of the economic approach is the recognition of free market forces which act as effective constraints on corporate management and the use of contractual controlling mechanisms by the participants to reduce the conflict of interests which usually arises between those who manage the corporation and the shareholders.

Proponents of the economic approach argue that the modern corporation is a competitive entity circumscribed by powerful market forces which should play a more significant role in shareholder protection than governmental or regulatory intervention.

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102 For leading works on the economic theory of corporations, see supra, notes 7-8.

103 Prof. Cheffins argues that the economic approach despite the apparent opposition to the entity approach, provides strong theoretical support for the Memorandum and Articles approach to corporate law. Under this approach which was developed in England, the Memorandum and Articles are viewed as a contract both between the members of the corporation and between the members and the corporation. See Cheffins, supra, note 9 at 784.

II: The Theory of the Firm

The theory of the firm explains the methods of carrying out economic activities within a market economy. Two basic methods of economic coordination in the market economy are the market coordination and firm coordination. Market coordination involves the direction of production decisions by the price system manifested by specific contracts while firm coordination involves the direction of production decisions by the firm. Firm coordination entails the use of hierarchical decision making methods in production processes instead of market contracts. The management organizes, coordinates and monitors the production process within the firm.[104]

A major contribution of economists has been their explanation of how an economic activity could be more conveniently carried on by means of the firm rather than by contracting in the market. The first economist to develop the modern theory of the firm was Coase.[105] He pointed out that the firm and trading in the market were essentially devices for coordinating economic activity with the distinguishing characteristic of the firm being the suppression of the price mechanism within its area of activity. He explained that the adoption of the firm was as a result of an effort to reduce the transaction costs of market coordination. The cost includes the effort to discover the various market prices and the costs of negotiating the many contracts with suppliers of services and commodities.

Many other factors which affect the cost of carrying on business through market coordination could be minimized where the business is carried on through the firm. Parties may behave opportunistically by pursuing their own self interest and where

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104 See Butler, supra, note 8, at 103.

105 See supra, note 7.

these risks are high, the firm presents a way of reducing them as members of the firm are better placed to monitor each'other's behavior. Furthermore, human limitations inhibit their capacity to draft contracts covering all future contingencies. This obviously reduces the utility of the contracts, The cost of contracting may be expensive and thus exceed the benefits to be derived therefrom. These problems are avoided or minimized when an activity is carried on by the firm because of its ability to adjust to contingencies.

While Coase focused on the factor of transaction costs as determinants for the development of firms, Alchian and Demsetz[106] took the issue a little further. They analyzed the issue of the shirking and information problems of team production in a firm. They developed a framework for explaining how the nature of the production process affects the type of organization and the internal organization of the firm. They observed that the firm emerged as a response to the benefits of team production and that in team production, marginal products of cooperative team members are not so directly and separably observable. What a team offers to the market can be taken as the marginal product of the team but not of the team members. They conceded that the benefits of team production has transaction costs based on the impossibility of monitoring the marginal productivity of individual members in allocating pro-rata rewards and some take advantage of this. But they assert that as long as the productive efficiency of the team outweighs the shirking costs, the firm continues to grow. The members of the team hire the manager to monitor their behavior in order to enhance team productivity. These individual team workers in the firm submit to the manager's commands voluntarily because of the shirking problem. Thus the role of the manager is to monitor the production process, coordinate team production and discourage shirking by linking compensation to productivity.

106 A.A. Alchian and H. Demsetz, "Production Information Costs and Economic Organization", (1972) 62 Am. Econ. Rev. 777.

The authors sought to determine who will monitor the monitor. They found the answer in the creation of automatic built-in voluntary incentives to monitor well. A most effective method is to give residual rewards, that is the ownership of net earnings, less payments to the other inputs.[107] This will give the monitor a great incentive to check the shirking of firm participants. If there are multiple owners, many of who do not engage in the monitoring business, the monitoring manager cannot receive the entire residual. The greater his rewards are tied to profits, however, the greater will be his incentive to monitor well. Another method is to develop methods by which outside rival monitors will be rewarded if they replace inefficient incumbent monitors. Another method is to increase the competition within firms for the top monitoring jobs.

III: The Economic. Structure of Closely-held Corporations

Closely-held corporations have relatively few managers who tend to be the largest residual claimants. Because the principal investors in these corporations are also its managers, it is often necessary to restrict the members' ability to alienate their shares. Such restrictions may increase the likelihood of compatibility of ideas amongst the managers. It ensure retention of control, especially where the corporation arises as a family venture. This also reduces opportunistic conduct among the managers.

Restrictions on alienations and the apportionment of jobs are important when the corporation distributes profits in the form of salaries instead of dividends. This has tax consequences because salaries are usually tax deductible.

From its very nature, the closely-held corporation lacks the benefit of specialization. The same people manage and bear the risk of investment. There are few managers. Furthermore, the members have great percentages of their wealth invested in the corporation and they lack access to capital markets. They are less

107 Ibid.

efficient risk bearers than their counterparts in the widely-held corporation who usually diversify a greater proportion of their investment portfolio.[108]

However, the lack of specialization has advantages. Because the number of participants is usually small and the both manage and bear the costs of their actions, there is every likelihood that each will be compatible with the other. Everything being equal, managers with large percentage of the corporation's shares will work harder and engage in less self-dealing than their counterparts in the widely-held corporations. Furthermore, the relatively small number of residual claimants in the closely-held corporation facilitates contracting and monitoring which reduces agency cost.

Most closely-held corporations arise out of familial or other personal relations.[109] Economic analysts argue that the continuous and non-pecuniary nature of the relationship reduces agency problems. The bond between parents and children, for example, reduces conflicts of interests.[110]

Shareholders in the closely-held corporations lack access to a public market for the liquidation of their investments. Traditional corporate law scholars argue that the absence of the market often results in a risk of exploitation and oppression of the minority by the majority shareholders. This may force the minority to sell their shares at a distress price. Commenting on this illiquidity problem, Bahls pointed out that:

> ". . . majority shareholders frequently have monopsony power . . . to the extent that the majority shareholder is the only buyer, minority

108 But if the closely-held corporation is a relatively small one without large business operation and no need for specialized experts or big capital, then it has a comparative advantage. See Easterbrook and Fischel, "Close Corporations and Agency Costs", (1986), 38 Stanford Law Review, 213,214.

109 Easterbrook & Fischel, supra note 108. Although a great proportion of closely-held corporations arise out of purely business relations.

110 Easterbrook & Fischel, (supra) points out that some of the famous cases dealing with closely-held 'corporations involve situations where these informal bonds have broken down as a result of death or divorce - see, e.g., Galler v. Galler (1964) 32 Ill. 2d. 16, 203 N.E. 2d. 577; In Radom & Neidorff, Inc. (1954) 307 N.Y. 1, 119 N.E. 2d. 563. See also In re Lundie Brothers Ltd. (1965) 1 W.L.R. 1051.

shareholders seeking to sell their shares are not able to find other bidders when the majority shareholders hold out for an unreasonably low purchase price . . .. In the case of close corporations, the majority shareholder has no incentive to purchase the minority shareholders' stock for a price greater than the discounted value of the future stream of payments to which the minority shareholder is otherwise entitled, plus the transaction costs of dealing with a minority shareholder on an ongoing basis."[111]

The lack of capital market for trading in the securities of the closely-held corporation may affect the investor in many ways. In the first place, it may negate the idea of reliance on the stock market as a monitoring device. The takeover mechanism[112] which helps to align management interest with that of the shareholders in the widely-held corporation has no application to the closely-held corporation. In closely-held corporations where the ability of outsiders to acquire shares is restricted, the market for corporate, control is insignificant in creating an incentive towards 'corporate management efficiency.

Lack of securities market for shares of closely-held corporations prevents uninformed investors from acquiring information concerning the relative strength and price oh the shares of the corporation. Many buyers and sellers compete to acquire information about public corporations, the competition and ensuing trading cause the price of securities to reflect reasonably well the available information about their value.[113] This provides the management with incentives to make credible commitments to potential investors to reduce their rational fears. Thus while an investor in a widely-held corporation is afforded the advantage of purchasing the shares at *the* market price, the reverse is the case with the investor in the closely-held corporation because there is no market price.

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111 Bahls, "Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy", (1990) Journal of Corp. Law 291.

112 For discussion on the takeover mechanism and the market for corporate control, see below.

113 See Gilson & Kraakman, "The Mechanism of Market Efficiency", (1984) 70 Va. L. Rev. 549; Easterbrook & Fischel, supra.

Furthermore, the absence of securities market makes the valuation of residual claims uncertain and difficult to obtain. Unavailability of market prices and the existence of contractual restrictions on the possible buyers makes the transfer of shares more difficult by high transaction costs. Easterbrook and Fischel point out that a shareholder willing to liquidate his interests faces costly haggling which sometimes frustrates such attempt.

Absence of securities markets may create problems over dividend policy and other distributions. The future stream of payments usually expected by a minority shareholder consist of four components - dividends, liquidation proceeds, court-ordered payments and salaries (where he is employed by the corporation). In closely-held corporations where the payment of dividends is adopted as a profit sharing mechanism, the directors may allow either no dividends or relatively small dividends. And where the corporation is in the habit of retaining a large proportion of its profits instead of declaring them as dividends, an investor who wishes to obtain immediate cash loan on the collateral of his share interest may find himself in a difficult situation. Lenders will be hesitant and unwilling to do so. The only alternative for such an investor may be to sell his interest to the corporation or other shareholders usually at a discount. His counterpart in the widely-held corporation would not envisage such difficulties. His ability to make use of the exit process enables him to sell his shares in the secondary market,-thereby eliminating the use of retention of earnings as a weapon against the minority interests.[114]

Notwithstanding the difficulties created by the lack of securities market for trading in the shares of the closely-held corporation, economic analysis suggests that it is a mistake to conclude that the shareholders face unique risks of oppression. Rather, it is more helpful to appreciate the agency problems in the corporation and the

114 For further discussion, see Fischel, "The Law and Economics of Dividend Policy", (1981) 67 Va. L. Rev. 699.

mechanisms that have developed to control them. This leads us to an examination of the governance mechanisms.

Governance and Contractual Monitoring Mechanisms in the Closely-held Corporation:

Shareholders in most corporations are usually concerned about the likelihood that the actions of others[115] may reduce their rate of return. The closely-held corporation is no exception. Economic analysis suggests that the corporation is best viewed as essentially founded on private contract among the participants to the nexus of contracts. The management usually have an' incentive to adopt governance mechanisms that respond to the shareholders' concern and allay their fears.

Closely-held corporations do not separate management from risk bearing. Monitoring is less costly when compared with the position in the widely-held corporations. Outsiders have less incentive to monitor managers. However, the lack of separation gives rise to the adoption of other types of governance mechanisms.

Shareholders in closely-held corporations usually adopt contractual monitoring devices such as the shareholders' agreements as planning devices in dispute prevention and resolution. These agreements may be oral or written. But many important advantages attach for reducing all aspects of the shareholders' bargain into writing. In the first place, written agreements enable the shareholders to digest and appreciate the ramifications of the proposed arrangements more carefully and make decisions on issues which otherwise might escape their attention and remain undecided. Secondly, the existence of written documents minimizes the chance of misapprehension and increases the probability that the shareholders will voluntarily comply with the terms of the agreement. In the words of O'Neal, "a bargain in writing has a psychological

115 Especially those in the management group.

effect on the parties and tends to reduce disputes, unfounded claims, squeeze plays and litigations".[116]

Contractual arrangements enable shareholders in the closely-held corporation to define the course of conduct of the business of the corporation.[117] Such arrangements also make up for the lack of control over corporate affairs which the minority shareholders are usually subject to.

Shareholders' agreements enable the participants to depart from the traditional corporate management framework and agree among themselves on how control of the corporations should be allocated. The aim of the minority shareholders in this regard usually is to obtain membership on the board of directors, some voice in the management of the corporation and protection against the power vested in the majority.

The use of the shareholders' agreements touches upon the realm of what could be described as corporate marriage and divorce. The marriage is the welding together of the parties are shareholders while an aura of optimism and enthusiasm prevails. It also provides a means of separation which is as certain and as simple as possible should the corporate love fail and turn into antipathy and distrust. Shareholders' agreements provide for some of those matters that are likely to require agreement by the shareholders at some time during the formation of the corporation; its corporate life and termination.[118]

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116 Hodge O'Neal, "Oppression of Minority Shareholders: Protecting Minority Shareholders" (1987) 35 Clev. S.L.R. 121 at 124.

117 Easterbrook & Fischel point out that the restriction on the power of members to alienate shares ensures that those who invest are compatible as managers. The restriction usually preserves an agreed on division of profits. Thus, if an active manager resigns or quits his job, it may be necessary to transfer his shares as well. Similarly, when he retires or becomes incapable of performing his duties by reason of death, he or his personal representatives cannot continue to receive the salary component of the profit from the business. Buy out agreements address these problems of illiquidity.

118 Apple, "Shareholders' Agreements", (1986) Special Lectures of the Law Society of Upper Canada.

Management and other provisions which might be included in the shareholders' agreements to help prevent disputes leading to squeeze-out of the minority shareholders and safeguard the interests of all parties include the following:[119]

(a) specified shareholders or their nominees shall constitute the board of directors;

(b) salaries of officers and key employees shall not be changed except by unanimous consent of the shareholders;

(c) whenever the corporation's surplus exceeds a specified sum, dividends in the amount of the excess share be paid to the shareholders; dividend agreements which require the corporation to pay dividends if the corporate treasury has a certain amount of funds serve the same function'

(d) each shareholder is to be employed in a key position by the corporation at a specified salary.[120] Employment and compensation agreements also make it difficult for those in control to act without the consent of minority shareholders. Agreements to keep people in office enable those not in control to get some return on their investments.

(e) a shareholder shall not transfer his shares until he has first offered them to the corporation and to the other shareholders;

(f) each shareholder or each of specified shareholders shall have the power to veto some or all corporate decisions;

(g) -disputes among the shareholders shall first be submitted to arbitration for settlement.

The shareholders' agreement may also set out the rights, duties and responsibilities of the parties in exercising management functions.

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119 H.O. O'Neal, Close Corporations, Vol. 1 (1958).

120 This may however be practicable only where there are very few shareholders.

Other Contractual Services =-

(a) Lone Term Employment Contracts

Minority shareholders often protect themselves against being deprived of employment with the corporation either as senior officers or otherwise, by insisting on long-term employment contracts. By this method, they enter into contract with the corporation and not with other shareholders. Often, the contract might include provisions for severance pay or liquidated damages in the event the corporation breaches the contract.[121]

(b) High Voting Requirement for Fundamental Corporate Acts

Another effective contractual monitoring mechanism is to include in the Articles of Association or by-laws a provision requiring unanimity or a high vote for shareholder and director action. Such a provision gives the minority shareholder a veto over corporate decisions. To obtain sufficient protection for the minority shareholder, "special resolution" for the corporation may be redefined to amount to "unanimous" consent of the shareholders. This provides the desired security for the minority. But, it may have some negative effects on reducing the power of the corporation to act and may be detrimental from a business viewpoint.

Validity of the Contractual Mechanisms

The validity of the contractual mechanism which attempts to determine some of the above-mentioned matters is open to question because it seems to take away from the

121 Of course, even where the shareholder is employed as an officer under a contract of employment, the corporation has power to remove him without cause. However, his removal without cause shall be without prejudice to his contractual rights. See S.157(5) B.C.C.A. See also Shindler v. Northern Raincoat Co. Ltd. (1960) 2 All E.R. 239; Read v. Astoria Garage (Streatham) Ltd. (1952) 1 Ch. 637, Southern Foundries (1926) Ltd. v. Shirlaw (1940) A.C. 701.

directors important decision-making powers traditionally within their province. Courts once viewed unusual contractual devices in closely-held corporations with suspicion. Many early decisions were hostile towards private arrangements, including restraints on alienation, voting agreements,[122] and agreements limiting the discretion of directors.[123]

Most attacks on shareholders' agreements are based on the premise that they isolate a statutory provision confemng the power of management on the directors or that they are incompatible with the scheme of corporation management and operation established by the Act. The most frequently used provision is the section which provides that the business of a corporation shall be managed by its board of directors.[124]

The decisions invalidating shareholders' agreements on the ground of their inconsistency with statutory provisions or with a scheme of corporation management supposedly fixed by the statute create grave problems for investors in the closely-held corporation who usually have the task of evolving suitable corporate structures for their businesses. A corporation from an economic view is, after all, a nexus of contracts which enables the participants to work out a corporate form that maximizes their expectations. Their expressed intentions and agreements which is reduced into writing

122 See, e.g., Bostwick v. Chapman (Shepang Voting Trust Cases) (1890) 60 Conn. 553, 24 A.32.

123 See, e.g., McQuade v. Stoneham (1934) 263 N.Y. 323 189 N.E. 234. The court in this case held invalid an arrangement between a majority shareholder and two minority shareholders entered into at the time.

124 Section 102 C.B.C.A. expressly makes the powers of directors to manage the corporation subject to the unanimous shareholders' agreement. This obviously removes any potential attack on the validity of shareholders' agreements as constraints on the powers of directors. In Section 142 B.C.C.A., the power of directors is made subject lo any provision in the Articles or the Act. Thus, an express provision in the Articles could validly restrict the managerial powers of the directors. However, such provision is often altered and this has the effect of practically removing the utility of the shareholders' agreements. But under the B.C.C.A., it may be possible to use the technique of incorporation by reference to make the shareholders' agreement a part of the Articles to which the directors' power would be subject.

should be the focal point of attention. Courts should pay much regard to such terms expressed by the shareholders who, it could be asserted, are in a better position than the law makers to express what they want. Courts should help to facilitate the contracting process by giving interpretation to the expressed intentions of the shareholders except where such a course would work manifest injustice or hardship on third parties or outsiders to the contractual arrangements.

The application of the Acts should be focused more towards the protection of shareholders and investors in the widely-held corporations where there is considerable separation of management from ownership and a real danger to the investing public. If the purpose of the statutory sections[125] rather than their literal language is allowed to control their application, they will not be applied to invalidate shareholders' agreements in closely-held corporations, at least where all the shareholders are parties.

The effect of applying the statutory provisions to shareholders' agreements in the closely-held corporation may be to give the shareholders a protection that they do not need and to hinder them in the operation of their business by making it improbable for them to mold or choose a corporate firm that best maximizes their reasonable expectations.

Today, courts enforce voluntary agreements of all sorts among investors in closely-held corporations. In Clarke v. Dodge,[126] the court enforced an agreement specifying that a minority shareholder be continued in office and receive one-fourth of net income as salary or dividends. Similarly, in Galler v. Galler,[127] the Supreme Court of Illinois upheld a shareholders' agreement providing for salary and dividend

125 Which, according to the economic approach to corporate law is to act as standard form contract touching on those areas that the parties would have provided for, had they adverted their minds to them.

126 (1936) 269 N.Y. 410, 199 N.E. 641.

127 (1964) 32 Ill. 2d. 16, 203 N.E. 2d. 577.

payments to the shareholders themselves as well as to their immediate families despite the death of an original signatory.[127] Other courts have upheld agreements that provide for the use of arbitrators or other third parties to break deadlocks[128] and restraints on alienation.[129]

In English law, collateral contracts among shareholders governing the voting of their shares have been held to be valid.[130] It must, however, be restricted to building the shareholders qua shareholders and not in any other capacity,[131] for example, as directors.

Where an agreement is held to be valid, its effect is invaluable in structuring the management of the corporation, as a remedy for breach of the agreement is specific performance. In Ringuet v. Bergeron,[132] an agreement among three shareholders provided for forfeiture of the shareholdings of any member in breach of the agreement. When two of the three shareholders did, in fact, breach the agreement, the court ordered that their shareholding be forfeited to, and taken over, by the third member who had relied on the agreement.

The usual requirements of a valid contract - for example, notice of the terms, absence of prejudice to third parties, - apply to corporate agreements. Contractual restrictions on alienation generally must be noted conspicuously on share

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128 See, e.g., Lehrman v. Cohen (1966) 43 Del. Ch. 222, 222 A. 2d. 800.

129 Colbert v. Hennessy (1966) 351 Mass. 131, 217 N.E. 2d. 914; Allen v. Biltmore Tissue Corp. (1957) 2 N.Y. 2d. 534, 141 N.E. 2d. 812; Edmonton Country Club v. Case (1975) 1 S.C.R. 534.

130 Puddephatt v. Leith, (1916) 1 C.A. 200.

131 Motherwell v. Schoof (1949) 4 D.L.R. 812.

132 (1960) S.C.R. 672. See also Hornby v. Nugent (1988) B.C.S.C. - compulsory buyout clause in a shareholders' agreement entitling a shareholder upon giving written notice to have his share bought out by the other shareholders held to be enforceable.

certificates.[133] Shareholders' agreements even if unanimous may be invalidated if prejudicial to creditors.[134]

The Economic Structure of Widely-Held Corporations

An extensive body of economic literature has developed over the last twenty-five years explaining how the various terms of the corporate contract address agency problems in the widely-held corporations. This literature refutes the 1932 claim by Berle and Means that managers control widely-held corporations and are free to operate these corporation sin their own interests rather than those of the shareholders. Under the Berle and Means view, the widely-held corporation is a trap for helpless shareholders and therefore an appropriate subject of legal regulation.

Economic analysis suggests, however, that managers are actually constrained by an identifiable network of incentive, bonding and monitoring devices to exercise their discretion in the shareholders' interests.[135] Diffused ownership of shares in widely-held corporations may enhance greater specialization among shareholders. Inefficient decisions by managers may induce the better informed owners to react sooner and more adequately, selling some or all of their shares and thereby lowering the stock market price and the cost of taking over the corporation. Corporate law and economic analysts point out that diffusion of share ownership in the widely-held corporation does not leave managers so autonomous or independentgiven the constraints supplied by market forces which compel the managers to act in the shareholders' interests.

133 See Section 51(1)(e) B.C.C.R.

134 See Galler v. Galler, supra, note 170.

135 In fact, economic analysts are highly critical of the Berle and Means thesis. Louis de Alessi, for example, observed that the Berle and Means thesis rested entirely on faith and on data reflecting increased diffusion of share ownership with no empirical evidence regarding the validity of the consequences alleged to follow from such diffusion. "Private Property and Dispersion of Ownership in Large Corporations", (1973) 28 J. Fin. 839, at 851.

Before discussing those market forces and contractual devices, it may be necessary to examine the economic implications of the separation phenomenon and agency problems in the widely-held corporation.

Separation of Ownership from Control and Agency Problems in the Widely-held Corporation

Management and risk bearing in the widely-held corporation are separate. Managers' incentives to act efficiently may thereby be weak because they neither bear the cost nor reap the benefits of their actions. Moreover, it may be difficult for shareholders to monitor managers' behavior.

However, economists argue that the widely-held corporation takes its peculiar organization structure because it is the best method of attracting large amounts of capital with a minimum of agency costs. The shareholders invest capital and directors and other senior officers monitor the productivity of the employees and coordinate the inputs of labor and capital into the corporation. The widely-held corporation comes into existence as a result of the desire of investors to entrust their money to skilled managers. It is the consequence of the desire of the large institutional investors who have no ability or urge to manage to put their finances in the hands of expert corporate officers. The centralized control by the senior management is as a result of the need to minimize shirking and agency costs.[136]

Separation of ownership from control may be necessary to maximize managerial efficiency in the corporate firm. Investors therefore desire the management to

136 Alchian & Demsetz, supra, note 106, pointed out that if every share owner participated in each decision in a corporation, not only would large bureaucratic costs be incurred, but many would shirk the task of becoming well informed on the issue to be decided, since the losses associated with unexpectedly bad decisions will be borne in large part by the many other corporate shareholders. More effective control of corporate activity is achieved for most purposes by transferring decision authority to a smaller group whose function is to negotiate with and manage the other inputs of the team. The corporate shareholders retain the authority to revise the membership of the management group and over major decisions that affect the structure of the corporation or its dissolution.

maximize their welfare to the same extent as would the shareholders themselves if they managed the corporation. But an important concern may shirk and engage in self-interested behavior and other forms of dishonesty. In fact, there exists great potentials for conflicts of interests between shareholders and managers. Such conflicts may arise from the fact that while one of the shareholders' objectives is that the corporation maximizes its per-share earnings, maximization of per-share earnings may not be the sole and often, not even the primary objective of the manager. Included in his objectives is monetary compensation. But non-financial objectives may constitute more important objectives. In the first place, there may be the desire for personal power and prestige. These objectives may bear heavily on structural changes because they may lead management to engage in expansion through amalgamation or otherwise for its own sake rather than for the sake of maximizing per-share earnings of the shareholders.[137]

Another non-financial objective may be the managerial tendency to identify with the enterprise and the desire for security. Enterprise identification and a desire for security may lead management to oppose corporate liquidations or amalgamations even though the shareholders' interests might be best served by such an action. Corporate managements seldom consider liquidation an alternative to unprofitable operations. The chief executive who has been long with his company rebels against the idea of 'his' firm's passing out of existence.[138]

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137 R.A. Gordon in "Business Leadership in the Large Corporation, 305-316 (Calif. ed. 1961) described this trend when he stressed that "one of the most important of the non-financial incentives offered by the large corporation is the opportunity to satisfy the urge for personal power . . . [the executives] power is a product of position rather than of personal wealth . . .. The corporation is the vehicle through which power comes to be held and exercised. . . . Widely-held corporations can also offer prestige over and above that which results from the executives' receipt of a large salary and bonus. Power itself brings prestige, as does the mere fact of heading a large and successful firm."

138 Ibid, at 308.

On the other hand, management may recommend an amalgamation with another corporation or a disposition of substantial assets to such a corporation because of benefits which are promised to management by way of employment contracts and the like. Henry Manne argues that:

> "When we find (management) recommending (such) a change it is generally safe to assume that some side payment is occurring . . . . The most obvious kind of side payment to managers is a position within the new structure either paying a salary or making them privy to valuable market information. This arrangement, easily established with mergers, can look like normal business expediency, since the argument can always be made that the old management provides continuity and a link with past experience of the corporation."[139]

Jensen in his seminal work[140] also identified some of the conflicts between managers and shareholders in the corporate firm as including the following:

(a) Non-payment of Dividends: Risk averse managers may prefer to re-invest their firm's profits in the firm rather than distribute them to shareholders even though the shareholders could put them to a more productive use.

(b) Risk Aversion: Managers in widely-held corporations tend to avoid bankruptcy at all costs but shareholders with diversified investments are risk neutral with regard to individual securities in their investments. Here, the manager's interest will be more aligned with that of creditors than the shareholders unless corrective governance mechanisms are adopted.

(c) Horizon: This conflict refers to the issue of how to encourage a manager to act in the shareholders' interests as the manager approaches retirement or prepares to leave the firm for other opportunities.

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139 Manne, "Mergers and the Market for Corporate Control", (1965) 73 J. Pol. Econ. 110, at 118. In England, this is some times called the "golden handshake".

140 Jensen, "Agency Costs of Free Cash Flow: Corporate Finance and Takeovers", (1986) 76 Am. Econ. Rev. 323. A list of conflicts between managers and shareholders may not be exhaustive but it serves as a reference point for discussing the roles of different corporate governance mechanisms that control corporate agency costs.

(d) Effort: This is a primary concern of the agency theory and the separation phenomenon in the widely-held corporation. The question is whether entrenched managers have the incentives to maximize their efforts in pursuing the maximum rate of return for shareholders.

Corporate law and economic analysts recognize these potential conflicts but argue that most of them are solved by competitive forces that align the manager's interests with that of the shareholders. This theoretical economic approach which his called the agency theory suggests that unity of ownership and control is not a necessary condition of efficient performance of a corporation. This view emphasizes the voluntary, contractual nature of the corporation. A corporation's managers[141] are agents of the shareholders. In this perspective, the separation of ownership and control in the widely-held corporation is an agency relationship which exists because the benefits of the relationship exceeds the agency costs associated with it.

The agency theory explores institutional devices that enable shareholders voluntarily to allow managers to control their resources. The resources devoted to controlling agency costs are equally identified as agency costs.[142] Managers select the least cost manner of controlling agency costs.

Governance Mechanisms in the Widely-Held Corporation

Much literature which exist on the economic analysis of the widely-held corporation reflect the examination of governance mechanisms that maximize the shareholders' expectations and align the management's interests with that of the shareholders. Professors Fama and Jensen observed that "absent fiat, the form of

141 Which are defined to include its officers and directors.

142 Agency costs thus include not only the direct costs associated with agents acting in their own interests at the expense of shareholders, but also the costs of controlling managerial agents through legal or market governance arrangements. See Butler, "The Contractual Theory of the Corporations" (1989), 11 Geo. Mason Univ. Law. Rev. 99 at 110.

organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs".[143] If the view is taken that the widely-held corporation exists as a result of the desire of the shareholders to entrust their capital to the managers, then the separation phenomenon shoold be seen as an advantage rather than a p.·.·blem. Most shareholders in the widely-held corporation do not have the time, knowledge, experience or desire to manage corporations whereas officers and directors are skilled in managing businesses.

Economic oriented corporate law scholars argue that managers assume their roles with knowledge of the consequences. investors part with their money willingly. Managers obtain their positions after much trouble and toil competing against others who desire the same positions. Corporations must attract customers and investors by promising and delivering what these people value. Corporations that do not do so will not survive. The key point lies in identifying some of the ways in which competition induces managers to act in the interest of the shareholders. The identification of the competitive forces and the appreciation of their interaction represents the contractual theory of ihe corporation. The corporation manifests a voluntary contract and the realities of the agency relationship presupposes that the managers select contractual terms that are offered to potential investors. Some of the governance mechanisms in the widely-held corporation include the following:

I. <u>Market for Corporate Control</u>:

Berle and Means depicted the widely-held corporation as a static institution and posited that the managers have control and retain it. The powerless shareholders accept the crumbs that managers hand out.

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143 Fama & Jensen, "Separation of Ownership and Control", (1983), 26 J. Law & Econs. 301.

Economic analysis suggests that one important element omitted by Berle and Means is the competition among the team of managers to have control of the corporation. Economists argue that the corporate control contest is the direct answer to the agency cost problem inherent in the separation phenomenon. The free market for control and management operates to limit management dereliction of responsibility.

Modem investment portfolio theory teaches individual and institutional investors to diversify their investments in many corporations and to hold the shares as long as the market price of the shares rises or does not fall. When a corporation is run on a profitable basis, the price of its shares will be high relative to comparable firms that are less efficiently run.[144] The inefficiency, incompetency, or dishonesty of a corporation's management will directly affect the price of the corporation's shares thereby decreasing it.

The market for corporate control may reconcentrate ownership by making use of the safeguard built into the shares when they were issued. The shares are freely transferable and carry voting rights that allow their owners to take control. Shareholders in widely-held corporations may decide to sell their shares at the first manifestation of significant management dishonesty or incompetency.[145] Where this happens, the result of the exit process is that the shares of poorly managed corporations trade at a discount below a level that could be attained with more competent and honest managers. The corporation- becomes vulnerable to outsiders and corporate raiders seeking to acquire corporate control and who believe that they ~ osess the ability to

144 The difference in the price of shares is a direct consequence of the Efficient Capital Market Hypothesis which states that all information which is publicly available about a firm is rapidly reflected in the firm's share price. For a discussion on this theory and substantial empirical verification and evidence supporting it, see Easterbrook & Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer", (1987) 94 Harv. L. Rev. 1161; 1165-68. See also R. Brealey & S. Meyers, Principles of Corporate Finance (3d. ed. 1988).

145 Although shareholders may use their voting shares to wage proxy battles with the aim of changing management, this may be an expensive strategy, the cost of which may outweigh any possible benefit to the shareholders with relatively small holding in the particular corporation.

manage the corporate more efficiently than the incumbent managers. Thus viewed, an issue of voting shares by a widely-held corporation may be a bonding technique to reduce agency costs.

Corporate raiders acquire the shares usually at a substantial premium over their market price but the premium is paid in the belief that as a result of their superior management, the price will rise to a level in excess of the premium, Economic analysts therefore argue that the constant pressure provided by the threat of a takeover probably plays a larger role in the successful functioning of the corporate system. It conditions managers to a specific point of view perfectly consistent with the shareholders' interests to wit; keeping the price of the corporation's shares as high as possible.[146]

Butler points out that the role of the market for corporate control in the governance of the modem corporation is not based on some mystical or ideological belief in the power of the market forces' but rather it is supported by numerous empirical studies[147] and that the role of stock capital market in constraining corporate management may be viewed as one of the important steps in the application of economics to corporate law.

From an economic perspective, the market for corporate control may be of great importance in creating incentives for management to maximize the welfare of shareholders. Incumbent managers acknowledge that they will be subjected to a control

146 Henry Manne, supra note 139. The market for corporate cantrol operates in many different forms. The most dramatic is the takeover through a hostile tender offer. Others include friendly mergers, negotiated tender offers, sales of control by larger shareholders and proxy contests.

147 Henry Butler, supra, note 142 at 112. Notable empirical studies on the issue include: Jensen & Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11 J. Fin. Econ. 5; Easterbrook & Fischel, "Managers' Discretion and Investors' Welfare: Theories and Evidence", (1984) 9 Del. J. Corp. Law 540; Jarrell, Brickley & Netter, "The Market for Corporate Control: The Evidence Since 1980, (1988) 2 J. Econ. Persp. 49.

contest if they do not act in the shareholders' interests. This knowledge induces them to behave appropriately.

II. Corporate Executive Performance and Compensation:

Corporate law economists assert that corporate compensation packages are often structured in a manner that solve most of the conflicts between managers and shareholders. Managerial salaries and other forms of compensation are often linked to how well the firm is performing. Compensation agreements may link changes in the manager's wealth to the performance of the firm.

An ex-ante compensation strategy would seek to alleviate agency costs through incentive features in the compensation package offered to managers. Where managers are risk neutral and their efforts can be observed with certainty, the optimal compensation package would be one in which managers would absorb all variations of profits, becoming in effect, the holders of a position of the firm's residual value. They would then be expected to adhere to proper levels of care and to adopt investment policies which maximizes the firm's value.

But a proper compensation package may be one in which the management and equity holders share firm risk, even though such does not eliminate adverse incentive costs. This may necessitate the use of bonus strategies which, in addition to his direct salary, the manager is awarded further compensation if the firm is profitable. Fama points out that managers monitor each other's performance and reward achievements with bonuses and salary adjustments as a form of "ex-post settling up" that substantially alleviates incentive problems.[148] Becker and Stigler further observed that if managers

148 E. Fama, "Agency Problems and the Theory of the Firm", (1980) 88 J. Pol. Econ. 288, 295-306.

enjoy favourable salaries or other forms of employment, they may be disciplined by the prospect of being fired.[149]

Stock options and bonus plans used as incentives to managerial efficiency may alter the manager's time horizon.

III. Product Market Competition:

Product market competition may constrain the divergence of interests between managers and investors. It forces managers to maximize the profits of the corporation. Failure to do so results in the failure of the firm which may be costly for both the managers and shareholders. A firm that is inefficiently run will have difficulties selling goods and services on the same terms as more efficiently run firms. Where a firm does not have market power for its products, this will result in the failure to maximize profits and will be reflected in a below-average return on shareholders' investments. This makes the firm an attractive target for takeover.

IV. Capital Structure:

Jensen and Meckling in their seminal article[150] used agency problems and monitoring of managers to identify the relevance of capital structure to the value of a firm. Corporation managers have an incentive to minimize their combined costs of debt and equity capital because failure to do so would make them vulnerable to takeover.

A high ratio of debt to equity restrains managers from retaining earnings beyond that which can be profitably reinvested by the corporation, thereby reducing the

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149 Becker & Stigler, "Law Enforcement, Malfeasance and Compensation of Enforcers", (1974) 3 J. Legal Stud. 1, 9-10.

150 "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", (1976) 3 J. Fin. Econ. 305.

manager-shareholder conflict. A low ratio of debt to equity may restrain the managers from'engaging in projects that are too risky from the debtholders' position, thus addressing the shareholder-creditor conflicts.

V. Markets for Management

Corporate managers may reduce agency costs by improving on the performance of the firm. A manager's future compensation package depends upon his reputation for efficiency and honesty. Managers compete with one another to attain the top positions in their corporations and most promotion decisions are made on the basis of an individual's productivity. Shareholders benefit as managers attempt to climb the corporate ladder by improving their productivity and impressing their superiors. Inefficient executives soon lose their jobs.

Moreover, top-level managers often increase their salaries by jumping to other firms (or at least threatening to do so).[151] Thus, competition for managerial services both inside and outside the corporation encourages managers to act in shareholders' interests.[152]

VI. Corporate Hierarchy and the Board of Directors

Economic analysis suggests that recent developments in the economics of corporate hierarchy have helped to clarify the board's role as a monitor of managerial decisions.[153] The analysis takes the separation of ownership (residual risk bearing) and control (decision management) analysis one step further and looks at the specialization

151 Butler, supra, note 142 at 116.

152 See, e.g., Faith, Higgins & Tollison, "Managerial Rents and Outside Recruitment in the Coasian Firm", (1984) 74 Am. Econ. Rev. 60.

153 Williamson, "Organizational Form, Residual Claimants and Corporate Control", (1983) 26 J. Law & Econ. 351.

of functions by agents who control the corporation. Theoretical contributions have found a role for the board of directors.[154] The control of the corporation by agents is separated according to function whereby decision management (the initiation and implementation of strategic plans) is entrusted to senior managers and decision control (the ratification and monitoring of the strategy formulation and implementation process) is the domain of the board of directors.[155] Agency problems are reduced by tying compensation to these specialized activities.

Thus, unlike the Berle and Means' perspective which views directors as pawns in the managers' hands, this view asserts that the role of directors is important to the control of agency costs and hence the long term survival of the corporation.

IV: Conclusion

Economic analysis allows us useful insights into corporate law problems and shareholder protection. Corporate law and economic analysts point out that free market and contractual devices play an important role in ensuring that the managers' interests are aligned with that of the shareholders. The influence of economic factors on corporate law cannot be denied.

-Contractual monitoring mechanisms" and shareholders' agreements in the closely-held corporation may condition the atmosphere within the corporation into one that is conducive for the successful operation of the business. They focus on those

154 Fama & Jensen, supra, note 143.

155 That is, the management control functions are delegated to the board by the residual claimants and the board then delegates most decision management functions and many decision control functions to internal agents but it retains ultimate control over internal agents - including the right to ratify and monitor major policy initiatives and to hire, fire and set the compensation of top level decision managers.

aspects of modem corporate life which often give rise to tensions and frictions. Courts may' therefore consider interpreting the corporate norms including the section providing that the business of the corporation shall be managed by its board of directors against the background of well known corporate facts of life. The conception of the board of a closely-held corporation as a body separate and apart from the shareholders with an unfettered independence and discretion in the conduct of corporate affairs m2y be regarded as a fiction which should not be permitted to becloud the real issue when a party to a business agreement tries to welch on his bargain.[156]

In the widely-held corporation, shares are freely traded'and carry voting rights. This facilitates efficient risk bearing, accumulation of large blocks of shares and transfers of control while ensuring that management have incentive to maximize the value of the firm. Compensation agreements also link changes in manager's wealth to the performance of the firm.

However, notwithstanding the adoption of these contractual mechanisms and the development of the economic approach to corporate law, it is still necessary that shareholders be offered the protection provided by the statutes. The use of contractual mechanisms may be inadequate to deal with all future contingencies which may give rise to difficulties and problems among the shareholders. They may be insufficient to constrain corporate management from misbehavior. Furthermore, the market forces do not work without costs and may be inadequate to deal with one time divergence or other corporate management misconduct. The takeover mechanism for example, may provide excessive leeway for managerial inefficiency because of the high transaction costs imposed by the mechanics of takeover bids, the requirements of relevant statutes,

156 From an economic perspective, there is much to commend the approach of English judges, who are reluctant to interfere with actions taken in accordance with the corporate constitution. See Re Postage & Denby (Agencies) Ltd. (1987) BCLC 8 (Ch.D); Re a Company (No. 00437) (1987) BCLC 94. Canadian courts have been more inconsistent in their treatment of agreed upon terms. E.g., compare Bernard v. Montgomery (1987) 36 BLR 257 (Sask. QB) with Re Bury (1984) 12 DLR (4th) 451 (Ont. HC).

the wide array of defensive tactics available to incumbent management, the incentives to takeover well run rather than poorly run corporations[157] and the time lag option experienced by the public in ascertaining managerial efficiency.

Another key empirical question bearing on the market for corporate control is how well acquiring corporations do after they buy other firms. Notwithstanding the claim of stock market efficiency by Jensen and Ruback and others,[158] if one examines the large literature that traces back into the 1920s featuring the study by Arthur Dewing[159] and 1930s (Shaw Livermore)[160] to the present, most investigations conclude that from the standpoint of the welfare of the shareholders of the acquiring corporation, acquisitions either damage them or are neutral in effect.[161] The uniform benefactors in mergers are the shareholders who sell out, especially if they make an early and graceful exit from any security package which they may have acquired. A study of British experience published in 1981 by Levine and Aaronovitch concluded that the evidence points to mergers "as strategic decisions not involving immediate economic or financial gains".[162] One aspect of such strategic thinking is the desire to become large.

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157 Many large corporations have deliberately embarked on buying programs which focus on well managed and profitable targets. The conglomerate movements of the 1960s in US was frequently characterized by low-earnings-rate corporations, buying more profitable ones. An example is the US Steel acquisition of Marathon Oil Corporation. The market having fixed the price on Marathon at about $60 a share, US Steel bought it shortly thereafter at $106. With a record of only modest success in the steel business to which it had been addressing itself for many years, US Steel was explicitly unwilling to claim that it was going to manage the oil business better.

158 Supra, note 147.

159 Dewing, "A Statistical Test of the Success of Consolidation", (1921) 36 Q.J. Econ. 84.

160 Livermore, "The Success of Industrial Mergers" (1935) 50 Q.J. Econ. 68.

161 Mueller, "The Effects of Conglomerate Mergers: A Survey of Empirical Evidence", (1977) J. Bank & Fin. 315.

162 Levine & Aaronovitch, "The Financial Characteristics of Firms and Theories of Merger Activity", (1981) 30 J. Indus. Econ. 149, 166.

Corporate legal rules and remedies are therefore important in inducing managers to act in the shareholders' interests. Contractual promises of faithful services may be worthless in the absence of these rules.

Our next discussion focuses on the role of the corporation statutes.

PART TWO

CHAPTER FOUR

THE ROLE OF CORPORATE STATUTES

Introduction:

This chapter examines the role of corporate statutes. It is divided into four sections. Section I examines the role of corporate statutes as standard form contracts. The cocception of corporate statutes as standard form contracts emanates from the economic approach to corporate law which views the corporation as a legal fiction serving as a nexus for a complex set of explicit and implicit contracts existing among the participants in the corporate organization. According to this view, the proper role of corporate statutes should be to facilitate the contracting process. In other words, the corporate statutes should be seen as providing for the terms that the participants would have bargained for, in the absence of contracting costs. In this descriptive sense, these provisions and terms ought to be such that the parties could contract out of, if they choose.

Section II examines the role of corporate statutes from the traditional conception of the corporation. Under this approach, a corporation is viewed as a legal person which possesses such powers-as conferred on it by the charter of incorporation. This implies that state intervention in the corporation in the form of either regulation or the facilitation of shareholder protection may be inevitable. It is observed that while the primary role of corporate statutes is to enable the corporate participants to organize and operate their businesses, most corporate statutes contain some provisions which are non-variable. This is in recognition of the fact that within the corporation are many groups with competing interests. It is therefore desirable to prescribe some non-variable standards of corporate conduct to protect the interests of the weaker groups (that is, minority shareholders) in the corporation. In this sense, corporate statutes do more than acting as standard form-contracts which provide terms that the parties are capable of contracting out of, if they desire.

Section III examines the main classifications of corporate law provisions. These fall into the general categorization of mandatory, presumptive and permissive ones. The classification is reflective of the fact that corporate statutes perform both mandatory and permissive/presumptive roles. In its mandatory role, corporate law prescribes non-variable minimum standards of corporate conduct, while in its permissive or presumptive role, it enables participants either to adopt provisions in the statute or to substitute them with alternatives.

Section IV offers some concluding remarks. It is suggested that an ideal corporate statute should first of all be an enabling Act since traditional corporate theory makes it necessary that corporations obtain legislative sanction not only for their existence, but for their exercise of corporate powers. Secondly, a corporate statute should aim to restrict and regulate as well as to enable the conduct of corporate business. In fact, corporate statutes should perform mandatory and enabling roles.

1. Corporate Statutes as Standard Form Contracts

The contractual basis of the corporation has led some commentators writing from an economic background to argue that the primary role of corporate law should be to facilitate the contracting process.[163] The assumption is that participants in the corporate contract are in a better position than the legislators or judges to make decisions regarding the manner in which the transactions will be deviced.

The recognition of the ability of the participants to choose the contractual form that best maximizes their expectations implies that corporate law economists recognize

163 For example, J.A.C. Hetherington, "Redefining the Task of Corporation Law", (1985) 19 USFR 229, 256-9; Butler, supra, note 8, 118-22.

the enforcement of expressly stated terms in intra-corporate contracts. But they do not focus solely on expressed terms-in the contract because intra-corporate bargains are never fully put down in writing. The costs of setting out a bargain in writing will, at some point, greatly exceed the benefits. O'Neal and Thompson identify some of the benefits to include clarifying the participants' assumptions concerning risk, reward and expected conduct increasing the likelihood of voluntary compliance and signalling to a dispute resolver how contentious matters are to be dealt with.[164]

On the other hand, the costs of articulating the bargain in writing may be many. In the first place, comprehending the contents of the agreement may he difficult because imperfections in information and communication can cause misunderstanding[165] and even in situations where the contents of the agreement could be appreciated with some reasonable clarity; financial and other inputs must be used in setting out the agreement in writing.[166] For corporations with sub-optimal capital financing, the consequences may he unfortunate. This may warrant the corporation in not using the services of a lawyer during the incorporation stage thereby going it alone or instructing a lawyer to incorporate as cheaply as possible.

Adequate investment in legal planning may not even solve the problem of ensuring that the intra-corporate contract is fully expressed in writing because it is practically difficult to commit into writing all clauses or bargains which can adequately deal with future contingencies-including, but not limited to changes in the legal and commercial environment and alterations in the assumptions and objectives of the

164 O'Neal and Thompson, "Oppression of Minority Shareholders, 2d. ed. (Wilmette; Ill: Callaghan & Co. 1985) Chapter 8.

165 See Cheffins; supra, note 9, 784.

166 D.D. Prentice suggests that substantial savings accrue to persons intending to start up business if they are able to adopt a convenient pre-set legal form which is easily available especially if the package has been used over times.

participants in the corporation.[167] The problems are increased due to the fact that the risk of misinterpretation by the courts increases when new formulations are used.

If the view is taken that the choice of the participants to the corporate contract prima facie leads to efficient solutions to corporate law problems, it then means that the obstacles to the contract should be reduced so that participants can come as close as possible to reaching the agreements that would have been formed through costless bargaining.[168]

Contracting costs may be reduced through the use of standardized terms. The use of corporate terms enables parties to engage in fairly complicated exchange transactions without incurring high transaction costs. Just as the techniques of contract interpretation and warranty law economize on contracting costs by in effect writing into all contracts those provisions which the parties would probably have included if they had been willing to incur the time and information costs and had been able to foresee the future, corporate statutes set out similar terms for the participants to the intra-corporate contract.

Furthermore, under the expanded choice theory,[169] corporate law can act as standard form contract that provides the participants with off the rack terms. Corporate law economists assert that participants under this approach choose whether the terms provided by corporate law are to apply to the corporation. Whenever the standard form is suitable, they will likely adopt it, since using the preformulated terms should reduce the costs associated with negotiation and articulation. If the standard form is not appropriate, however, either in whole or in part, it can be displaced with express terms

167 Cheffins, Ibid, at 784.

168 Ibid, 787. Corporate statutes can alert the participants to the areas where negotiations should be considered. Prof. Cheffins refers to this as the signalling function of corporation statutes. See Cheffins, "US Close Corporation Legislation: A Model Canada Should Not Follow", (1989) 35 McGill L.J. 160.

169 Supra, note 12.

that better represent the participants' bargain.[170] Corporate statutes supply these terms "for free"[171] to every corporation enabling the participants to concentrate on matters that are specific to their undertaking.

Even when the parties work through all the issues they expect may arise in the course of the business, they are apt to miss something. In a world of changing commercial and legal environment, all sorts of complexities will arise later. Corporate law fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance. Corporate law in this sense, supplements but does not displace actual bargains.

One merit of this is that the standard form becomes attractive to most corporations which in turn increases the cost savings to participants. Secondly, whenever contracting out is not considered by participants in the corporate contract, the standard form provides them with terms that would have been agreed to and that thus reflects their collective best interests.

II. Traditional Role of Corporate Statutes

The traditional corporate legal theory teaches us that a corporation is a legal person, separate and distinct from its members, possessing only those powers conferred on it by its charter of incorporation. This implies that state intervention in the corporation in the form of either regulation or the facilitation of shareholder protection may be inevitable. Certain basic questions however arise from this proposition. Do the legislators show the awareness of commercial values and priorities when they formulate the rules of corporate law? Is it of importance to the businessman of being able to get things done and done in the way he wants? Is there reflected in the

170 Corporate law economic analysts argue that there are lots of terms such as rule for voting, establishing quorums and so on.

171 Easterbrook & Fischel, "The Corporate Contract", (1980) 89 Col. L. Rev. 1444.

principles of corporate law a proper concern to avoid delays, to keep costs down to stimulate innovation and facilitate-enterprise? Is there a willingness to let business get on with the job? For the law to intervene no more than is strictly necessary?

Modern corporate statutes in Canada may be described as attempts to furnish reasonable facilities for doing business and proper safeguards to creditors and shareholders. Much legislative progress have been made since the 1970's and 1980's in Canada towards well-drafted corporate statutes. These improvements in the laws regulating the corporate set up involved much study by legislative draftsmen and long sessions of reform committees. These workers aimed to formulate clear and concise provisions which would facilitate legitimate business transactions, eliminate arbitrary, harsh and unreasonable liabilities on shareholders and directors, and at the same time, safeguard the investor, the creditor and those dealing with the corporation. The task force which was charged with undertaking the review and formulating proposals for the reform of the Business Corporations Law of Canada said:

> "We set to design a scheme of law that is clear, workable and above all, written for the businessman who will operate under it; not for the corporation lawyer. Accordingly, the Act simplifies and codifies wherever possible. We have sought to eliminate the obsolete and anachronistic, and to remove the trivially arcane."[172]

More recently, the Ministry of Finance and Corporate Relations Department of the province of British Columbia, in presenting its policy proposals and intentions towards a major revision of the Company Act 1985 stated that:

> "Government intention in the internal operations of the companies in general will be reduced to a minimum. The result should be increased efficiency of operations to the benefit of the entire community . . .. The Company Act simply provides the legal framework for companies and is an enabling rather than a regulatory statute. Regulatory issues such as the regulation of financial institutions, environmental regulations and the

172 Dickerson, Howard & Getz, Proposals for a New Business Corporation's Law of Canada (1971) Vol. 1, Para. II.

regulation of securities are addressed with specific policies and legislation."[172]

Every business association necessarily has legal relations with a variety of groups, including its employees, customers, creditors and shareholders. In as much as its relation with employees and customers are little, if at all, affected by the fact that the association has assumed a corporate form, legislative regulation of these relations is ordinarily embodied in statutes other than business corporation acts. The same is true to some extent of the relations between a corporation and its creditors although the peculiar privilege of limited liability necessitates certain safeguards for creditors.[173]

Shareholders unlike creditors have votes. They or at any rate a majority of them, can in theory depose any director or officer whose performance of his managerial functions fails to measure up to their conceptions of efficiency and integrity. The question arises therefore, whether the legislators should permit shareholders to invest their savings in corporate enterprise without inventing legal devices for their protection?

Traditional corporate legal theory suggests that because of the separation between ownership and control in the large modern corporation[174] and because of the fluidity of contract rights under modern corporate Articles of Association and shareholders' agreements, no modern business corporation act can be regarded as satisfactory unless it provides substantial safeguards for the shareholders, particularly the minority shareholder. The non-controlling shareholder needs legal protection with respect to certain corporate subjects. He needs effective enforcement of the fiduciary obligations of officers and directors. He needs to have voting rights equitably

172 Ministry of Finance & Corporate Relations, Province of British Columbia, Company Act Discussion Paper, January 1991.

173 For example, see S.258 B.C.C.A.; Sections 238-241 C.B.C.A.

174 Subsuming under that phrase both these cases in which a corporation is controlled by a minority and those in which a controlling majority has interests more or less antagonistic to those of the minority.

distributed. He needs adequate restrictions on the funds which are legally available for dividends and for purchases of a corporation's own shares and effective means of enforcing their restrictions. He needs safeguards against abuse of the power to make organic changes in the structure of the enterprises by amendment, merger or consolidation. Finally, he needs to be assured of adequate and readily available information about the corporation's activities and the state of its finance. Although most of these issues could be taken care of, through adequate planning and contractual agreements, complexities may arise later. Furthermore, parties may be unable to foresee all areas likely to give rise to problems in the future. Contractual efficacy is impaired. Again, reliance on the market forces for adequate protection will not adequately produce an optimal solution to the agency problems inherent in the corporate form of organization, especially in the case of widely-held corporations. This is partly because the operation of some of the monitoring institutions and incentive mechanisms that seem theoretically desirable in a frictionless model is hindered by transaction costs such as the cost of acquiring information and the cost of contracting in the real world.

Corporate statutes however achieve these protective purposes. Generally, they seek to facilitate the conduct of business through the corporate organization. In this respect, they reflect a non-regulatory policy in corporate affairs. Professor Ballantine who drafted the legislation for California in the 1930's succinctly stated that:

> "The <u>primary purpose</u> (underlining is mine) of corporation laws is not regulatory. They are enabling Acts to authorise businessmen to organize and to operate their businesses, large or small, with the advantage of the corporate mechanism. They are drawn with a view to facilitate efficient management of business and adjustment to the needs of change".[175]

Corporate statutes thus provide the legal frame and financial structure of the intricate corporate device by which business can be carried on and in which the

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175 Ballantine on Corporations (1946) 41-42.

combined energies and the capital of the managers and of many investors may work together. They deal with the internal affairs of the organization, the content of the Articles of Association, the rights of the shareholders, the powers and liabilities of directors, the authorized number and variety of the shares, the holding of meetings, restrictions on corporate finance, such as the withdrawal of funds by way of dividends and share purchases, the corporate records, the authorization of organic changes such as amendments, sale of assets, merger and consolidation and dissolution and winding-up.

However, notwithstanding the primary enabling function of corporate statutes, sight should not be lost of the fact that the corporation represents a conglomerate of various groups of participants with conflicting and competing interests. Each group seeks to protect its interest. In such a situation, the possibility is not ruled out that those with greater corporate power might often suppress or oppress those with relatively little power. In fact, the possibility that majority shareholders will manifest the tendency to oppress the minority cannot be discounted. It becomes inevitable that corporate statutes should take the plight of the minority shareholders into consideration. The result is the inclusion of some non-waivable mandatory provisions in the various statutes. These provisions by their nature prescribe minimum standards which must be observed, with remedies available to the minorities in the event of failure to comply. Some of these provisions include the oppression remedy, the derivative action, appraisal remedy and the winding-up remedy. Corporate statutes therefore perform some mandatory functions.

III. Classifications of Corporate Law Provisions

While it may be accepted that corporate statutes can act as standard form contracts, the proposition that participants to the corporate contract are free to adopt or displace the terms provided by corporate statutes is not applicable with respect to all the provisions of the statutes. Canadian corporate statutes reflect an amalgam of mandatory presumptive and permissive provisions.[176] Under the present analysis, mandatory provisions of corporate law are non-waivable because the idea is to regulate the conduct of corporate affairs while providing protection to the shareholders against the likelihood of abuse of corporate power by those in control. The presumptive/permissive provisions perform enabling functions. Therefore, while parties can opt out of the permissive provisions, the mandatory provisions remain non-waivable and incapable of being replaced by private contractual agreements.

(a) Mandatory Provisions

Mandatory provisions define issues in corporate law that cannot be varied by the participants and direct outcomes that may not be waived by individual agreements. Under the British Columbia Company Act, there are several mandatory provisions, for example, the company's directors have a duty of loyalty and care to the corporation that cannot be altered.[177] Payout of dividend is limited by a statutory formula and directors are personally liable in negligence in making wrongful dividend payments.[178] Any shareholder who owned shares at the time of a breach of the duties of care or loyalty can bring suit against the wrongdoer on the corporation's behalf.[179] Directors of non-reporting companies shall before alloting shares offer those shares pro rata to the members.[180] A member has the right to apply to the court for relief on the grounds

176 For similar classifications, see A. Schwartz and R.F. Scott, Commercial Transactions: Principles and Policies (Mineola, NY: Foundation Press 1982) 3-5; Cheffins, supra note 9, 794.

177 S.143, B.C.C.A.

178 S.151(1)(c).

179 S.225.

180 S.41(1).

that the act or conduct of those in control of the company unfairly prejudice or affect or oppress him.[181]

Generally speaking, mandatory provisions reflect one aspect of corporate law as a device for regulating the conduct of corporate affairs. They supply minimum standards of corporate performance. Some writers have suggested that the mandatory provisions of corporate law are based on the presumption that private ordering - market contracting - is incapable of producing an entirely efficient financial contract.[182]

But if the view is accepted that the corporation comes into existence as a concession from the state and that it possesses those powers conferred on it by its charter of creation, then the existence of mandatory provisions could be justified. Being a creature of the state, it is inevitable that there should be some degree of the state's intervention in the corporate affairs either in the form of direct regulation or the facilitation of shareholder protection. Mandatory provisions prescribe rules for the orderly conduct of the corporate business. The rationale is to protect the shareholders and the investors and to achieve a certain standard for the operation of the corporate business through its regulatory functions. In effect, mandatory provisions limit the ability of the participants to customize their agreements as reflected in the Articles.

(b) Presumptive Provisions

Some corporate law provisions are enabling; that is, they supply a type of standard form contract with terms that the parties in many corporations would agree to in an environment where transaction costs were zero or negligible. Under its enabling form, corporate law supplies rules that are prescriptive in character. Some of these rules are contained in the B.C.C.A., for example, the members of a non-reporting

181 S.224.

182 For example, J. MacIntosh, "Shareholders' Appraisal Remedy in Canada: A Critical Reappraisal", (1983) 24 Osgoode Hall L.J. 201.

company may, by consent in writing, waive the requirement of appointment of an auditor.[183] Unless the Articles of a company otherwise provide, every member of a company shall have one vote in respect of each share held by him.[184] Unless the Articles require an actual meeting, any resolution of the directors or of any committee of them, may be passed without a meeting if all the directors or the members of the committee consent to the resolution in writing.[185] Unless there is a provision to the contrary in its Memorandum or Articles, a reporting company may allot and issue its shares at the times, in the manner and to the persons or class of persons the directors determine.[186]

Corporate law economists argue that the motivating reason for the rules of this character is the reduction of the transaction costs of financial contracting. The statutory standard form makes it necessary to specifically contract to a given outcome. They further assert that under this rationale, there is no reason to prevent those involved in a corporation from contracting for other rules where they consider it appropriate to do so. The enabling function of corporate law assists in the process of private ordering.

(c) Permissive Provisions

Permissive provisions govern defined corporate issues but corporate participants are permitted to adopt other rules in a specified manner. In other words, permissive provisions authorize corporations to do things they might not otherwise be able to do. Most of the examples which reflect permissive provisions also take the presumptive character of corporate law. An example of a permissive provision is that which

183 S.203(1).

184 S.185(c).

185 S.149.

186 S.41(6).

provides that every company shall have at least one director and a reporting company shall have at least three directors.[187] Another example is the one which states that a company other than an insurance company may by its articles adopt all or any of the provisions of Table A in the First Schedule.[188] Similarly, where the Articles do not provide for the election, appointment or removal of officers, the directors can do so.[189]

The aim of permissive provisions is to set out the corporate rules that may govern if the parties make no contrary agreements.

Corporate law economists argue that corporate law provisions should be permissive or optional and that the contractual theory of the corporation with its emphasis on the freedom of the parties to fashion out a corporate form of their choice implies that the state should not have a greater role in corporate governance than in other private contractual relationships.

IV. Conclusion

The corporate legal fiction remains the major legal mechanism for economic development. The reason for its significance is presumably the efficiency and flexibility of the corporation as a system for organizing aggregation and use of capital.

Corporate statutes do not merely act as standard form contracts which provide the terms that the corporate participants would have provided for in the absence of transaction costs. In fact, such statutes reflect an amalgam of mandatory, presumptive and permissive provisions. In the same vein, the statutes perform mandatory and enabling functions.

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187 S.132 B.C.C.A.

188 S.6 B.C.C.A.

189 S.157(4)(c)(d) B.C.C.A.

In its mandatory role, corporate law regulates the conduct of corporate affairs. Such regulation is designed to protect shareholders and creditors against abuse of the corporate form. This regulation continues in other laws, for example, Securities acts. Setting up regulations for the control of security issues to prevent fraud on investors are treated as regulations of business superimposed upon corporate statutes and apply to corporations.

The enabling provisions apparently facilitate the efficient conduct of business and also enhances the contractual process within the corporation.

An ideal corporate statute should provide for a simple and cheap method of incorporation and operation of the corporate organization which is flexible enough to meet the demands of diverse organizations. It should identify the duties and powers within the corporate structure, ensure that regulation to prevent abuse is appropriate and commensurate with the risk of abuse so as not to frustrate the economic and social benefits of the corporate form. The provisions should be concerned with striking a balance between the enabling use of the corporate form and regulating to prevent its abuse.

However, it should be ensured that the balance does not undermine the economic and social benefits of the corporate form.

CHAPTER FIVE

THE ARGUMENT FOR MAKING STATUTORY MINORITY REMEDIES OPTIONAL

A. Introduction and Outline:

I observed in Section III of the preceding chapter that corporate law provisions could be classified into mandatory, presumptive or permissive provisions.[190] A majority of the statutory remedies available to the minority shareholders within the corporation are mandatory in nature. This implies that neither the corporation nor the parties can waive nor displace them by alternative contractual arrangements. Amongst these remedies are the oppression remedy;[191] the derivative action,[192] and the appraisal remedy.[193] The notion that shareholders should be allowed to contract out of these statutory remedies (if they choose to) and adopt a different regulatory regime derives from the contractarian theory of the corporation which sees corporate statutes as simply providing a model or standard form contract from which shareholders may deviate as they choose.[194]

In this chapter, I will examine some of the various arguments put forward by the contractarians for optional, as opposed to mandatory, statutory remedies. Most of the justifications for optional remedies reflect the costs and disadvantages of judicial supervision of statutory remedies. Therefore, for proper evaluation of the weight of

190 For discussion of these terms, see supra, Chapter Four.

191 S.224 B.C.C.A.; S.241 C.B.C.A.

192 S.225 B.C.C.A.; S.239 C.B.C.A.

193 S.231 B.C.C.A.; S.190(1) C.B.C.A.

194 Supra, Chapter Four.

their arguments, it will be necessary for us to examine also, the opposite side of the issue:- the justifications and advantages of judicial supervision of the mandatory statutory remedies. A cost-benefit approach will be adopted in this analysis. This will enable one to make a decision on whether the benefits of judicial supervision outweigh the costs. Where this is so, then a case in favour of mandatory statutory remedies is made. The work shall be divided into three sections.

Section I examines the contractarian argument for making the statutory remedies optional. This contractarian perspective has been most forcefully advanced in a series of articles by Easterbrook and Fischel. In their view;

> "The code of corporate law is a standard form contract for issues of corporate structure. To the extent that corporate legal rules [and remedies] anticipate the desire of the contracting parties, these off-the-rack principles reduce the number of items to be negotiated and the costs of negotiating them."[195]

The contractarians argue that corporate legal rules exist simply to reduce transaction costs. Corporate law offers a model form contract; shareholders are free to buy off-the-rack. From this perspective, statutory corporate law can be seen as only a presumptive set of default rules that fill in the void where the parties have not chosen to write their own contract in more detail.

Section II examines the justification and benefits of judicial supervision of the mandatory remedies. The mandatory nature of the remedies has been upheld by the traditional corporate law -scholars who reject the contractarian perspective as oversimplified - in effect, "an interesting intellectual thought experiment that has few empirical references in the real world of complex institutional structures and high transaction costs".[196] Mandatory statutory remedies may be justified on the grounds

195 Easterbrook & Fischel, "Voting in Corporate Law", (1983) 26 J. of L. & Econ. 395, 401.

196 J.C. Coffee, Jr., "No Exit? Opting Out, The Contractual Theory of the Corporation and the Special Case of Remedies", (1988) 53 Brooklyn L. Rev. 919, 933. Prof. Brudney has also dismissed the claim that private bargaining can restrain management self-dealing and shirking as mere rhetoric. See Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract", (1985) 85 Colum. L. Rev. 1403, 1410.

that shareholders may be too dispersed to take effective coordinated action; they lack the requisite information and the necessary institutional mechanisms to bargain effectively; outside directors may be too compromised and insufficiently motivated to be effective monitors; the market forces operate at great costs and may be incapable of affording adequate safeguards to the shareholders.

Section III offers some concluding remarks. It will be canvassed that despite the costs of judicial supervision, it is still desirable to have certain mandatory, non-waivable statutory remedies available to the shareholders. Opting out of corporate mandatory rules and the remedies may have considerable implications. If corporations are allowed the freedom to opt out, this may bring significant changes to corporate life, Corporate law has never regarded the corporation as simply a private contract. Although corporate law may have moved far from the original position which saw corporations as quasi-public bodies to become a largely enabling body of law, most corporate statutes remain mandatory on a number of important points including the remedies. Such mandatory provisions are necessary to provide minimum standard of corporate conduct while at the same time, reassuring the investor's confidence in the corporation as a form of business investment.

I: Arguments for Optional Statutory Remedies:

(A) Basis for the Argument;

To help us understand the basis of the contractarian argument for optional statutory remedies we may recapitulate their propositions in the following words:

1. The corporation is an entity that serves as the centre of a complex web of contractual relationships freely entered into by the affected participants. On this premise, it will be inadequate to view the corporation as being a creature of the state in any important or fundamental basis.

2. The proper function of corporate law is simply to provide an efficient set of default rules to govern the nexus of contracts. It is desirable to have standard form boiler plate language available for adoption by the contracting parties because contracts are often costly to write and negotiate. Corporate law furnishes such off-the-shelf language.

3. Except when bad third-party effects (known as negative externalities) exist, managers and shareholders would be free to change any of the default rules by mutual agreement. And since most rules traditionally described as being within the sphere of corporate law do not involve any significant third party effects, but concern only the welfare of managers and investors, private contractual arrangements in the corporation should almost always have dominance over legal rules and remedies. This means that there should be virtually no mandatory role for corporate law.

(B) <u>The Justifications for Optional Remedies</u>

The contractarians have put forward many reasons in their attempt to justify the argument for optional statutory remedies. Some of these reasons include the following:

i. <u>Freedom of Contract Argument:</u>

One argument put forward in support of optional statutory remedies for shareholders is the freedom of contract argument. The reasoning is that the participants in the intra-corporate contract know their interests best or at least better than do public officials. Thus, where they agree to a rule governing their relationship, they think they will be better off or otherwise they would not have agreed to it. The contractarians argue that contractually created rules will tend strongly to be pareto-superior rules: such rules will make the parties better off.

Again, it is argued that where corporate contractual freedom exists, the price shareholders will be willing to pay for shares in an initial offering will generally reflect the initial provisions in the Article and the party designing the Article will take this into consideration. Provisions in the Article will consequently tend to be the efficient value-maximizing provisions. The contractarians are strengthened in their position by their perception that the corporate context is most fitting for the freedom of contract argument. The market for initial shares is viewed by them as quite competitive with many sophisticated participants and with many mechanisms that transmit and spread information.

ii. Organizational Costs of Judicial and Legal Supervision

The contractarians are further strengthened in their argument by the presumed fact that although strict corporate law may facilitate shareholder activism; the benefits of enhanced legal controls and remedies are offset by significant organizational costs. They assert that increases in the legal rights of shareholders potentially opposed to managerial prerogatives reduce the ability of managers to exercise delegated authority. At some point, increases in such constraints will reduce shareholders' wealth by stifling innovation and increasing the likelihood of opportunistic behavior by individual shareholders.[197]

iii Litigation Costs

Corporate law economic analysts who uphold the contractarian view of the corporation argue that judicial supervision of intra-corporate behavior can generate significant costs. These costs include the lawyer's fees. A shareholder

197 Baysinger and Butler in their work had gone further to argue that the provisions of stricter corporate law may allow maverick shareholders to block mergers, acquisitions, changes in the Articles of Association and by-laws or other major changes that would likely increase shareholders' wealth. See Baysinger & Butler, "The Role of Corporate Law in the Theory of the Firm", (1986) 28 J. of L. & Econ., 1982.

must invest a substantial sum of money lo build and sustain a case. High legal fees may discourage a shareholder with small investments in the corporation from pursuing an otherwise legitimate course in courts.[198]

Litigation may have other side effects. Legal proceedings can disrupt intra-corporate relationships; give rise to undesirable publicity and less of confidentiality, create uncertainty and give rise to opportunity costs since the participants have to forgo productive activities while preparing for, and appearing at court proceedings. The shareholders may therefore want to substitute a statutory remedy with a private contractual alternative arrangement. For example, they may want to substitute arbitration for the derivative action in order to protect corporate privacy. Arbitration, it is argued, is a private proceeding without public or press access and often reduces the direct or administrative costs of enforcement. However, the use of third-party arbitration in preference to judicial supervision generates its own costs which may outweigh its utility. To reduce total enforcement costs, the reduction in administrative costs must be greater than any increase in indirect costs such as the cost of increased error, bias or non-enforceability. Arbitration may work best in specialized environments such as labor law, where the arbitrators develop an acknowledged expertise, operate frequently enough to correct for bias and issue judgments enforceable by the state. It may be an inadequate dispute resolution mechanism in the corporate context.

Contractarians further argue that the minority shareholders also face a number of other practical problems when seeking damages in court to remedy the harm caused by the incompetent or dishonest management. Apart from

198 Even if the possibility of recovery of attorney's fees exists upon a successful prosecution of the case, he may yet consider that the troubles with litigation is not worth his investment in the corporation.

investing substantial sums of money to build and sustain a case, the directors control the books and records of the corporation and have been known to alter them.[199] Similarly, the directors with the benefit of hindsight may recharacterize a questionable transaction or find new and acceptable justifications for the transactions.[200]

iv Risk of Strategic and Opportunistic Behaviour

Litigation costs may have spin-off effects. They may give potential applicants an incentive to engage in opportunistic conduct "which is self interested behaviour that departs from the standard of conduct that would maximize the collective wealth of participants in a bargaining relationship".[201] A typical situation in which the risk of strategic and opportunistic behaviour is likely to arise is in connection with statutory amalgamation or merger at a premium over the market price. Corporate statutes usually require a special resolution of shareholders to approve the amalgamation transaction.[202] Unanimous consent of shareholders is not required because that may presumably create incentives for shareholders to behave opportunistically. A shareholder, even if convinced that the amalgamation is beneficial and the terms fair may decide to refuse consent. His reasoning could be that the cost imposed on all other shareholders (the premium forgone) would force the corporation to "buy" his approval with some type of side payment. Such behaviour would be

199 F. O'Neal & R. Thompson, Oppression of Minority Shareholder (2d. ed. 1985) 2-17.

200 Id.

201 Cheffins, supra, note 9 at 789. On the nature of opportunistic conduct generally, see T.J. Murris, "Opportunistic Behaviour and the Law of Contracts", (1981) 65 Minn. L.R. 521, at 522-6.

202 For example, see S.272(4) B.C.C.A.; S.183 C.B.C.A.

privately rational but wealth reducing for shareholders as a whole. In the first place, resources may be wasted in haggling over the division of gains. Secondly, value increasing transactions would be abandoned altogether or never started under a unanimity rule because of strategic power of minorities.

Contractarians argue that shareholder litigation enables a shareholder who is unable to blackmail other shareholders due to the absence of a unanimity rule to attempt to accomplish the same objective by alleging in an application that some aspects of the terms or disclosure in connection with the amalgamation are inadequate. The hope would be that the potential loss inflicted on other shareholders in the form of direct and indirect litigation costs as well as the possible loss of the premium would enable the shareholder to obtain a disproportionate share of the gains.[203]

Opportunistic conduct may also arise because the applicant's cost benefit incentives concerning litigation may differ from those of the corporation.[204] For instance, while an applicant can begin an application without substantial inconvenience, for a corporation, the litigation costs may be substantial. Where such a cost differential exists, it may cause the corporation to settle before trial for an amount that was higher than was justified by the applicant's prospect of success in the case.

v Lack of Judicial Expertise in Corporate Matters

Another argument for optional statutory remedies rests on the lack of judicial expertise in corporate matters. The corporation faces potential cost if a

203 For a discussion of the problem of strategic use of litigation in the merger context, see Fischel, "The Race to the Bottom Revisited: Reflections on Recent Developments in Delaware's Corporation Law", (1982) 76 NW. U.L. Rev. 913, 923-41.

204 Cheffins, supra note 9.

matter reaches trial. There may be possibility of error by the judge which will impose costs on the participants' bargain. The likelihood of misinterpretation is increased when it is realised that judges often have little expertise in corporate matters, which it is argued, may reduce their ability to appreciate why conduct that disadvantaged an applicant was in fact reasonable in the circumstances.

vi Problems of Generality and Statis

Legislative and judicial rulemaking may share the institutional problems of generality and statis. In other words, rules made by these institutions apply generally to the subjects of the rule and these rules remain in force even when the business environment and changing commercial world demand their reform. This argument has been applied in the corporate context by the contractarians to justify their argument for optional statutory remedies. For instance, Butler and Ribstein in one of their articles[205] point to this assertion when they stated that "even a rule that is formulated by an all-wise and disinterested policy maker cannot suit every business equally well, any more than a well-made suit is right for everybody". They added that the literature on the theory of the firm reveals a wide range of organizational corporations that need to own substantial resources or that involve complex decision processes may look very different from smaller, simpler corporations and may want to adopt very different governance structures. A remedy that is both initially perfect and suited to a particular corporation may become imperfect or unsuitable over time as a result of rapidly changing business conditions. Legislative and judicial rules tend to remain past their welcome.[206]

205 Butler & Ribstein, "Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians", (1990), 65 Washington L. Rev. 1, at 56.

206 Ibid.

vii Efficacy of the Market Forces as Adequate Constraints on Corporate Management

The call for optional statutory remedies is further predicated on the presumed efficacy of the market forces as adequate constraints on corporate management and thus, providing safeguards for the shareholders. In our previous discussions, we observed that the proponents of the economic approach to corporate law argue that the modern corporation is a competitive entity circumscribed by powerful market forces which should play a more significant role in shareholder protection than governmental intervention.[207] They argue that the managers are constrained by an identifiable network of incentive, bonding and monitoring devices to exercise their discretion in the shareholders' interests.[208] In their view, mandatory statutory remedies serve no need for shareholder protection in the light of the market constraints on corporate management.

Summary:

The foregoing discussions are some of the arguments put forward in justifying the call for optional statutory remedies. Some advocates of optional statutory remedies recognize that the mandatory statutory remedies may give the minority shareholders adequate protection against opportunistic behaviour by the controlling shareholders and directors but they assert that such protection is obtained at greater costs. The effect of making the application of the statutory remedies optional would enable the corporation

207 See supra, Chapter Three, at p.66.

208 For further discussion on the governance mechanisms in the corporations from an economic viewpoint, refer to Chapter Three.

and the participants to determine whether any particular remedy would apply to their corporation or not. This may lead to greater contractual freedom in corporate law.

However plausible the arguments for optional statutory remedies may seem; there still exists a real necessity for some mandatory statutory remedies. The necessity becomes obvious when the benefits of legal and judicial supervision of corporate affairs and conduct is juxtaposed against the arguments for optional remedies; for it will be seen that such benefits outweigh any cost which may arise from judicial supervision. This assertion leads us to an examination of the reasons and advantages of having mandatory statutory remedies available to the shareholders'and which the court are readily willing to uphold.

II: Justifications for Mandatory Statutory Remedies

There are times when the law should not yield to private ordering either because of third party effects or because of distrust of the bargain between the parties. The corporate form of organization reflects an appropriate subject for legal intervention for the protection of the minority shareholders and other investors who entrust their wealth with the managers of the firm. The intervention of corporate law statutory provisions becomes more meaningful when it is appreciated that the use of alternative mechanisms for private ordering of the corporate affairs either generate greater costs than their benefits or are not sufficient to protect the investment interests of the corporate participants.

In the widely-held corporation, the scattered shareholders may lack the requisite information and institutional mechanisms either to bargain over the terms of management's employment or to monitor and control management's activities. The 'markets' for managers and for securities may not effectively implement investor constraints on management. Outside directors may be insufficiently independent from management to serve as agents for shareholders in selecting or controlling management and too many factors, including information imperfections may affect the price of shares for it to serve as mechanism for effective shareholder impact upon managerial performance.

In the closely-held corporation, private contractual controlling mechanism may be inadequate safeguards for shareholders because of the inherent limitations of the human mind to foresee future contingencies and make adequate provisions for them in the contract. Secondly, even where the future may be predicted with reasonable clarity, there exists an added risk of opportunistic amendment of the contractual agreements by those in control. It therefore becomes necessary for corporate law to evolve adequate mechanisms for safeguarding the interests of the shareholders and other participants in the corporation. This protection is achieved by the existence of some non-waivable mandatory remedies which enable shareholders and sometimes other investors (notably creditors) to enforce a corporate right or remedy a wrong suffered by them directly or indirectly.[209]

Investor protection may therefore be regarded as an umbrella justification for the existence of some mandatory statutory remedies. But other specific reasons and advantages of judicial supervision are subsumed under this principal justification. Some of these reasons include the following:

1. <u>High</u> Transaction Costsof <u>Drafting</u>

The high costs of contracting may preclude the participants in the intra-corporate contract from writing contracts that completely define the duties of corporate managers. Identifying all possible contingencies as well as appropriate responses is

209 For example, directors owe their fiduciary duties to the corporation and not shareholders. Any breach of these duties constitutes a wrong to the corporation but shareholders may suffer a dilution of their investment interests by the occurrence of such breach. Derivative action enables shareholders to recover indirectly for any such breach. For a more detailed discussion of the derivative litigation, refer to Chapter Six.

highly impracticable because the direct costs of negotiating and drafting such contracts would be prohibitive. More importantly, the attempts to define in advance what managers should do in the light of certain contingencies may simply prove to be wrong in the light of new information and expertise. Thus, the direct and indirect costs of defining all possible future contingencies with attendant liabilities that might affect manager's decision making as well as responses to these contingencies may make defining adequate performance impossible.

Contractarians may reply that if high transaction costs deter the participants from providing adequate safeguards and remedies in the contractual arrangement, then the provisions of corporate statutes should be used as standard form contracts which provide for those terms that the parties would have agreed on; in the absence of transaction costs. In other words, that high transaction costs do not justify making the statutory remedies mandatory because those statutory remedies could more adequately be seen as off-the-shelf terms which the parties are capable of contracting out of. But this argument seems weak. If we accept the above argument, the fear is that it might lead to a midstream opportunistic amendment of the Articles or the contractual documents with the possibility of removing an otherwise adequate remedy provided for the shareholders. Thus, the existence of some mandatory non-waivable remedies remove the possibility that corporations take away those rights and powers of the shareholders which compel management to behave well in the conduct of corporate affairs.

2. Imperfect Information

Lack of adequate information by the shareholders constitutes another justification why some of the statutory remedies should remain mandatory. Shareholders may, and usually have imperfect understanding of the terms in the corporate charter or Articles of Association, of the risks that it allocates; of the differences between the charter terms that various corporations are offering or of the likely impact that a difference in terms will have on managerial behaviour. The lack of adequate information may lead to the result that participants waive or consent to the waiving of otherwise protective remedies against management misbehaviour. The minority shareholders might thus be locked up in the corporation without means of addressing conduct which appear harmful. It therefore stands to reason to assume that minority shareholders rationally, would not assent to the effective confiscation of their investments even when the parties have executed a shareholder contract in a manner that assigns the minority shareholders a minimal governance voice. What is lacking on their part, is adequate information upon which to reach a desirable contractual bargain. The directors may understand that the shareholders (more especially, those in the minority) have not entered the venture knowingly taking the investment risk that they may have to suffer the deprivation of any meaningful governance input or share in economic return because they have submitted to the exercise of an undiluted and untempered power short of fraud, misappropriation or breach of fiduciary duty.

Additionally, awareness shall extend to the fact that the brunt of economically disappointing ventures or personality mismatches or incompatible expectations is ordinarily borne by the minority shareholders. In closely-held corporations, the majority shareholders (and in the widely-held corporations - the management team in addition), are in control of the governance levers and may conscript the minority shareholders' investment to the pursuit of their expectations. Mandatory statutory remedies may therefore be essential to guard the interests of the minority shareholders.

3 Imperfections of the Market Forces as Effective Constraints

Contractarians doubt the efficacy of mandatory statutory rules and remedies to correct perceived abuses within the corporation. They argue that if any abuse is prevented or cured, it generates greater costs.[210] The operation of statutory remedies not'only give rise to direct costs, for example attorney's fees, the threat of applying them may stifle innovation and risk taking incentives (on the part of the managers) that may most efficiently, produce the goals and services that society desires.

The contractarians believe that market forces monitor management and prevent abuses more effectively than can legislators or judges (through the statutory remedies). Firstly, they argue that a competitive product market rewards efficient corporate management with greater sales and profits, while high cost management would loose profits long before corporate law fiduciary duties could operate. Secondly, the market for corporate control operates as a check on inefficient or self-dealing managers. A third market force which the contractarians assert, is superior to judicially or legislatively imposed restraints is managements' reputational stake. To enhance career mobility, it is argued that managers must cultivate reputations for efficiency. Inefficiency inherent in shirking and opportunism at the expense of the corporation imposes agency costs on managers' firms. In turn, this impugns the reputation of those firms' managers. According to contractarian philosophy, agency cost theory and the market for managers are significant regulators of behaviour within the corporate world. Making the corporate statutory rules and remedies optional, the contractarians argue, will give freer play to market forces which are 'better' regulators of conduct.

However, the market forces suffer from imperfections that make them inadequate for the protection of the shareholders. In the first place, market forces may be inadequate to deal with last period *or* one time divergencies when the agent rationally concludes that the benefits of the one time use of discretion is worth whatever penalties may be forthcoming in the employment market for the agent's services. Secondly, market forces generate great costs in their operation. Such costs

210 Anderson, "Conflict of Interest: Efficiency, Fairness and Corporate Structure", (1978) 25 U.C.L.A. L. Rev. 738, 788-89.

further reduce their efficacy as adequate safeguards against corporate management misconduct. In addition, managerial self-dealing has to become quite significant before it would justify the high cost of the market based remedy of a hostile takeover bid followed by installation of new management and might not be policied much at all in the supposed market for managers. Much lower levels of self-dealing might be remedied or deterred by statutory remedy; for instance, a derivative action for breach of fiduciary duty.

4 The Benefits of Legal and Judicial Enforcement of the Statutory Provisions

Corporate law provisions which embody the statutory remedies recognize the benefits of legal dispute resolution systems which has significant advantages over extra legal mechanisms in ameliorating the problems that give rise to intra-corporate disputes. These advantages become evident when the parties have a genuine disagreement over the meaning of key terms in the agreement. Judicial knowledge of the accumulated experience of other, similarly situated contracting parties who have grappled with analogous contingencies adds to the advantages of legal enforcement of corporate statutory remedies. Even if the state has no interpretative advantage, its ability to authoritatively resolve disputes would be a key factor in developing a cooperative equilibrium within the corporation.

Access to legal enforcement may provide a credible threat of severe retaliation should one party deviate significantly from the cooperative pattern. Scott[211] argues that without such a "large strike capability", each contracting party would be subject to the other's defection whenever the shadow of the future proved insufficient to prevent evasive behaviour.

211 Scott, "Conflict and Cooperation in Long-Term Contracts", (1987) 75 Colum. L.R. 2005, 2042-4.

The demand for a mechanism to maintain the fundamental structure of the relationship between the management and shareholders within the corporate represents a classic public goods problem. Mandatory statutory remedies make up for the minority shareholders' weaker position in the intra-corporate relationship by providing them with means of judicial enforcement of their corporate rights.

III: Conclusion:

I shall conclude the discussion on the desirability of optional statutory remedies by evaluating the arguments raised on either side of the issue. This will enable me to determine whether the continuous mandatory nature of some statutory remedies is still justified.

The use of corporate law statutory provisions to regulate the shareholder-manager relationship turns on the relative strength of markets and specific private ordering, as compared to law, in providing sufficient constraints on managers' freedom to use their position for selfish gain instead of for the benefit of all residual owners. In this regard, the contractarian view which supports opting out of the mandatory remedies stands in distinction to the more traditional coercionist or regulatory view which casts the role of law as prescribing and delimiting what shareholders and managers may do. The difference between the two views is most pronounced on the subject of mandatory legal terms and remedies.

Under the contractarian view, the law should never override the preferences of the parties stated affirmatively in their contracts (absent fraud, duress or some other common law defence). Any standard form supplied by the law shall be an option that parties can use if they want but which they are free to contract around if they prefer.

To justify their arguments, the contractarians rely on certain basic assumptions which may be characterized as follows:

1. Market forces alone are sufficient to enforce managerial diligence,
2. Legal remedies have high error rates that could make management excessively risk averse.
3. The costs of legal remedies, such as the derivative action arc unnecessarily high in comparison with remedies that could be designed through private ordering.
4. Specifically, shareholders might prefer arbitration which is a substituted remedy for derivative action to protect corporate privacy. Arbitration, it is argued, is a private proceeding without public or press access and has the advantages of lower cost, relative speed and expertise. In the same vein, shareholders might prefer buy-out agreements to the appraisal remedy which it is argued, suffers from the problems of technical and procedural statutory impairments and the cost of retaining a lawyer during the appraisal process.

Notwithstanding the contractarian arguments, the mandatory nature of some of the statutory remedies has positive net values which may outweigh the costs involved in their application. The mere existence and threat of invoking the remedies may have the effect of preventing majority shareholders and directors from engaging in conduct that will not be wealth maximizing to the shareholders. For instance, the corporate fiduciary duty provides an indispensable backdrop to corporate relationships, including protection against actions permitted by statute but nevertheless inequitable or overreaching. The breach of fiduciary duty is usually remedied by corporate action against the defaulting directors or by a derivative action in situations where those in control neglect or refuse to initiate proceedings on behalf of the corporation. The derivative action serves as a guarantee which ensures that some degree of accountability and control exists over the board of directors and senior officials either directly by allowing shareholders the right to bring an action against directors or indirectly by the threat of such an action if duties might be breached.

Mandatory statutory remedies thus, may have deterrent effects on corporate management. They are necessary to attract investors to entrust money to the common enterprise a corporation often represents. Without a non-waivable limit on the director's ability to self-deal,[212] no sensible individual would invest in an incorporated venture.

In addition, any contracting process that seeks to design a privatized substitute for the statutory remedies would have to write an extremely detailed contract and would have to develop and rely upon largely untested procedures. Such a process may involve very high information costs for shareholders and is subject to opportunistic manipulation by managers at various stages. For each procedural stage that any private contract must address, small differences in technical language could mean the difference between an effective and an illusory remedy. It may not worth the market's time to monitor these differences closely in advance of a particular transaction or event that gives them significance. Moreover, management may have little incentive to subject itself to litigation in any form because of its ability to exploit its de facto control over the process of formulating amendments to the corporation's Articles and by-laws.

In conclusion, it may be stated that the benefits of judicial supervision of corporate conduct outweighs its costs. The continued presence of shareholder litigation suggests that judicial supervision does provide a net gain for corporate participants.[213] It is therefore desirable to maintain the mandatory nature of some of the statutory remedies that are available for minority shareholders.

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212 That is, to expropriate to themselves the shareholders' contribution to the venture.

213 However, little empirical evidence exists to confirm or deny this, as research along such lines is just beginning. See Fischel & Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law", (1986) 71 Cornell L.R. 261 (studied the effects of bringing derivative actions); E. Weiss and L. White, "Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law", (1987) 75 Cal. L.R. 551 (considered the aggregate market effect of a number of significant Delaware derivative action, fiduciary duty and cash-out merger cases). See generally, Cheffins, supra, note 9 at 790.

In the next chapter, an economic analysis of selected statutory minority shareholder remedies will be undertaken.

Part Three

CHAPTER SIX

ECONOMIC ANALYSIS OF SELECTED STATUTORY MINORITY SHAREHOLDERS' REMEDIES

Introduction and Outline:

This chapter focuses on the economic analysis of selected statutory minority shareholder remedies. The remedies which will be examined are: the oppression remedy, derivative action, appraisal remedy and the winding up remedy. My primary purpose is to determine whether the presence of these remedies can be explained in economic terms which have earlier been surveyed in Chapter Three of this work. Central to this chapter is the examination of the costs and benefits of retaining these statutory remedies. It will be canvassed that in some instances the costs of applying a particular remedy may outweigh the benefits. This may necessitate the application of alternative remedies supplied either by private contractual mechanisms or by market forces. In addition, I shall examine the relationship between these remedies and the corporate structure.

In my previous discussion on the economic analysis of the closely and widely-held corporations,[214] it was observed that economic analysis suggests that the corporation is best viewed as essentially founded on private contract among the participants to the nexus of contracts and that the closely-held and widely-held corporations adopt governance and contractual monitoring mechanisms that suit their different economic structures. Shareholders in the closely-held corporation usually adopt contractual monitoring devices such as the shareholders' agreements as planning

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214 See Chapter 3 supra.

devices in dispute prevention and resolution. The widely-held corporations have a wide array of governance mechanisms that align managers' interests more closely with those of investors. For example, residual claims are freely traded and carry voting rights. This facilitates efficient risk bearing, accumulation of large blocks of shares, and transfers of control while ensuring that management teams have incentives to maximize the value of the firm. Similarly, compensation agreements link changes in managers' wealth to the performance of the firm.[215] In both corporations, while much emphasis is made on contractual devices and market forces, less reliance is placed on corporate law as a governance mechanism.

It was also observed that these contractual devices and market forces working alone cannot produce optimal governance structures. In the first place, because of inherent human limitations, it is impossible to foresee the future with reasonable clarity and the corporate contract may not fully articulate all the terms in writing. Secondly, at some point, the cost of articulating the terms will even exceed the benefits. Equally true is the fact that the market forces acting alone will not adequately produce an optimal solution to the agency problems in the corporate form of organization. Market forces may be inadequate to deal with last period or one-time divergence when the agent concludes that the benefits of the one time use of discretion is worth whatever penalties that may be forthcoming in the employment market for the agent's services.[216]

Because of these factors, some economic analysts have recognized that corporate law can play some role in corporate governance; albeit a limited one. These commentators assert that it is more appropriate to view corporate law as a standard

215 See supra notes 159-170.

216 Supra, see Chapter 4.

form contract which provides for those terms that the parties would have bargained for absent transaction costs.[217]

Modern corporate statutes provide for remedies which are available to the shareholder whenever there is an allegation of corporate wrong either to himself or to the corporation.[218] If one accepts the economic argument that corporate law is standard form contract, it then implies that the corporate statutory remedies are equally standard form contracts which provide for protection that the corporate participants would have bargained for, absent transaction costs.

Furthermore, if one agrees that these remedies can be explained in economic terms, another consideration comes to mind. The closely and widely-held corporations have different economic structures. This implies that the presence of these remedies may have different economic effects depending on the nature of the corporation.

This discussion shall be divided into four parts, reflecting the four remedies. Each part shall be divided into four sections. In Section I, a brief summary of the remedy will be undertaken. This will furnish a general background to my analysis.

Section II offers an economic analysis of the remedy. The purpose, as indicated above is to determine whether the presence of the remedy can be justified in economic terms.

Section III considers the interrelationship of the remedy and the corporate structure. My observation is that some remedies are more suited to shareholders in one type of corporation than the other, because of the nature of bargain reached among the participants in each corporation.

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217 See for example, Easterbrook & Fischel, "Corporate Control Transactions", (1982) 91 Yale L.J. 698; 702; Fischel, "The Corporate Governance Movement", (1982) 38 Vand. L. Rev. 1259; See also my discussion on Ch. 5.

218 Through the oppression remedy or the derivative action.

Section IV offers a brief concluding remark depending on the preceding analysis.

It remains to add that Chapter Six does not pretend to be an exhaustive analysis of all the issues relating to the adequacy of the statutory minority shareholder remedies. In fact, this chapter approaches the issue only from an economic perspective. The discussion extends to the next chapter where I intend to present an examination of the problems arising from the current form of the selected statutory remedies.

In selecting the above-mentioned remedies, I am not oblivious of the fact that a minority shareholder has other alternatives both under corporate and securities laws for the protection of his interest in the corporation. For instance, he may apply to the court for an order that an investigator be appointed to examine the conduct of corporate affairs. Similarly, the disclosure requirements of securities laws are provided for the protection of the uninformed investor who often turns out to be a minority shareholder.

The choice of these statutory remedies as my focus is however predicated on the fact that they constitute the most handy and readily available remedies for the protection of the minority interests. Moreover, the corporate law reform which took place in Canada in the late 1960's and the early 70's saw the introduction of these remedies as the most potent remedies in the minority shareholder's arsenal. It becomes necessary to examine the extent to which these remedies have gone in protecting the minority shareholders.

A. THE OPPRESSION REMEDY

I. General Overview of the Remedy

For many years, British Columbia was the only Canadian jurisdiction to provide shareholders with a general remedy against oppressive conduct in their corporation.[219]

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219 Companies Act, R.S.B.C. 1960, C.67, S.185.

However, beginning with the Canada Business Corporations Act in 1975,[220] the remedy has gained a much broader acceptance. It has been adopted in Manitoba and Saskatchewan,[221] and other jurisdictions as well.

Under these Corporations Acts, an oppression remedy is provided for any member for even a single act or course of conduct of the directors or those in charge of the corporation which oppresses him or unfairly prejudices or, in some statutes,[222] unfairly disregards his interests in the corporations. The parties whose interests are protected by the remedy include most of the groups directly concerned in the corporation; all the statutes permit complaints to be brought not only by shareholders but by anyone else whom the court considers proper. This may include directors, officers or potential creditors of the corporation. The Canada Business Corporations Act specifically includes not only the security holders, directors and officers, whether present or former, but also any person who, in the discretion of the court is a proper person. The British Columbia Company Act does not name any group other than beneficial owners of shares and any other person who, in the discretion of the court is a proper person.

The circumstances complained of need not amount to a continuous course of conduct but include isolated actions. In addition, a shareholder can bring an action under the remedy in respect of merely threatened or proposed acts of oppression.

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220 Canada Business Corporations Act, S.C. 1974-75, C.33, S.234.

221 Business Corporations Act, S.M. 1976, C.40 (continuing Consolidation, C.(225), Business Corporations Act, S.S. 1977 C.10. Today, in British Columbia, the remedy is provided under Section 224, B.C.C.A. See, also S.241 C.B.C.A. for similar provision. In Britain, it is provided under Sections 459-461 of the British Companies Act 1985; Nigeria in Sections 310-313 of the Company and Allied Matters Decree 1990. In the United States, some states do not have any direct equivalent of the oppression remedy but Rule 10b-5 of the U.S. Securities and Exchange Commission Act 1942 enables shareholders in some corporations to obtain a remedy for conduct that would arise under the oppression remedy in Canada.

222 C.B.C.C., S.241. Also provided under the Manitoba and Saskatchewan Acts.

The current form of the remedy in all jurisdictions provides the court very wide discretion to rectify the matters complained of.[223]

Leave of the court is not required before the applicant can initiate proceedings under the remedy, provided that he comes within the group of potential applicants.

The remedy applies to a wide variety of situations in both the closely and widely-held corporations. It could apply where the directors of a corporation unfairly withhold dividends which are otherwise available for distribution in the form of profits.[224] Similarly, a member can apply for relief under the remedy where the directors allot shares at a time when it would be financially impossible for him to take up the issue, with the sole purpose of effecting the dilution of his interests.[225]

II. Economic Analysis and the Oppression Remedy

One of the main assumptions of economic analysts is that absent transaction costs, minority shareholders would bargain for protection against oppressive conduct and unfairly prejudicial acts by the majority shareholders and those in control of the corporation. It stands to reason to assume that minority shareholders rationally, would not assent to the effective confiscation of their investments as part of their involvement in the corporation. On this basic premise, the presence of the oppression remedy in the corporate statute may be justified. It provides the participants (and more especially the minority shareholders) with a term they would have articulated absent transaction costs.

The presence of the oppression remedy calls for judicial supervision and enforcement of corporate rights. This generates its own costs which include the

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223 B.C.C.A. Section 224(2); C.B.C.A. Section 241(3).

224 Re Ferguson and Imax Systems (1983) 43 O.R. (2d) 128.

225 Browning v. C&C Plywood (1967) 434 P. 2d. 339 (S/C Oregon).

financial expense involved in retaining a lawyer and the social side effects of litigation.[226] Where these costs are relatively high, a potential applicant may engage in opportunistic conduct which involves the pursuit of selfish motives that run contrary to an ideal standard of behaviour necessary for maximizing the collective wealth of all participants. In the context of the oppression remedy, the potential for opportunistic conduct is high because the applicant's cost-benefit incentives regarding litigation may differ from those of the corporation's while an applicant can begin an application without substantial inconvenience, the litigation costs may be substantial for the corporation. The existence of such a cost differential may cause the corporation to settle before trial probably for an amount that was higher than was justified by the applicant's prospect of success in the case. Knowledge of this possibility may give the applicant an incentive to commence an application.[227] Apart from the risk of strategic and opportunistic behaviour, other costs which may diminish the effectiveness of a judicially supervised oppression remedy include; the organizational costs of judicial supervision, and lack of judicial expertise in corporate matters.[228]

Notwithstanding these costs, it is assumed that the benefits of judicial supervision outweighs the costs. This does not however conclude the analysis in favour of an open ended statutory oppression remedy as currently contained in the corporate statutes because an alternative would have been to expressly provide for the types of conduct which would give rise to an action under the remedy. Prior to the introduction of the current form of oppression remedy in Canadian corporate law, minority shareholders were protected by specific statutory provisions and by fiduciary duties. Those responsible for corporate law reform however felt that the combination "created

226 See supra note 214 and subsequent paragraphs.

227 Cheffins, supra, note 9 at 790.

228 See the discussion in Chapter Five for details.

substantial uncertainty and provided at best, erratic protection for minority shareholders".[229] Emphasis was--shifted to the oppression remedy (amongst other remedies) to aid minority shareholders. In cases where the classification of the instances which would give rise to oppressive conduct is impossible because of unforeseen future contingencies, parties *to* contracts will usually leave terms imprecise, thereby instructing the dispute-resolver to construe the contract equitable. The presence of an open-ended standard term suck as the oppression remedy can be justified on this basis.

The dispute resolver of intracorporate disputes are the courts. Any economic justification for the presence of the oppression remedy is highly dependent on the ability of the court to correctly interpret the provisions in a manner that reflects the parties' bargain. This implies that economic theory suggests that in applying the oppression remedy the court should focus on the content of the agreement between the participants, both in relation to express clauses and what the agreement would have been, in the absence of transaction costs. Participants in the corporation would gain more from the addition of the oppression remedy to corporate law if the courts can conveniently do this.

However, difficulties may arise where the matter upon which the court is called to interpret is not covered in the contractual agreement. A plausible approach to the problem would be to begin by determining the issues that the parties had agreed on but had not included in the agreement because of transaction costs. Such terms would be treated in the same manner as an expressly provided term. Where the parties had not agreed on the matter in question, the ideal approach would be to consider the matter in terms of a hypothetical bargain. Where such is the case, the nature of the corporation and the circumstances under which the applicant became involved in the business might

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229 Cheffins, ibid.

provide some assistance. Provided the structure of the corporation is fully appreciated, there should be little difficulty in determining whether or not in a given situation an applicant has been subjected to oppressive conduct. Although the expectations of a shareholder cannot be confined into a straightjacket, the two dominant characteristics of the interests of a shareholder in a corporation are the ability to monitor the affairs of the corporation and the expectation of a return on his investment. When these have been infringed without good business justifications,[230] this may constitute prima-facie evidence of oppression.

III. Inter-relationship of the Oppression Remedy and the Corporate Structure

The closely and widely-held corporations manifest different economic structures. This implies that the application of the oppression remedy may be more suited to the shareholders of one corporation than the other. Indeed, some writers have suggested that the remedy should not be available to the shareholders of widely-held corporations.[231] In the United States, the remedy is limited to corporations with a specified number of shareholders.[232] No Canadian corporate statute contains such limitation and there are case laws where relief have been granted under the remedy in widely-held corporations.[233] However, the Dickerson Committee suggested that the

230 This is in recognition of the fact that the withdrawal of dividend payment-per se is not evidence of oppression. Directors may decide to re-invest profits into the business instead of declaring dividends. Contrast: Devall v. Wainwright Gas Co. Ltd. (1932) 1 W.W.R. 281 with Re: Ferguson & Imax Systems (1983) 150 D.L.R. 3d 718.

231 See, for example, Buckley & Connelly. Supra note 101 at 611-12, 677-8 of first edition.

232 For example, the Minnesota and North Dakota legislation limit the application of the remedy to corporations with less than 35 shareholders.

233 For instance, see Sparling v. Javelin Int'l Ltd., (1986) RJQ 1073 (Que. SC), Palmer v. Carling O'Keefe Ltd., (1989) 67 OR 161 (Ont. Div. Ct.) Alexander v. Westeel-Rosco Ltd. (1978) 22 OR (2d) 211.

remedy would be of most use in the closely-held corporations. Academic opinion is in support of this view and there are judicial pronouncement to the same effect.[234]

To determine what economic analysts has to say about the oppression remedy and the type of corporation, the identification of the interests of the shareholders and the nature of the bargains reached in the closely and widely-held corporations is necessary.

A closely-held corporation is usually formed or continued on the basis of a personal relationship involving mutual confidence. There is usually an agreement or understanding that all or some of the shareholders are to participate in the conduct of the business. Restrictions on the transfer of shares is the rule rather than the exception. The members often make relatively substantial capital contributions to the corporation. Shareholders in such corporations are a small close-knit group involved in the day to day operation of the business and financially and personally committed to the corporation. These identifying features suggest that shareholder interests in such corporations lie in four main areas:

1. in employment and participation, given their close involvement with the corporation;
2. in the status quo, in order to protect the basis on which the business has been set up;
3. in the proper conduct of the corporation%affairs, in order to ensure continued goodwill among the parties and the prosperity of the business;
4. in their financial position, given the commitment of their personal resources to the corporation.

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234 Prentice, supra, note 101, 59-60, Hannigan, "Section 459 of the Companies Act 1985 - A Code of Conduct for the Quasi-Partnership?", (1988) Lloyds Mar. and Comm. Law Q 60, 62-64. See supra, note 13 for judicial pronouncements.

On the other hand, the interests of shareholders in the widely-held corporation are quite different and considerably more restricted. There is usually no underlying personal relationship and employment is rarely an issue. Generally, the relationship is a much more commercial one, with shareholders interested in such matters as dividend yield, capital appreciation and possible takeover bids and less concerned with the day to day running of the corporation.[235]

Moreover, while there is generally a liquid market for shares in widely-held corporations, it is often difficult to find a buyer for shares in a closely-held corporation especially when a minority interest is involved.[236] One important effect of this is that absence of liquid market negates the ideas of reliance on the stock market as a monitoring device. The takeover mechanism which helps to align management interests with that of the shareholders has no application to the closely-held corporation. In the widely-held corporation, the market for corporate control creates great incentives for management to maximize the welfare of the shareholders. Incumbent managers acknowledge that they will be subjected to a control contest if they do not act in the shareholders' interests. This knowledge induces them to behave appropriately. Managers and those in control of the closely-held corporation have little reason to be concerned about being displaced by outsiders regardless of the manner in which the business is carried on.

Another important effect of the lack of market for the shares of closely-held corporations is that a minority shareholder does not have an effective exit option. Minority shareholders seeking to sell their shares will not be able to find bidders.

235 This does not imply that all the shareholders are not interested in the management of the corporation. Indeed, institutional shareholders and other shareholders with large shareholdings are as much concerned as shareholders in the closely-held corporation about management matters. However, a large proportion of the shareholders usually have little stakes and therefore no identifiable management interests.

236 See supra, note 111.

Frequently, the only buyer is the majority who will have no incentive to purchase the shares at a price greater than the discounted value of the future stream of payments to which the minority is otherwise entitled. In contrast, as long as there is a market for the shares, a dissatisfied shareholder in a widely-held corporation can obtain the full value of his shares by selling them on the stock exchange.

Given these factors, a minority shareholder in the closely-held corporation has a greater incentive than his counterpart in the widely-held corporation to contract for protection. Some of these protection are contained in the shareholder agreements.[237] In the same vein, buy-sell agreements provide exit option for them. However, these agreements are not often fully articulated because the costs of contracting will at some time exceed the benefits.

Under economic analysis, this is an ideal situation for the application of oppression remedy since it will provide a remedy for conduct that breaches the agreement that the participants would have reached, absent transaction costs. Also, in the widely-held corporation, the bargain between shareholders and the corporation is not fully committed to writing because of transaction costs. The likelihood of self-interested opportunistic conduct continues to exist despite the market for corporate control, the market for managerial talent and internal and external monitoring.[238] This indicates that the oppression remedy should be as important for widely-held corporations as for their closely-held counterparts. However, minimal role is assigned to the remedy in the widely-held corporations under economic analysis. This attitude is predicated on two reasons.

The first reason is premised on ex ante compensation of shareholders. The reasoning here is that shareholders in widely-held corporations will have been

237 See supra, note 119 for usual contents of the shareholders' agreements.

238 See supra, Chapter 3, Section III.

compensated ex ante against the possibility of wealth reducing conduct by those in control of the corporation. This ex-ante compensation is reflected in the price which the shareholders pay for the corporation's shares at the time of initial offering. Under economic analysis, the efficient capital market hypothesis teaches us that the price of a corporation's shares reflects all important public information concerning the corporation. On this level, shareholders would be taken to have consented to any self-serving conduct by the managers, hence the payment of a low price for the corporation's shares. Any investor buying shares in a corporation with poor or dishonest management should not complain about subsequent misconduct, as he was compensated ex ante by lower share prices.

The second reason is premised on diversification of investments, the purpose of which is to reduce loss arising from unsystematic risk.[239] Modem investment portfolio theory teaches individual and institutional investors to diversify their investments in many corporations. While an investor may lose by virtue of some unsystematic risks, he should gain from the superior performance of other corporations in his investment portfolio. The method in which a particular corporation is run should therefore be of little concern to the shareholders; what they lose from some corporations, they should gain from others.

The combined effect of these two reasons is that the conduct of those in control of the widely-held corporation will be of no concern to its shareholders. This implies that legal restraints on such conduct, such as the oppression remedy has little purpose in widely-held corporations.

239 Unsystematic or company specific risks are those tied to a specific corporation. Systematic or market risks are those that cause the securities of all corporations to move in the same direction. See MacIntosh, supra, note 387, 210-211.

Economic analysts however, accept that legal rules *can* be used in widely-held corporations ***to*** restrain one-time divergencies by those in control of the corporation. Such conduct is assumed to be wealth reducing.

IV Conclusion

The oppression remedy accords significant protection for the interests of minority shareholders. It would be possible for a shareholder to provide either in the corporation's Articles or in a shareholders' agreement for adequate protection but the possibility of such is hindered by transaction costs of drafting a lengthy contract, coupled with the inability of the parties to sufficiently provide for all future contingencies. The inclusion of a broad and open-ended oppression remedy therefore fulfills the need for protection by providing for the minority shareholders what they would have bargained for in the absence of transaction costs. In interpreting the remedy, the court have a role to play in filling the void created by any corporate contracts. In realization of this need, Hoffmann, J., noted in Re: Posteate & Denby (Agencies) Ltd.[240] that the oppression remedy enables the court to give full effect to the terms and understanding upon which the members of the corporation became associated, but not to rewrite them.

Where this is the case, the nature and structure of the firm should provide guidance as to how internal disputes should be settled. And, given the nature of the bargains reached by the shareholders in both the closely and widely-held corporations, a strong argument can be made that the oppression remedy ought to be limited to the closely-held corporations.

240 (1987) B.C.L.C. 8, at 14.

B. THE DERIVATIVE ACTION

I. General Overview of the Remedy

Where a Corporation has been injured by some wrongdoing, a shareholder of the corporation arguably also has been injured through the diminution in value of his or her shares that is traceable to the corporate injury. Responding to the problem, the courts, followed by the legislatures, developed the derivative action whereby a shareholder was permitted to bring an action to rectify a wrong committed against the corporation for which management did not seek redress, often because they or one of their members were the alleged wrongdoers. Under the derivative action, a shareholder brings an action on behalf of the corporation.

Today, most jurisdictions contain detailed provisions for the derivative action in their corporation statutes.[241] Under the British Columbia Company Act, a member[242] or director of the company, subject to four grounds being established, may with the leave of the court bring or defend an action in the name and on behalf of the company. Such action may be brought to enforce any right, duty or obligation owed to the company that could be enforced by the company itself or to obtain damages for any breach of any such right, duty or obligations. The four qualifications are that:

(i) he has made reasonable efforts to cause the directors of the company to commence or diligently prosecute or defend the action;

(ii) he is acting in good faith;

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241 For example, B.C.C.A., S.225, C.B.C.A. S.239.

242 Under the C.B.C.A., the action is available to a complainant which is defined in Section 238 as meaning (a) a registered holder or beneficial owner and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates; (b) a director or an officer or a former director or officer; (c) the Director; or (d) any other person who in the discretion of a court is a proper person to make an application.

(iii) it is prima facie in the interests of the company that the action be brought or defend; and

(iv) in the case of a member, that he was a member of the company at the time of the transaction or other event giving rise to the cause of action.[243]

Under the derivative action provisions in most corporate law jurisdictions, a paramount role is given to the court. For instance, while such action is pending, the court may give directions for the conduct of the action and order that the corporation pay the interim costs of the persons controlling the conduct of the action.[244] Similarly, no action brought or defended under the section can be discontinued, settled or dismissed without the approval of the court.[245]

The orders that the court could make are wide including an order authorizing the complainant or any person to control the conduct of the action.

Where provision is made for a statutory derivative action, it is the usually exclusive method by which a shareholder *can* vindicate corporate rights.[246]

II. Economic analysis of the Derivative Action

A central concept in modem institutional economics is that of "agency *costs*" which refers to the costs that shareholders must incur to hold their management accountable. Corporate law as applied to widely-held corporations, builds on the assumption that share ownership is separate from control. The shares of most widely-held corporations are widely dispersed and managers tend to own relatively small

243 The C.B.C.A. does not contain this fourth qualification.

244 S.225(4) B.C.C.A.; 5.240 C.B.C.A.

245 S.225(6) B.C.C.A.; S.242(2) C.B.C.A.

246 See Farnham v. Fingold (1973) 2 O.R. 132; 135 (C.A.).

percentages of the shares of corporations that they control. Given the separation of management from ownership in widely-held corporations, the agency theory assumes that the managers may sometimes find it possible and profitable to divert income or assets from the corporation to themselves or engage in other forms of self-opportunistic behaviour which is not wealth maximizing for the shareholders.

The separation of control from ownership thus demands a system of accountability and monitoring to ensure that managers act in the interests of the shareholders. Shareholders seek to limit these possibilities of self-seeking conduct by a variety of private contractual control mechanisms which include internal and external monitoring and incentive compensation. In addition, market forces which include the market for corporate control act as constraints on corporate management. The stock market also penalizes the manager to a limited degree by discounting the value of the corporation's stock if it believes repetition of the misconduct is likely.

However, none of these techniques is costless. The high costs of contracting preclude writing contracts that completely define the duties of corporate managers. Identifying all possible contingencies as well as appropriate responses is highly impractical because the direct costs of negotiating and drafting such contracts would be prohibitive. More importantly, attempts to define in advance what managers should do in light of certain contingencies may simply prove to be wrong in light of new information and expertise. Thus, the direct and indirect costs of defining all possible future contingencies that might affect the manager's decision making, as well as responses to those contingencies, make defining adequate performance impossible.

In addition, internal and external monitoring is cost efficient only up to the point that additional expenditures spent on monitoring avert a greater discounted loss in the future. Further expenditures on loss prevention would not be rational if the cost of detection or enforcement will exceed the additional loss prevented. As a result, there is always a minimum level of exposure to losses caused by managerial misbehaviour that rational shareholders must accept. This level is called the corporation's "agency cost".

No single corporation's agency costs can be specified with precision. The result is that the stock market has imperfect information regarding the true agency cost of each corporation. Potential shareholders would be unable to differentiate among corporations in terms of the relative likelihood that their managements will misbehave in the future. They will to a degree treat both good and bad corporations alike. This implies that even the shares of corporations whose managements have not misbehaved will be discounted and some shareholders may suffer to the extent that their corporation's stock is excessively discounted because the average agency cost exceeds the "true" agency cost applicable to their corporation.

Thus, an economic justification for the presence of the derivative action is that it reduces average agency costs. Because shareholder coordination is not necessary in the case of the action, its availability economizes on costs that otherwise would be necessarily incurred if shareholders were required to take collection action. For example, the costs incurred when a plaintiff in a derivative action obtains an injunction would likely be far less than those that shareholders would have to incur to organize a proxy fight.

Similarly, in jurisdictions which allow the plaintiff's counsel to be compensated only to the extent that he is successful,[247] the cost of wasted efforts is not directly borne by shareholders. On this basis, the derivative action represents an efficient solution to the organizational problem that would otherwise arise were it necessary to allocate the costs of opposing management proportionately among all shareholders,

Moreover, the law applicable to derivative actions gives the court the discretion to make an order both while the action is pending and on a final disposition of the case,

247 Most jurisdictions in the United States allow this practice.

allowing the plaintiff's legal fees to be paid by the corporation.[248] The practical effect of this rule is to create a mechanism that taxes the legal costs proportionately among all shareholders thereby ensuring that no shareholder is able to "free ride" on the efforts of another.

Another important use for derivative suits is to protect the market for corporate control when confronted with a hostile tender offer, target corporation management often resorts to various devices to thwart the bid, consequently denying shareholders a profitable opportunity. Whether this conduct is in the best long-term interest of the corporation is debatable, but who bears the immediate cost and who reaps the short-term benefits is clear. The availability of shareholder derivative action may curtail the ability of target managers and target boards to defeat a tender offer by manipulating the corporate machinery. Although shareholders have, in the past, unsuccessfully challenged the devices employed by target management to block hostile tender offers,[249] the courts have not been unresponsive to the plights of the shareholders.[250]

Derivative action represents a cost-effective means of deterring opportunistic behaviour by agents, particularly in the case of non-recurring "one shot" transactions that the market cannot be expected to discipline effectively. In addition, a successful derivative action has the potential of increasing the value of the corporation's equity for two reasons. First, in most derivative actions, money is in dispute. Presumably, if the plaintiff succeeds, the money flows back into the corporation and be claimed by its equity holders. Secondly, since the potential of a derivative action deters managerial

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248 See B.C.C.A. S.225(4)(b) and (5)(b); C.B.C.A. S.240(d).

249 See, for example, Data Probe Acquisition Corp. v. Datatab Inc. (1983) 722 F.2d 1; Panter v. Marshall Field & Co. (1981) 454 US 1092.

250 In Norlin Corp., 744 F.2d 264, the court held that once a prima facie showing is made that directors have a self-interest in a particular corporate transaction, the burden shifts to them to demonstrate that the transaction is fair and serves the best interests of the corporation and its shareholders.

malfeasance, a successful action improves the extent to which the corporation is run in the interests of its shareholders. A successful action puts the corporation's management on notice that they are being monitored more closely and this monitoring aligns managerial behaviour with shareholder interests.

However, the foregoing benefits do not suggest that the derivative action does not generate its own costs. As with other liability rules, the derivative action has costs associated with its use. The most significant of these costs is the risk of strategic and opportunistic behaviour by minority shareholders. Shareholders with little investments can bring derivative actions on behalf of the corporation. Because of his small stake in the corporation, the applicant or his counsel may have little incentive to consider the effect of the action on other shareholders, who ultimately bear the costs. Where the action appears to be a positive net value project because of the possible recovery of attorney's fees, an attorney may pursue it regardless of its effect on the value of the corporation.

Another cost generated by the derivative action is the chilling effect it imposes on sensible risk taking. Derivative actions discourage risk taking by managers. Managers have a tendency to avoid risk because they cannot diversify the value of their human capital. Shareholders, however, can better diversity risk because of their access to capital markets. Therefore they want to create incentives for managers to accept all positive net present value projects, even those that are risky. However, risky projects can have poor outcomes; if managers are sued whenever decisions that were optimal ex ante turn out poorly ex post, they will tend to avoid risky projects. This result may not be wealth maximizing for the shareholders.

The problem of error cost similarly discourages risk taking by managers. Courts may have great difficulty in measuring manager's efforts or output. Because most law suits follow poor outcomes, courts may tend to assume that such outcomes are a product of bad actions. This results in the reinforcement of manager's tendency to avoid risk, which may not be in the interest of most shareholders.

In addition, derivative suits may reduce net shareholder wealth. The litigation costs imposed on the firm may well exceed the damages awarded even in successful actions. Some derivative actions are based on public policy issues and if won, will reduce shareholder wealth. For example, actions motivated by environmental concerns or brought to halt the payment of bribes to foreign officials would, if successful, undoubtedly decrease the wealth of the corporation's equity holders. However, because most shareholders hold a portfolio of securities, the fact that the costs in an individual derivative action may exceed the recovery to the corporation is not necessarily adverse to their interests, if there is a generic benefit to their broader interests as diversified shareholders in the form of enhanced deterrence against unfair self-dealing.

On a balance, it may be asserted that shareholder litigation as represented by the derivative action profoundly affect the conduct of corporate managers. Although the system of corporate governance is not costless, its benefits are quite immense.

III. The Derivative Action and the Corporate Structure

To enable one to determine what economic analysis has to say about the relationship of the derivative action and. the corporate structure, it will be useful to examine the nature of the interests and bargains reached by the shareholders in both the closely ana widely-held corporations. This exercise has been undertaken earlier in Section II (Part A) of this chapter, when the relationship between the oppression remedy and the corporate structure was examined. Suffice it to say that while a closely-held corporation is usually formed or continued on the basis of a personal relationship involving mutual confidence and understanding that all or some of the shareholders are to participate in the conduct of the business, the interests of shareholders in the widely-held corporation are quite different and considerably more restricted. In addition, while there is generally a liquid market for shares in widely-held corporations, it is often difficult to find a buyer for shares in a closely-held corporation, especially when a minority interest is involved.

In some circumstances, in closely-held corporations, the normal policy reasons for requiring a plaintiff to employ the form of the derivative action may not be present or will be less weighty, even though the action alleges in substance a corporate injury. A closely-held corporation is often treated as essentially an incorporated partnership with each shareholder retaining the right to sue individually to rectify wrongs to the corporation.[251] On the one hand, the likelihood of a disinterested board is far smaller in such corporations because the majority shareholders are likely also to be the corporation's managers. Similarly, the concept of a corporate injury that is distinct from an injury to the shareholders approaches the fictional in the case of a corporation with only a handful of shareholders. In addition, the typical procedural rules applicable to derivative actions often make little sense in the context of a dispute between persons who are effectively incorporated partners. These rules originated in the United States and were essentially designed to protect widely-held corporations against strike suits and frivolous actions by plaintiffs holding only a nominal interest in the corporation. In Watson v. Button[252] the court found that the usual policy reasons that require an action principally alleging an injury to the corporation to be treated as a derivative action are not always applicable to the closely-held corporation.

Apart from policy considerations, the presence of an open-ended oppression remedy constitutes another reason why the derivative action may be of little concern to minority shareholders of a closely-held corporation. Facts giving rise to wrongs to the

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251 For example, Donahue v. Rodd Electrotype (1975) 367 Mass. 578, 328 N.E. 2d 505.

252 (1956) 235 F.2d 235.

corporation, such as breaches of fiduciary duties owed by directors, can often be the subject matter of an oppression remedy as well as a statutory derivative action.[253] An applicant seeking to bring a derivative action must satisfy a number of statutory prerequisites and must obtain the leave of the court before proceeding. No such prerequisites exist with the oppression remedy and leave is not required to bring an application. Moreover, the remedies available are much broader under the oppression remedy.

The above reasoning suggests that the derivative action may be a more ideal remedy for the protection of minority shareholders in the widely-held corporation. The widespread ownership structure and the separation phenomenon which exists in the widely-held corporation makes the derivative action an effective system of policing the board of directors. It ensures that some degree of accountability and control exists over the board of directors and senior officials either directly by allowing shareholders the right to bring an action against directors or officials if they have breached their duty or indirectly by the threat of such an action if duties might be breached.

However, some economic analysts do not go this far.[254] They believe that the derivative action is relatively unimportant in providing desirable management behaviour and in reducing agency costs. They maintain that the derivative action fail for several reasons: the threat to an otherwise valuable relationship, the chilling effect of derivative actions on sensible-risk taking and the existence of less costly alternative methods of assuring proper conduct. Contractual and market based governance mechanisms are believed to be more effective means of protecting minority shareholders.[255] For instance, the market for corporate control is believed to provide

253 For example, Sparling v. Javelin Int'l Ltd. (1986) R.J.Q. 1073, Re: Peterson and Kanata Invs. Ltd. (1975) 60 D.L.R. 3d 527.

254 See, for example, Fischel & Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis", (1986) 71 Cornell L. Rev. 261.

255 For a more detailed discussion of these governance mechanisms, see Chapter 3.

managers with an incentive to perform well and thus keep share prices high, as well as a device for displacing management teams who perform poorly. Similarly, managerial performance is subjected to internal and external monitoring. Such arrangements is believed to reduce the probability of managerial misconduct. In addition, emphasis is placed on executive compensation agreements which are often structured in a manner that presumably solve most of the conflicts between managers and shareholders. Product market competition may force managers to maximize the profits of the corporation.

Furthermore, the availability of an exit option enables dissatisfied shareholders to liquidate their investments and re-invest same in other corporations which they believe that are more efficiently managed. The existence of these alternative corporate governance mechanisms implies that liability rules such as the derivative action has little purpose in widely-held corporations.

Economic analysts however, do not completely write off the utility of the derivative action in the widely-held corporations. They recognize that it plays some role in deterring large one-shot frauds. If there were no such thing as a derivative action,[256] managers could decide, at least in theory, to distribute all of their corporation's assets to themselves. They also recognize that the derivative action plays a useful role in deterring other egregious derelictions by corporate managers.

IV Conclusion

Derivative actions assist in maintaining the efficiency of an economic system. The availability of the recourse is essential if management's fiduciary obligations to its shareholders are to constitute more than a precatory body of law. But it must be recognized that the derivative action is neither the initial or primary protection for

256 Ignoring here the role of criminal law.

minority shareholders against managerial misconduct. A variety of contractual and market forces also operate to hold corporate fiduciaries accountable: internal and external monitoring; compensation agreements; the disciplinary power of the market and shareholder voting - all these mechanisms and the regulatory authority of governmental agencies would constitute significant protections in the absence of private litigation. Even if dissatisfied shareholders had no other recourse than to sell their shares, such action taken collectively, might also inhibit managerial overreaching, to the extent it depressed the value of the corporation's shares.

However, no single technique of accountability is likely to be optimal under all circumstances. Each has its characteristics and limitations. Shareholders would be better served by an overlapping system of protections when properly structured. The derivative action could enhance the capabilities of these other remedies of accountability by

(i) ensuring a measure of judicial oversight,

(ii) providing a remedy that does not depend upon the ability of widespread shareholders to take coordinated action, and

(iii) protecting the free functioning of the market for corporate control by subjecting to a measure of judicial review improper actions intended to prevent a change in control.

Moreover, derivative action may offer the only effective remedy in those situations where a control group has the ability to engage in self-dealing transactions with the corporation.

The minority shareholders of closely-held corporations may have little need for the protection offered by the derivative action. In the first place, the oppression remedy covers most types of conduct which could be appropriate subject matters of a derivative action. Minority shareholders might prefer seeking relief under the oppression remedy because of the broad remedies available and absence of statutory pre-requisites for the initiation of proceedings. Secondly, most of the policy reasons for requiring a plaintiff to employ the form of the derivative action may be lacking in the case of a closely-held corporation. This line of reasoning suggests that the derivative action may be more suited to shareholders of widely-held corporations.

C. THE APPRAISAL REMEDY

I. General Overview of the Remedy

Of central concern to any minority shareholder would be the many and varied changes which occur in the corporation. Certain changes not only change the structure of the corporation and the nature of investment in it, they also radically alter an individual shareholder's position. Legitimate business expectations may be frustrated, the shareholder may be squeezed out, in that his personal interest in the corporation is made less desirable by management or majority shareholder design, he may be "locked in" by destruction of the market for the company's shares; he may be expropriated by statutory procedure; he may suffer adverse income tax consequences.

By the old rules of common law, corporations were viewed through the jurisprudential prism of partnership. Unanimity was required for all fundamental corporate changes.[257] Within the limits of business risks, investment in corporate enterprise was antecedently known and certain in that the enterprise could not change without the shareholder's approval. The unanimity rule vested in each shareholder a veto power over decisions to change the corporation fundamentally. But the necessity for corporate flexibility in adapting the enterprise to changing fortunes or business conditions eclipsed that avenue of shareholder protection. Such changing environments may demand an internal recasting of the capital structure of the enterprise, perhaps

257 Laltin, "Minority and Dissenting Shareholders' Right in Fundamental Changes, (1958) 23 L. & Contemp. Prob. 307, 308.

including an alteration of the relative rights of outstanding securities, or the addition or even elimination of a class of securities. Business conditions may also dictate a rescaling of the enterprise either by corporate combination or by increase or reduction in the size or scope of the enterprise.[258]

Minority shareholders would want to protect themselves against being forced to participate in ventures beyond their initial contemplation; that is, to continue to invest in an enterprise that has altered its character in some material respect from the investment initially contemplated.

Appraisal remedy represents the right of a shareholder to require the corporation to purchase his shares at an appraised valueif the corporation takes certain triggering actions from which he dissents.[259] The appraisal right tries to mitigate the risk of hardship or injustice to minority shareholders. It works as a device to reconcile the majority's need to adjust to changing economic conditions with the right of the members of the minority to refuse to participate in ventures beyond their initial contemplation. Such a right of appraisal is intended to avoid the common law difficulties of trying to restrict an abuse of power detrimental to minority shareholders by the directors or by majority shareholders where shareholder approval is required.

Corporate law statutory provisions authorize a shareholder who dissents from a triggering transaction in the proper manner and time to demand that the corporation purchases his shares at their fair value.[260] The right arises only in situations involving major structural changes often described as fundamental corporate changes and while the enterprise is a going concern.

258 MacIntosh, "Shareholders Appraisal Rights in Canada", supra, note 9.

259 J.S. Ziegel, Daniels, Johnston & MacIntosh, Cases and Materials in Partnerships and Canadian Business Corporations (2d. 1989) 1143.

260 Section 231 B.C.C.A.; Section 190 C.B.C.A.

If the shareholder and the corporation cannot agree on the price, the statutes make provision for judicial appraisal of the shares to determine their prices.[261] Where the action to which exception is taken does not fall under one of the events triggering the appraisal remedy, the shareholder can sometimes bring an action for relief from oppression or a derivative claim.

II. Economic Analysis of the Appraisal Remedy

The appraisal right may be seen as a trade-off for the loss of individual veto rights which shareholders had when fundamental corporate' transactions required unanimous approval. The exit option provided by appraisal rights supplements the requirement of super majoritarian ratification through a special resolution.

But it cannot be assumed that the existence of an appraisal remedy will always increase the value of investments. The exercise of the right of appraisal generates its cost. Because dissenters have the right to demand that their shares be purchased by the corporation, they have the right to withdraw capital from the corporation. This may force the corporation to sell organization-specific assets at distress prices or incur flotation and related costs to raise new capital.[262] A relatively modest number of shareholders claiming the appraisal remedy may constitute a severe economic threat to the corporate enterprise. A sudden and largely unpredictable drain may be imposed upon a corporation's cash position if some shareholders go the appraisal road. This demand for a cash payout to the shareholders may come at a time when the enterprise is in need of every liquid dollar it can put its hand on.

261 Section 231(4) B.C.C.A.; Section 190(15) and (16) C.B.C.A.

262 Because of these costs, non-financial firms do not use redeemable shares as a financing device. By contrast, financial organizations such as open-end mutual funds can issue redeemable claims because financial assets (i.e., publicly traded securities) are not organization specific and can be traded with low transaction costs. See E.F. Fama & M.C. Jensen, "Agency Problems and Residual Claims", (1983) 26 J. Law & Econs. 327, 337-39.

Exiting the corporation through the exercise of an appraisal right might give rise to a taxation event, the cost of which might have been avoided by remaining in the corporation and accepting the fundamental corporate change. There is an added problem generated by reinvestment and brokerage costs in situations where the minority shareholder, after exercising his right of appraisal in one corporation, seeks to reinvest in another. The appraisal procedure is highly technical with several distinct steps to be completed in limited time periods. A little slip may extinguish the exercise of the right. Moreover, the appraisal process itself is costly. Corporations must devote considerable time and hire lawyers and other experts. The same applies to the minority shareholder who may not be able to afford the financial costs of retaining a lawyer. To make matters worse, some of these costs may not be recovered in the appraisal proceeding. The uncertainty created by the possibility that dissenters will be over-compensated represents a further cost. Lack of precise valuation methods adds to the possibility of over-compensation. Any method of valuation may be highly inexact; different appraisers will reach radically different conclusions regarding the value of the firm and a particular shareholder's proportionate interest. Uncertainty is a cost to risk-averse shareholders and it makes the appraisal procedure less attractive. Shareholders are the losers if these costs deter value-increasing transactions.

The foregoing costs do not imply that the appraisal right does not have its benefits. Its chief benefit lies in the fact that it is a mechanism admirably suited to reconcile the need to give the majority members of a normally perpetual organization the right to make drastic changes in the enterprise. To meet new conditions as they arise with the need in such organization to prevent the minority from being involuntarily dragged along into a drastically changed enterprise in which it has no confidence. The potential value of the appraisal right lies in holding a put option that arises on the happening of specified triggering events. The put option enables the minority shareholder who would not otherwise be able to do so, to cash out of the enterprise (in the case of a closely-held corporation) or to cash out at a better price than the current market price (in the case of a widely-held corporation) and (in both cases) to avoid the effects of the fundamental change. This has the prospective effect of protecting shareholders against certain risks.

Ex ante, it may not be clear to a shareholder if he will be in the majority or minority with respect to an intended fundamental corporate change. Where he is in the majority, he will bear part of the cost of an exercise of the appraisal right by the majority. Thus, from a prospective viewpoint, it is not clear whether an appraisal right will represent a benefit or burden. Nevertheless, by reducing the probability of unprofitable fundamental corporate changes, the appraisal right represents a value to all shareholders.

In a situation where an opportunistic fundamental corporate change may have the potential effect of reducing enterprise value, the availability of an appraisal right may serve as a backstop if the requirement to secure voting approval of fundamental changes fails. And where the existence of a controlling shareholder, management control of the proxy machinery or shareholder apathy makes it possible to secure the approval of a value decreasing fundamental change, a widespread exercise of the appraisal right may abort the change. On the other hand, the existence of an appraisal right will not prevent value-generating transactions. It is possible that widespread exercise-of appraisal right may in some cases occur with respect to value-generating changes, especially 'where shareholders are unable to share the inside information processed by managers. But in such cases, the managers have an incentive to reveal the information to shareholders insofar as such a course of action will not harm the corporation's business and competitive interests.

From a more general perspective, the appraisal right furthers the ideals of fairness in the modern corporate enterprise. It prevents a shareholder from being forced into a change he thinks ill-considered or **unfair.**[263] It attunes management sensibilities to shareholder interests as opposed to those of insiders. Voting requirements and an oppression provision further this end too, but absent an appraisal right, power in the modem corporation may be unduly concentrated in the majority. Appraisal creates an additional consideration which the insiders **must** take into account. It is more than a shield of protection; it is often used as a weapon to gain real advantage for the minority. Without this weapon, there is a deep void in the power relations within the **corporation.**[264]

Whether the benefits of appraisal outweigh the costs is **an** empirical question for which there is no obvious answer. The retention of appraisal remedies in most **corporate statutes creates a presumption, however, that appraisal produces net benefits. But the strength of this presumption should not be exaggerated. Under economic analysis, the appraisal remedy is viewed as an implied as opposed to an express** contractual term. The costs of writing and enforcing protective cove**nants in bond contracts, for example, are deliberately incurred by the parties to the agreement. It is unlikely that the parties would incur this expense unless there were net benefits. With the appraisal remedy, the parties do not directly incur the costs of writing and negotiating contracts but instead adopt the standard term set by corporate statutes. Thus only a weak inference can be drawn about the desirability of appraisal remedies.**[265] However, the presence of appraisal remedies is evidence that they

263 Appraisal involves "[a] delicate balancing of the interests of majority and minority owners . . . for the majority owners should not be chained to what they believe to be unsound business judgment; yet, neither should the minority owners be bound to remain shareholders when they have similar misgivings.", Voeller v. Neilston &Warehouse Co. (1941) 311 U.S. 531 at 535-6. See also Chicago CoT. v. Munds (1934) 20 Del. Ch. 142.

264 Folk, "De Facto Mergers in Delaware: Hariton v. Arco Electronics Inc. (1963) 49 Va. L. Rev. 1261 at 1293.

265 The inference would be stronger if firms could contract out of an appraisal remedy provided by corporate law. In this event, appraisal would be a standard form contractual provision that the parties could alter by agreement.

produce net benefits. Recent judicial decisions have also emphasised the importance of the appraisal remedy.[266]

III. Appraisal Remedy and the Corporate Structure

Generally speaking, shareholders in widely-held corporations will not be very concerned with fundamental corporate changes that do not decrease the market value of their shares. In contrast, shareholders in closely-held corporations may have good reason to be concerned even if there is no adverse effects on the value of their shares. While the appraisal rights may be of little value in the former case, in the latter case it may be of great value. Two reasons exist for this proposition: the modern capital theory which includes the investment portfolio diversification theory and the availability or non-availability of a market-exit option.

The Modern Capital Theory and the Investment Portfolio Diversification Theory

Modern capital theory[267] indicates when shareholders are likely to be concerned with fundamental corporate changes that do not adversely affect share values. Economists divide the risks facing shareholders into two types; namely unsystematic and systematic risks. This division indicates that some risks are peculiar to a given corporation while others are reflective of general economic conditions and trends affecting the market as a whole. Peculiar risks are unsystematic while the latter is systematic.

Investment portfolio diversification theory teaches shareholders to diversify unsystematic risks by holding a portfolio of shares in many corporations. The effect of

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266 For example, see Re Domglas Inc. (1980) 13 B.L.R. 135. Weinberger v. UOP, Inc. (1983) 457 A. 2d 701.

267 R. Brealey & S. Meyers, Principles of Corporate Finance (New York: McGraw-Hill Inc. 1981).

a fluctuation in the price of any single share in the portfolio arising from unsystematic influences will, on the average, be offset by contrary movements in the prices of other shares in the portfolio.[268] Shareholders who diversify their investments will be substantially less unconcerned with changes in unsystematic risk of the corporation than those who cannot do so.

Systematic risk is not diversifiable because the shares of all corporations will tend to be affected in the same direction by general economic conditions.

The value of the appraisal right against fundamental corporate changes will thus depend on the ability of shareholders to diversify their investments and also on the ability to sell their shares in the market in response to changes in risk that do not suit their risk preferences. The widely-held and closely-held corporations will be considered.

The Widely-Held Corporations

Economic analysts argue that the appraisal remedy is likely to be of little value in protecting the shareholders. Because of the availability of a liquid market, a dissenting shareholder may simply sell his shares in the market without loss of capital and purchase a more satisfactory investment. But the quoted price may not reflect the fair value of the shares. Where a corporation's shares are thinly traded (as in most Canadian corporations) there is a risk of short-run fluctuations in the market price of the shares away from an equilibrium value. Arguably, the minority shareholder might wish to be protected against this risk by being assured a reliable and fair exit option as represented by the appraisal right. However, given the relative costs of the appraisal option as opposed to a market value, it will be inconceivable that the right would be a

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268 MacIntosh, supra, note 9 at 211.

valued protection for minority shareholders against changes that do not affect the share value;

In Canada, the Ontario Business Corporations Act[269] formerly restricted the appraisal remedy to closely-held corporations. This was based on the recommendation of the report of the Committee on Mergers, Amalgamations and Certain Related Matters,[270] which advised that the determining factor on which an appraisal remedy, if it should be granted at all, should rest in the presence of absence of a market. According to the Committee, in the case of the widely-held corporation, the remedy would not appear to be any more effective than if the shareholder were to sell his stock in the face of a triggering transaction and certainly not persuasive enough to compensate for the cash drain which may be caused a corporation, to the possible detriment of the corporation, its creditors and the majority or the possibility that a transaction might have to be called off, because of the cash drain in meeting appraisal rights. The Committee seemed to have agreed with the conclusion reached by Bayless Manning[271] that "appraisal should be considered an economic substitute for the stock exchange and its use should be limited to situations at which the exchange, or some kind of a reasonable market is not available".

However, the current form of the Ontario Business Corporations Act and indeed other corporate statutes in Canada do not limit the exercise of the right to closely-held corporations. There are some good reasons why the market exit option may not be an adequate protection for the shareholders. First, large shareholders who are forced to sell quickly to escape the fundamental corporate change may realize an inferior price in the market because of the hurried liquidation of the large block. Second, all

269 Section 100.

270 Ontario Select Committee on Company Law (1973) 52.

271 Manning, "The Shareholder's Appraisal Remedy: An Essay for Frank Coker" (1962) 72 Yale L.J. 223.

shareholders, whether large or small, may only be able to realize a price that already reflects the market's anticipation of-the effect of the fundamental change."[272] The possibility of a demoralized market in which fair prices are not available and in which many corporations publicly offer to buy their own shares because the market grossly undervalues them suggests that access to market value is not a reasonable alternative for a dissenting minority shareholder.

Finally, any restriction in the exercise of appraisal rights based on the availability of stock market may be inconsistent with the purpose of appraisal - establishing a reservation price for all or part of the corporation in situations where coordination or conflict of interest problems might otherwise lead to inferior outcomes.

The Closely-Held Corporations

Shareholders in closely-held corporations for which there exists no liquid market for their shares tend to have different response to shifts in enterprise risk than their counterparts in widely-held corporations. They are often substantially underdiversified since a large part of their wealth (including their employment) is tied up in the corporation. In most such enterprises, there is no reliable market exit option. Although members often attempt to reduce the adverse effects of the absence of the market exit option by private contractual arrangements such as the buy-sell agreements, such arrangements have limited effects. Shares of closely-held corporations will generally be difficult to sell and may be subject to strict restrictions on alienability, reflecting the quasi-partnership status of many small, incorporated businesses. On this basis, the exit option provided by the appraisal right reflects an important protection for the minority shareholder against the dangers of shifts in the risk of the enterprise.

272 M.A. Eisenberg, "The Structure of the Corporation", (Boston: Little, Brown & Co., 1976) 79-84.

Similarly, opportunistic fundamental corporate changes designed to accommodate the risk preferences of managers or majority shareholders are likely to occur. Managers of closely-held corporations are often underdiversified, given that both their private wealth and employment are tied up in the enterprise, thus increasing the chances of opportunism. If protection is desired against unwise or opportunistic fundamental changes that the majority have approved, the appraisal procedure is likely to be (aside from private ordering arrangements to effect the same result) the only exit option available.

IV <u>Conclusion</u>

The exercise of appraisal right generates many costs for the minority shareholders. The procedure is technical, long and expensive. The amount of the award is often unpredictable and may be taxable whereas the transaction dissented from may have produced tax free benefits to the minority shareholder. These costs notwithstanding, the exercise of the right is desirable in connection with transactions of the utmost gravity in which self-interest and lack of investment skills may seriously obscure management's vision.

While the right presumably may not be of substantial concern to the minority shareholder of a widely-held corporation because of the availability of a market exit option, there are good justifications why it is still desirable that the right be made applicable to those corporations. This line of reasoning stems from the inadequacy of the stock market sometimes to accurately reflect the value of the minority shareholder's shares.

The absence of a market exit option increases the value of the remedy to a minority shareholder of a closely-held corporation who is often substantially underdiversified. Moreover, events compelling a minority shareholder to desire to bail out of the enterprise in response to an anticipated diminution in value are likely to arise with some frequency in the closely-held corporation.

D. JUST AND EQUITABLE WINDING UP

I. Nature of Winding Up Remedy

Corporate statutes provide for liquidation and winding-up to take place either voluntarily by shareholders' resolution or involuntarily by court order.[273]

In the context of shareholder remedies, the dissolution order is the most drastic form of shareholder relief. A dissolution order usually consists of an order dissolving the corporation, sale of its assets and distribution of the proceeds to investors. Most of the corporate statutes provide for a shareholder application to the court for such an order on the grounds that it is "just and equitable" to do so.274

The circumstances in which the court will find it "just and equitable" to order a winding-up have defied any precise categorization. The courts have made it clear that there are no fixed outside limits to the rule but rather that each case must be decided on its own facts. Thus, the courts, over the years, have expanded the rule into new areas as fresh circumstances and situations have arisen and as the courts' reformulation of standards of intra-corporate conduct have developed. In one of the leading cases where this remedy was applied,275 the role of the court was characterized as that of a court of equity not bound by any classifications of wrongful behaviour and able to order a winding-up whenever it appeared "equitable" to do so.

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273 See generally, Sections 291-320 B.C.C.A.; Sections 207-228 C.B.C.A.; Section 408 C.A.M.D. (Nigeria).

274 S.295(3)(a) B.C.C.A.; S.214(1)(b)(ii) C.B.C.A.; S.408(e) C.A.M.D. (Nigeria).

275 Ebrahimi v. Westbourne Galleries Ltd. (1972) 2 All E.R. 492.

However, the remedy is a drastic one and is usually **only** addressed to a serious condition affecting the proper conduct **or** management of the corporation's affairs. Although there are no fixed definitions of what circumstances will constitute sufficient grounds under the "just and equitable" rule, three principal categories have emerged from judicial decisions over the years as circumstances in which a court may readily grant an order under the just and equitable grounds. These categories include:

(a) justifiable lack of confidence in the directors and management

(b) deadlock

(c) the partnership analogy.

But as stated earlier, the facts rendering it just and equitable that a corporation should be wound up cannot be resolved into precise categories. Cases on the subject usually illustrate the diversity of the circumstances calling for the exercise of the court's discretion in winding-up a corporation because it is just and equitable to do so. In general, the words "just and equitable" are words of the widest significance and do not limit the jurisdiction of the court to any case. It is a question of fact and each case must depend upon **its** own circumstances.

II. Winding Up and the Corporate Structure

(a) The Closely-Held Corporations

Generally speaking, the theory 'of winding-up on the just and equitable ground is more suited to shareholders of closely-held corporations. However, no Canadian corporate statute has limited its application to such corporations. The closely-held corporation has certain basic features which makes the remedy more suited for protection of minority interests. It is usually formed or continued on the basis of a personal relationship involving mutual confidence. There is usually an agreement or underlying assumption that all or some of the shareholders are to participate in the conduct of the business. Members often make relatively substantial capital contributions to the corporation: shareholders in such corporations are'-a small close-knit group involved in the day to day operation of the business and financially committed to the corporation. Restriction on alienability of shares is also a dominant feature of such corporations. Because members also manage the corporation, distribution of profits is usually by way of salaries instead of dividends. These features suggest that most closely-held corporations are incorporated partnerships in which the shareholders have some expectations based on their personal and financial involvement in the conduct of corporate affairs.

While these reasonable expectations vary from case to case, the following are some of the usable reasonable expectations of minority shareholders:

(i) the expectation of dividends or other distribution of earnings if there are sufficient earnings to otherwise provide for the reasonable needs of the corporation,

(ii) the expectation of the right to participate in management,

(iii) the expectation that the majority would agree to a reasonable share valuation as required by a share transfer agreement or law,

(iv) the general expectation that all shareholders will receive benefits that bear a pro rata relationship to their ownership interests.

Minority shareholders often enter into contractual agreements to protect these expectations. For instance, buy-sell agreements enable a minority shareholder to liquidate his investment whenever he desires to do so. However, transaction costs might prevent parties from entering into appraisal contractual agreements. Similarly, inherent human limitations often prevent parties from taking care of unforeseen future contingencies. The result is that contractual agreements often do not fully articulate the parties bargains.

In situations where the minority shareholder's reasonable expectations have been breached or are not adequately protected under the corporate constitution, he may resort to the corporate law remedy or the other. However, the majority shareholders might well be acting within their legal rights and in doing so, treat the minority unfairly. The presence of the winding-up remedy in closely-held corporations seems to be premised on the fact that it covers some of those situations in which a minority shareholder is entitled to expect a certain standard of conduct from his corporate partners and such expectations has been frustrated.

The remedy is based on equitable considerations and it enables the court to subject the exercise of legal rights to equitable considerations that are of a personal character arising between one individual and another which may make it unjust or unequitable to insist on legal rights or to exercise them in a particular way. The most significant benefit of the remedy is that in many dissension cases in the closely-held corporation, fulfilling reasonable expectations of shareholders by application of remedies short of winding-up may not be practical because of continuing animosity or irresponsible damage done to a relationship. Either the administrative cost associated with resolving these problems are prohibitive or the courts may lack the ability to construct orders that will result in profitable operation In these cases, severing the relationship between the shareholders may be the only viable alternative.

However, the remedy has its own limitations. First, a minority shareholder who invests in a closely-held corporation often expects a voice in management and a steady source of income from the investment. Although winding-up of the corporation may enable the shareholder to generate income by reinvesting the proceeds of the liquidation, it does not enable him to realize expectations of continuing employment or participation in management.

Second, the proceeds from dissolution might not in any way, reflect the damage already allegedly inflicted'upon the **minority** shareholder's investment. The proceeds could also be small compared to the earnings potential of the business especially where the only buyers for the shares are the alleged oppressors. In addition, the minority shareholders would in most cases incur legal expenses in retaining **a** lawyer. Moreover, the disruption of the business associated with a winding-up order may on a general level, harm the public. The harm may arise from displaced employees, suppliers, and frequently, customers.

Notwithstanding these limitations, the remedy might be an appropriate relief to a minority shareholder, whose wealth and lifetime savings are substantially tied to the corporate venture. It would be unfair merely to give an order compelling the majority or the corporation to buy the shares of the minority in situations where the latter reasonably expects continuous participation in the corporation with a voice in management. The degree of discussion might be such that any other remedy (such as the oppression remedy) would be insufficient especially where the corporate low have turned into antipathy and distrust.

(b) Widely-held Corporations

Winding-up on the just and equitable ground may not be an appropriate remedy for the protection of the minority shareholder in the widely-held corporation. Often, there is no underlying personal relationship amongst the shareholders. Given the fact that the interests and expectations of shareholders in widely-held corporations are usually more restricted than in the closely-held corporation, winding-up may not serve any purpose to a minority shareholder of a widely-held corporation.

The presence of an effective market exit option makes winding-up a less useful protection in such corporations. Absent personal commitments in the corporate venture, a minority shareholder would prefer to liquidate his investment by selling his shares in the market whenever the management manifests any value decreasing conduct than going through a winding-up application and incurring the legal and time costs involved in such application.

Moreover, shareholders in widely-held corporations usually diversify their investment portfolio. The effect is to reduce unsystematic risks arising from the poor management of a particular corporation. A minority shareholder having a portfolio of investments would be substantially unconcerned about the manner in which a particular corporation's affairs are conducted. And whenever he feels that it is no longer profitable investing in such corporation, the presence of a liquid market enables him to exit the corporation at a less costly term

However, as stated above, no Canadian corporate statute has expressly limited the application of the remedy to closely-held corporations only. In fact, there is a Canadian reported case where a widely-held corporation was wound up on the just and equitable ground. The case is Re R.J. Jowsey Mining Co. Ltd.[276] Here one Smith gained control of Jowsey Mining through a highly complex series of manoeuvres, including appropriation of funds without the directors' knowledge or consent from another widely-held corporation that he controlled. Jowsey Mining's sole productive asset was shares of Denison Mines Ltd. An application for winding-up of Jowsey Mining was made by a minority shareholder, the son of Jowsey Mining's founder, on the eve of a sale proposed to be made by Smith of a substantial portion of Jowsey Mining's Denison shares. The trial court ordered dissolution and the Court of Appeal affirmed. Laskin J.A. concluded that there was a substantial danger of dissipation of Jowsey Mining's liquid assets if a winding-up were not ordered. The learned judge noted Smith's fast and loose history of dealing with widely-held companies controlled

276 (1969) 2 O.R. 549, 6 D.L.R. (3d) 7 (C.A.) aff'd (19700 SOR.

by him and noted also that Jowsey Mining was not in need of cash and that Smith had no plans for the investment of the Denison share proceeds on behalf of Jowsey Mining. In deciding that it would not be appropriate to make a supervisory order for the conduct of Jowsey Mining's affairs, as opposed to a winding-up order, Laskin J.A. observed that any possibility of the court becoming a superior board of directors should be avoided.

It should be pointed out that the above decision was based on the peculiar facts of the case and does not suggest that winding-up on the just and equitable grounds is ideal for widely-held corporations. On the contrary, there is reason to suggest that the remedy is more suited for the protection of minority shareholders of closely-held corporations who have personal and underlying assumptions in entering into the corporate venture.

Conclusion

Just and equitable winding-up is a remedy ideally granted in those circumstances when the reasonable expectations of a minority shareholder in a closely-held corporation has been frustrated. Not every breach of a reasonable expectation gives rise to the availability of the remedy. The remedy is a drastic one and applies in those unusual circumstances where continuance of the corporate venture would be wholly impracticable.

As a remedy predicated on frustration of some personal understanding between the corporate participants, it may not be of great value to a minority shareholder in the widely-held corporation. The likelihood of diversification of investments by shareholders in widely-held corporations and the existence of market based exit option render the remedy less valuable to the minority in such corporations. Shareholders in widely-held corporations would arguably prefer to sell their shares in open markets rather than pursuing a winding-up application and incurring the legal and other costs inherent in the procedure.

CHAPTER SEVEN

THE ADEQUACY OF THE SELECTED STATUTORY MINORITY SHAREHOLDERS' REMEDIES

Introduction

This chapter will examine some of the practical considerations arising from the operation of the selected remedies. My aim is to determine whether these statutory remedies in their current form afford adequate protection to the shareholders in the corporation.

It is common knowledge that the major aim of the corporate law reform in Canada over the past decade has been to overcome the substantive and procedural hurdles placed in the way of minority shareholders by previously decided Canadian English cases. For instance, in Percival v. Wright,[277] it was held that the directors' fiduciary duties run only to the corporation and not to the shareholders requiring the latter to obtain leave to sue derivatively should the board refuse their request to lend the company's name to the proceedings. Similarly, in Foss v. Harbottle,[278] it was held that the proper plaintiff in an action for wrongs committed by the directors against the corporation is the corporation itself. Most of the procedural hurdles that grew from the court's decision in Foss v. Harbottle has been removed by the statutory shareholders' derivative action. The substantive aspects of majority rule and the lack of a fiduciary duty owed by the directors to the shareholders or by majority shareholders to the minority have been dealt with in an ad hoc fashion over the past ten years by the

277 (1902) 2 Ch. 421.

278 (1843) 2 Hare. 461.

legislature and the courts culminating in the inclusion of the oppression remedy in the corporate statutes. In general, the position of the minority shareholders has been enhanced by the increased protection afforded by these statutory remedies. However, it is suggested that more could be done by way of removing some procedural obstacles with respect to some of the remedies and adopting a liberal rather than a narrow and strict approach in interpreting these remedies to reflect the aims of those responsible fur corporate law reform in Canada and to further ensure adequate protection for the shareholder.

The first remedy to be examined is the oppression remedy. I shall start the discussion by examining the historical background of the remedy. This will enhance the understanding of the mischief that the remedy seeks to prevent. I shall thereafter look at the legislative provisions and the procedural matters relating to the operation of the remedy. The judicial response to the remedy is also relevant to an examination of the adequacy of the remedy. It is intended to end the discussion by examining the relationship of the oppression remedy with the other statutory remedies. My interest in this regard is to determine the potential efficacy of the remedy vis-a-vis other statutory remedies for the protection of the shareholders.

A. <u>The Oppression Remedy</u>

History of the Oppression Remedy in Canada

Major corporate law reform took place in Canada in the late 1960's and early 1970's. This period saw the establishment of various committees.[279] set up by both the federal government and some provinces to examine the law relating to corporations. In

279 For example, the Select Committee on Company Law (1967) (Ontario Legislature) [otherwise called the Lawrence Committee]; See also, Dickerson, Proposals for a New Business Corporation Act for Canada (1971) (The Federal Report) [otherwise called the Dickerson report]; R. Bird, Report on Company Law [otherwise called the New Brunswick Report] 1974; D. Sheppard & M. Smith, Departmental Study Report of the Department of the Attorney General of British Columbia (1971).

consequence, new corporate and securities statutes came into force in various jurisdictions.[280] The committees that reviewed the previous statutes in these jurisdictions were very much influenced by corporate law developments in other jurisdictions outside Canada, notably England and United States.

It was recognized that the position of minority shareholders was unsatisfactory under Canadian corporate law. In the first place, the protection for minority shareholders under the common law was not adequate. The Canadian judiciary was reluctant to interfere in internal corporate affairs and the Canadian common law relating to corporations reflected this. The general rule was and still is, that directors owed fiduciary duties to the corporation, and not to shareholders directly.[281] In addition, the majority shareholders owed no duties directly to their shareholders. Thus, the majority shareholders could act in their own interest and were entitled to use their votes to exculpate themselves from acts which would otherwise constitute breaches of their fiduciary duties as directors of the corporation. Common law also precluded the individual shareholder from bringing an action on behalf of the corporation or other shareholders.[282] Although certain exceptions existed to this common law rule,[283] these exceptions were nonetheless insufficient. The statutory protection provided to minority shareholders was equally inadequate.

The absence of effective statutory and judicial remedies implied that the only alternative open to a dissenting minority was to apply to have the corporation wound up

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280 For example. the Ontario Business Corporations Act 1970, the British Columbia Companies Act 1973, the Canada Business Corporations Act 1975. For developments in other jurisdictions, see Cheffins, "The Oppression Remedy in Corporate Law: The Canadian Experience", (1988) 10 U. Pa. J. Int'l Bus. L. 305.

281 For judicial recognition of this principle, see Percival v. Wright (1962) 2 Ch.421.

282 Foss v. Harbottle (1843) 2 Hare. 461.

283 These exceptions constituted instances where individual shareholders were permitted to bring [illegible] Some of these [illegible]nces are enu[illegible] below under the discussion on Foss v. Harbottle.

under statutory provisions that authorized the court to dissolve a corporation on the application of a minority shareholder. But the remedy itself was far from being adequate to solve the problems of the minority. There were many potential disadvantages in applying for the remedy. Firstly, the remedy could result in a disadvantage to the minority shareholder who wished to continue his investment and maintain the business enterprise as a viable entity. Secondly, the proceeds from dissolution might not reflect the damage inflicted upon the shareholder's investment and the proceeds could also be small compared to the earnings potential of the business especially where the only buyers for the shares were the alleged oppressors. Furthermore, although Canadian corporate legislation often set out a variety of grounds for dissolution, more especially on the ground that it was just and equitable that the corporation be wound-up, the courts laboured under the assumption that winding-up was a drastic remedy to be granted only very occasionally.

Thus, it was no surprise that those responsible for recommending corporate law reforms proposed major statutory revisions to improve the position of the minority shareholders. These proposals were generally accepted by those jurisdictions enacting new general incorporation legislation.

With respect to the oppression remedy, the Canadian corporate reformers relied on the English corporate law provisions. The remedy first appeared in Canada when it was introduced into the British Columbia Company Act in 1960. The provision was borrowed directly from Section 210 of the 1948 English Companies Act. But the English provision suffered many defects and the British Columbia provision was similarly defective in many important respects. For example, the applicant was required to show that the conduct of the directors or those in control was serious enough to warrant a winding-up before the courts could exercise remedial powers under the remedy. Secondly, because the conduct had to be oppressive against a person in his capacity as member (shareholder), the remedy did not reach one of the prototypical fact situations, exclusion of a director or manager. Furthermore, the remedy was read as requiring a continuous course of oppressive conduct rather than a single oppressive transaction.[284]

Throughout the 1960's and early 1970's no other Canadian jurisdiction had an oppression remedy and the remedy received a poor and pessimistic response from other committees appointed to consider corporate law reform. In Ontario, the Lawrence Committee did not find favour with the remedy which it described as constituting a complete dereliction of the accepted principle of judicial non-interference in the management of corporations. The Committee said further that the underlying philosophy of the remedy had an air of reservation and defeatism about it, as if the legislature was unable to offer any solution to the plight of minority shareholders other than abandoning the problems to the judiciary to be dealt with ad hoc on the basis of determining, from case to case, whether or not the affairs of the company are being conducted in a manner oppressive to some part of the shareholders.[285]

In England, in 1962, the Jenkins Committee recommended substantial amendments to overcome what turned out to be a number of judicially constructed limitations on the scope and application of the remedy. In particular, the Jenkins Committee highlighted four situations where the remedy would be most appropriate:

(i) where controlling directors unreasonably refuse to register transfers of the minority's holdings to force a reduced sale price for them to take advantage of;

(ii) where directors award themselves excessive remuneration that diminishes the funds available for distribution as dividends;

(iii) to prevent the issuing of shares to directors and others on special or advantageous terms; and

284 See Re H.R. Hammer Ltd. (1958) 3 All E.R. 689 (C.A.).

285 Lawrence Report, supra, note 279 at 60.

(iv) to prevent the refusal to declare non-cumulative preference dividends on shares held by the minority.

These categorizations notwithstanding, the determination of the type of conduct which amounts to oppression has been evolving and it would not take an abundance of imagination to envision many other circumstances in which the oppression remedy would be an appropriate response.

In Canada, when the new British Columbia Compan Act was enacted in 1973, the remedy was significantly revised in accordance with other important recommendations made by the Jenkins Committee although the revised Company Act did not expressly incorporate the situations where the remedy would be most appropriate. First, the requirement that grounds for winding-up exist for there to be a successful application was removed. Secondly, the type of conduct for which relief could be granted was broadened to include unfair prejudice. Thirdly, the requirement that the petitioner show a course of conduct which was oppressive was removed. It was specified that a single and isolated act of oppression is enough to justify the application of the remedy. Fourthly, the scope of potential applicants were increased to include legal personal representatives and others to whom shares are transmitted by operation of law. The types of relief which could be made were also expanded. Finally, it was specified that unfairly prejudicial conduct did not have to exist at the time of the application for the application to succeed.

Gradually, other Canadian jurisdictions subsequently adopted and improved on the English provisions which in turn was significantly altered by Section 459 of the English Companies Act 1985 (as amended by the Companies Act of 1989).

Essence of the Remedy

The introduction of the oppression remedy into Canadian corporate law was premised on the belief that minority shareholders did not have adequate protection against corporate misconduct by those in control of corporate affairs. It vias introduced to cover all those situations in which there has been some act of oppression but for which the winding-up remedy could not be an appropriate one.

Judicial decisions have helped in clarifying and stating what the oppression remedy intends to achieve. In Goldex Mines Ltd. v. Revill, the court made a broad statement of principle with respect to the essence of the oppression remedy:

> "The principle that the majority governs in corporate affairs is fundamental to corporation law, but its corollary is also important - that the majority must act fairly and honestly. Fairness is the touchstone of equitable justice and when the test of fairness is not met, the equitable jurisdiction of the court can be invoked to prevent or remedy the injustice which misrepresentations or other dishonesty has caused."

In Elder v. Elder and Watson Ltd.,[286] Lord Cooper said that the essence of the remedy seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair dealings and a violation of the condition of fair play on which every shareholder who entrusts his money to a corporation is entitled to rely.

A shareholder has some reasonable expectations in investing in the corporation. He is equally entitled to expect a certain pattern of behaviour from management and fellow shareholders depending on the nature of the corporation and other circumstances. It therefore follows that relief ought to be granted when those expectations have been frustrated. The courts have indicated that the oppression remedy should be applied in situations where the reasonable expectations of the shareholder have been frustrated. In Ebrahimi v. Westbourne Galleries Ltd.,[287] the court stated that "the foundation of the remedy lies in the words "just and equitable" . . . . The words are a recognition of the fact that a limited company is more than a mere legal entity, with a personality in law of its own: that there is room in company law

[286] (1952) S.C.49.

[287] (1973) A.C. 360.

for the recognition of the fact that behind it, or amongst it, there are individuals with rights, expectations and obligationhinter se which are not necessarily submerged in the company structure.". This statement lends credence to the fact that the interest of shareholders should not be tramelled by those in a position of advantage over them: a purpose which the oppression remedy seeks to achieve.

However, the reasonable expectations approach may have limitations primarily because the criteria for ascertaining and evaluating shareholder expectations are left open.

The Statutory Provisions

Outside of British Columbia, the oppression remedy was introduced into Canadian statutes by the Canada Business Corporations Act in 1975. The result was what is now Section 241 of that Act.

Section 241 contains the revisions which were incorporated into its counterpart in the British Columbia Company Act. Under the section, a "complainant"[288] may apply to a court for an order and where the court is satisfied that

(a) any act or omission of the corporation or its affiliates effects a result, or

(b) the business or affairs of the corporation or 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 is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, or officer,

the court may make an interim or final order it thinks fit. The remedies which the court may grant are comprehensive allowing it to rectify almost any type of conduct so as to protect the interest of the minority.[289]

288 The term is defined in Section 238 C.B.C.A.

289 See S.241(3) C.B.C.A.

Section 224 of the British Columbia Company Act has similar provisions.[290] However, there are some major differences between the two statutes. The class of potential applicants is wider under the federal legislation. Secondly, although both Acts permit applications by persons the court deems proper, under the British Columbia Act, only present shareholders are expressly authorized *to* apply.[291] Under the Canada Business Corportions Act, past shareholders, other security holders, former and present directors, and officers of the corporation and the Director are expressly authorized to apply. Furthermore, there is a third class of conduct which can give rise to relief under the Canada Business Corporations Act: conduct which unfairly disregards the interests of the applicant. Moreover, conduct of an affiliated corporation can also give rise to the remedy.

Also while the British Columbia Company Act provides that the impugned conduct must affect the applicant in the capacity of member (shareholder), the Canada Business Corporation Act provides that the conduct can affect the applicant in the capacity of security holder, creditor, director of officer. The list of remedies which are specifically authorized is broader under the Canada Business Corporations Act.

However, the British Columbia statute has a prospective aspect. The applicant can seek relief from "threatened" acts of the company and "proposed" resolutions of the members or class of members. The Canada Business Corporations Act provisions appears to be limited to cases where the complained act of conduct has already taken place.

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290 The section provides that a member of a company may apply to the court for an order on the ground that the affairs of the company are being conducted or the powers of the directors are being exercised in a manner oppressive to one or more of the members including himself or that some act of the company has been done or is threatened or that some resolution of the members or any class of members has been passed or is proposed that is unfairly prejudicial to one or more of the members, including himself.

291 The Company Law discussion paper (B.C.C.A.) recommends the extension of potential applicants to include former members and directors.

Other provinces which have adopted statutes based on the Canada Business Corporations Act have enacted an oppression remedy which closely resembles Section 241.[292]

1. The Procedural Issues Relating to the Remedy.

(a) Standing to Sue:

The initial issue with respect to the adequacy of the statutory oppression remedy is to determine whether the standing requirement is adequate for the protection of shareholders. All jurisdictions that have the oppression remedy allow shareholders to apply. Moreover, all jurisdictions except British Columbia also allow other security holders, creditors, directors and officers to apply. The extension of the availability of relief to groups other than shareholders indicates that the oppression remedy is an open-ended one which recognizes the existence of the many groups of interests in the corporation. Apart from shareholders, the creditors and directors have economic interests in ensuring the honest management of the corporation. Corporate statutes recognizes that certain acts of those in control might prejudice the interests of those other groups. Thus provision has been made for them under the oppression remedy.

On the nexus of contract approach, there may seem some apparent justifications for extending the scope of potential applicants beyond shareholders. Under the economic approach, the shareholders are not treated as owners of the business, but as parties who have contracted to lend capital to the corporation. They are simply viewed as one of the groups who contract with the corporation. This implies that they should not be singled out for special treatment in corporate law. It presumably justifies the open-ended Canadian approach that allows applications by other persons who contract with the corporation such as the creditors and management. Under this analysis,

292 For example, S.247 Ontario Business Corporations Act 1982, although that provision seems broader than the C.B.C.A. because it specifies that threatened conduct can give rise to the relief.

secured creditors, the federal government and trade creditors have applied under the oppression remedy with success.[293]

However, it should be realized that even if the nexus of contract view is accepted, the contracts between creditors and corporations and between shareholders and corporation differ in many respects. A debt contract is generally simpler than a contract entered into by a shareholder because a creditor's claim is for a fixed amount rather than for a flow of income based on the corporations profits. A creditor will be less concerned about profit maximization of the corporation and will have less reason to negotiate with respect to corporate governance. The result is that a contract between a creditor and a corporation is usually easier to articulate in express terms than a contract between a shareholder and the corporation.[294] When the contractual relationship is of this nature, it apparently seems that there is no need for an open-ended term such as the oppression remedy to fill the gaps in the creditor's bargain. In addition, creditors can protect themselves by the terms of their contract with a corporation and there is no compelling justification for giving them standing to apply. Given the nature of the corporation, there is not the same need to legislate for the protection of creditors as there is for shareholders.

The same reasoning applies to the directors and officers who are treated as one of the contracting participants under the bargaining approach. To determine whether the inclusion of this group within the scope of potential applicants is justified, it may be necessary tu examine the nature of the contractual relationship between them and the corporation. The managers usually invest a considerable amount of their human capital in the corporation, in the hope of a long-term reward and cutting this off by fixing

293 Cheffins, supra note 7 at 795. A secured creditor applied in Bank of Montreal v. Dome Petroleum 91987) 54 Alta. L.R. (2d) 289 (Alta. Q.B.). The federal government was the applicant in R. v. Sands Motor Hotel Ltd. (1985) w W.W.R. 59 (Sask. C.A.).

294 This may not be so in all situations however.

them might be seen as a form of a shareholder opportunism.[295] This may lead to inefficiencies, since informed managers would react to the threat of shareholder opportunism by under-investing in firm specific human capital, Offering them the opportunity to apply for relief from oppression might be an efficient response to the problem since the managers could have been given a greater incentive to seek long term rewards in the firm.[296]

The Canada Business Corporations Act and other jurisdictions which have followed the federal model also give standing to the Director[297] to apply for relief under the remedy. The Inclusion of the Director as a potential applicant may not seem justifiable since the shareholders usually. suffer the direct consequences of any impugned conduct by those in control. They are therefore in a position to decide whether or not to seek redress.[298] Where oppressive or unfairly prejudicial acts have direct effects on shareholders, they ought to be left to their own devices to decide whether to seek redress or not. As an action under the oppression remedy is primarily designed to protect the private interests of shareholders such a hands off policy is on the whole defensible.[299] Provided that shareholders have adequate financial resources to protect their interests, they are the best judges of what those interests are. The only

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295 See Buckley & Connelly; supra, note 101 at 394.

296 Cheffins asserts that it is not clear whether the possibility of shareholder opportunism justifies allowing the directors and officers to apply under the oppression remedy and that the answer depends on whether other potential sources of implied contractual terms such as employment law supply adequate gap-fillers. See Cheffins, supra, note 9 at 797.

297 The Director is an administrative official appointed under the Act in contradistinction to the directors of a particular corporation.

298 Often, the impugned conduct of those in control of the corporation usually has direct adverse effects on the shareholder necessitating an application for relief under the remedy without more.

299 This is not to argue that there is not a compelling public interest that the affairs of corporations should be conducted in a proper manner as if they are not his will have an external effect in reducing enthusiasm for the use of the corporate form.

argument for granting the director standing is where the costs of litigation preclude an action by the shareholders.

One notable omission from the British Columbia Company Act as regards standing to sue, is the non-eligibility of past members to bring an application under the oppression remedy. The Canada Business Corporation Act and other statutes modelled after the federal legislation clearly extend the standing requirement to previous members and officers. The British Columbia provision should therefore be extended to cover former members of the corporation, as unfairly prejudicial conduct which occurred when they were members may only come to light after they have ceased to be so. This would correct one of the defects of corporation law which tends to ignore the plight of ex-members who discover wrongdoing which may have diminished the value of their shares, only after ceasing to be members.[300]

(b) What must be proved:

To obtain relief under the oppression remedy, the applicant must prove either that:

(i) oppression arose out of the way the affairs of the company are being conducted or the powers of the directors are being exercised, or

(ii) he or any member(s) (including himself) has been unfairly prejudiced as a result of some act of the company which has been done or threatened or some resolution of the members or any class of members which has been passed or proposed.[301]

300 Fortunately, the British Columbia Discussion Paper on company law (January 1991) has recommended the extension of the scope of applicants to cover former members. Similarly, in Buckley v. B.C.T.F. (1990) 44 B.C.T.F. (1990) 44 B.C.L.R. 31; the court extended the meaning of "members" under S.224 B.C.C.A. to include past members, otherwise expelled members of the Teachers Association would be precluded from bringing an action under the oppression remedy following their unlawful expulsion from the Association.

301 S. 224 B.C.C.A. Due to lack of space, the discussion will be limited to the provisions of the B.C.C.A.

The first way the applicant can bring himself within the ambit of the remedy is to show that the oppressive conduct arose out of the manner in which the company's affairs are being or have been conducted. There is no precise definition of what constitutes the "affairs" of the company. In Morgan v. 45 Flers Avenue Property Ltd.,[302] it was stated not to be limited to trade matters, but to encompass capital structure, dividend policy, voting rights, consideration of take over offers and indeed, all matters which may come before the board for consideration.

Another way in which an applicant can bring himself, within the ambit of the oppression remedy is by showing that the unfairly prejudicial act arise out of any actual or threatened act of the company or actual or proposed resolution of the members. Although the phrase "actual act" raises no explanatory problem, there may be great uncertainty with respect to the circumstances in which a "threatened act" will constitute the basis for obtaining relief. Many corporate acts never advance beyond the stage of discussion which, had they been implemented, would have been unfairly prejudicial to some members. It may be asserted that such tentative acts do not, and cannot constitute the basis for successful application under the oppression remedy. For a threatened act to justify a relief, it must have reached a degree of maturity that there is a strong likelihood of its implementation by the company, so as to constitute a threat on its own.

Again, for any actual or threatened act to give rise to relief, the applicant must prove that it is the act of the company. This requirement would be satisfied in the case of an act of the board of the directors.[303] Similarly, the acts of a managing director to

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302 (1986) 10 A. C.L.R. 692, 704 (C.A.).

303 This is more especially under the organic theory of corporate law which states that the corporation is an entity which functions through many organs including the board of directors. Under the theory, the acts of directors may be attributed to the company provided they act within the limits of their powers.

whom the powers of the board have been delegated, or of a director who has been allowed to conduct the affairs of the corporation without any interference from the other directors, would conveniently be treated as those of the corporation.[304]

The section also gives protection to actual or proposed resolution of the members which unfairly prejudices the applicant. The inclusion of this proviso is apparently in recognition of the likelihood that majority shareholders could use their powers to pass resolutions which unfairly prejudices the minority. In situations, such resolutions may be equated to the acts of the corporation since the majority shareholders control the meeting. In this regard, the British Columbia provision may be seen as an advancement over the English corporate statute which makes no express provision for actual or pioposed resolution of the shareholders.

(c) The Concepts of Oppressive and Unfairly Prejudicial Conduct

The various statutes which have provided for the oppression remedy do not define what constitutes oppression or unfair prejudice. The Canadian courts have however, taken a narrow view of what constitutes oppression and have followed the jurisprudence developed under the original English provision.[305] Thus, oppression has been held to amount to conduct which is burdensome, harsh and wrongful or which lacks of probity and fair dealing.[306]

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304 Re H.R. Harmer Ltd. (1959) 1 W.L.R.62, 75 where the court while considering s.210 of the U.K. Companies Act 1948 which has been replaced by S.459 of the English Companies Act 1985 (as amended in 1989) and which provision is similar to S.224 B.C.C.A., stated that the section is wide enough to cover the activities of someone taking part in the conduct of the affairs of the company whether de facto or de jure.

305 Cheffins, "Oppression Remedy in Corporate Law: The Canadian Experience", (1988) 10 U. Pa. J. Int'l. Bus. L. 305, 320.

306 Nystad v. Harcrest Apartments (1986) 3 B.C.L.R. 40; Journet v. Superchef (1984) 29 B.L.R. 205 (Que.S.C.), Redekop v. Robco Constr. Ltd. (1987) 89 D.L.R. 3d. 507.

The concept of "unfairly prejudicial" has however, not received a narrow interpretation from the courts. In fact it is not feasible to formulate a generally accepted or comprehensive definition of what will be treated as being unfairly prejudicial. Any attempt to formulate a precise definition would have the unfortunate effect of confining the term within a judicially imposed straightjacket. The existence of unfairly prejudicial conduct is usually determined by the impact and effect on the shareholder and not the motives or the nature of the conduct of the majority. In Re Bovey Hotel Ventures Ltd.,[307] Slade J. stated that

> "The test of unfairness must be an objective, not a subjective one. In other words, it is not necessary for the petitioner to show that the persons who have had de facto control of the company have acted as they did in the conscious knowledge that this was unfair to the petitioner or that they were acting in bad faith; the test is whether a reasonable bystander observing the consequences of their conduct would regard it as having unfairly prejudiced the petitioner's interests."

It is not necessary for the applicant to point to any actual irregularity or to an invasion of his legal rights.[308]

However, an applicant will not be unfairly prejudiced merely because he is adversely affected by the operations of the corporation.[309] The conduct must be detrimental or damaging to the applicant's rights in a manner which is unjust or inequitable.[310]

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307 31st July, 1981 (unreported). See also Sparling v. Javelin Int'l Ltd., (1986) R.J. Q.1073, 1077; Re R.A. Noble & Sons (Clothing) Ltd. (1983) B.C.L.R. 273, 290-91 (per Nourse J.).

308 Thomas v. H.W.Thomas Ltd. (1984) 1 N.Z.L.R. 686, 693. In Re M. Dalley & Co. Pty. Ltd. (1974-76), 1 A.C.L.R. 489, 492, the court stated that "it is not necessary for a complainant to point to any actual irregularity or to an invasion of his legal rights or a lack of probity or want of good faith towards him or the part of those in control of the company. It is for this reason that acting on legal advice would not necessarily prevent conduct from being unfairly prejudicial if it is otherwise so".

309 O'Connor v. Winchester Oil & Gas Inc. (1986) 69 B.C.L.R. 330, 337.

310 Diligenti v. RWMD Operations (1976) 1 B.C.L.R. 36, 45-46.

It may also be pointed out that the boundaries of what constitutes unfairly prejudicial conduct do not stop at constitutional propriety.[311] While a particular act may on its face appear to be legally proper, it may nevertheless constitute unfair prejudice. In Re A Company,[312] Harman J. held that a rights offer on a pro rata basis could unfairly prejudice a shareholder where it was known that the shareholder did not have the resources to take up his allotment and the allotment was intentionally made to exploit this and to dilute his holdings in the company.[313] Similarly, on this reasoning, the failure by a corporation with distributable profits to declare a dividend could constitute a ground for relief.[314]

2. Judicial Response to the Oppression Remedy

The various committees that recommended corporate law reform in Canada in the early 1960's and 1970's did not provide guidelines as to how the oppression remedy was to operate. Only the Dickerson Committee which formulated the proposals for reforming the federal corporation legislation made a comprehensive statement on the matter. The committee gave examples of freeze-out techniques as instances where the remedy would be invoked more frequently in relation to closely-held corporation and indicated that a broad standard of fairness should be invoked in applying the remedy.[315] It became obvious that the sections dealing with the remedy would rely heavily upon judicial discretion for its effect. Instead of defining clear-cut standards that the applicant must meet, the sections demand only a vague standard of "unfairness"

311 D.D. Prentice, "The Theory of the Firm: Minority Shareholder Oppression: Sections 459-461 of the Companies Act 1985" (1988) 8 Oxford Journal of Legal Studies, 55, 79.

312 (1985) B.C.L.R. 80.

313 See also Browning v. C&C Plywood Ltd. (1967) 434 P. 2d 339 (Supreme Court of Oregon).

314 Re Ferguson and Imax Systems, (1983) 43 O.R. (2d.) 128.

315 Cheffins, supra, note 280 at 313.

be proved. It is therefore, the judicial interpretation of the sections that determines the range of this remedy.

Despite the lack of legislative guidance however, the judiciary have made extensive use of the oppression remedy, notwithstanding that some judges have adopted a narrow interpretation of it.[316] On the whole, the judicial response to the oppression remedy has brought it to the forefront of remedies available to minority shareholders, as applications has succeeded in a wide range of cases.

Case law has gradually increased over the years, affirming the rights of minority shareholders as the oppression remedy is used with greater versatility to define and correct unacceptable corporate behaviour. Courts have followed the often cited recommendation in Ferguson v. Imax Systems Corporation[317] that

> "the section which provides for the oppression remedy must not be regarded as being simply a codification of the common law today. One looks to the section when considering the interest of the minority shareholders and the section should be interpreted broadly to carry out its purpose . . . .. What is oppressive or unfairly prejudiced in one case may not necessarily be so in the slightly different setting of another."

Notwithstanding judicial readiness to ever increase the ambit of the oppression remedy, the remedy has limits. In Mason v. Intercity Properties,[318] the court stated that the remedy does not open the door to every disgruntled shareholder. And in H.J. Rai Ltd. v. Reed Point Marina,[319] the court said that the remedy does not alter the basic principle of majority rule and cannot be used by the minority to abuse the majority.

However, the absence of any precise categorization of circumstances giving rise to relief under the remedy has not precluded the courts from using it in a wide variety

316 For example, Brant Investments Ltd. v. Keepright Inc. (1987) 37 B.L.R. (Ont. H.C.), C/F Sparling v. Javelin International Ltd. (1986) R.J.Q. 1073 (Que. S.C.). Re Ferguson and Imax Systems Corp. (1983) 43 O.R. 2d. 128 (Ont. C.A.).

317 (1983) 43 O.R. (2d.) 128, 137.

318 (1987) 37 B.L.R. 6, 29 (Ont. C.A.).

319 (B.C.S.C. 1981) unreported.

of situations in which it is difficult to make any classifications. The difficulty in classifying the cases which has arisen under the remedy becomes more evident when it is realized that any such attempt will not only be arbitrary to some degree since the factual circumstances in each of the cases have been different, but also some cases can fit comfortably into two or mare classes.

Notwithstanding these qualifications, most typical applications under the oppression remedy often involve bad faith on the part of the management or directors of the corporation and the denial of shareholders rights to return on investment or some economic damage to the corporation. Applications under the remedy have also succeeded in cases where it is alleged that the controllers of the corporation have divested corporate profits to their own use or have used corporate money or assets for their personal advantage. In Redekop v. Robco Construction Ltd.,[320] the breach was a conflict of interest through which the majority shareholder of Robco received shares in another corporation as a result of his position in Robco. As a shareholder and director of both, he caused Robco to contract with the new corporation to carry on its construction business for the new corporation's account at a fixed price, thus bearing the risk of cost over-runs. There was no allegation of fraud or bad faith and the evidence before the court was at least consistent with the new agreement being a sound business deal for both companies. Because he had not complied with the disclosure provisions of the Companies Act,[321] the majority shareholder was bound to account to Robco for his shares in the new company and for any profits he might have made through it. Despite lack of evidence of loss to Robco, the courts held that the majority shareholder was "helping himself with the use of Robco's assets, ultimately at the expense of Robco's shareholders". The conduct was held oppressive.[322]

320 (1978) 89 D.L.R. 3d. 507 (B.C.S.C.).

321 S.B.C. 1973, C.18, SS.144 to 146, now Company Act R.S.B.C. 1985.

322 Supra, note 320 at 515.

Many oppression applications allege that the corporate affairs and proceedings have not been conducted in accordance with the corporate constitution. But mere proof of non-compliance with corporate constitution generally is not sufficient to warrant the granting of an order under the remedy. Something more is usually required, such as that the non-compliance is a device by the controllers to run the corporation to the total exclusion of other shareholders. In Jackman v. Jackets Enterprises Ltd.,[323] the major complaint was that the majority shareholder had caused the defendant corporation to mortgage its assets as security for a loan paid to another corporation of which he was the sole shareholder. The related corporation had no prospect of being able to repay the loan and, consequently, the complainant's equity in the defendant corporation had been impaired. The court found that this conduct was indeed oppressive, even though the previous relationship between the companies by which the related corporation had provided considerable assistance to the defendant corporation, made the loan a reasonable business arrangement. What was oppressive was the lack of adequate security for the loan from the related corporation.

In deciding on his order, Fulton J. examined the financial statements of the corporations and concluded that even if the related corporation were a party to the action, it could not give meaningful security. With the consent of the defendant shareholder, the court ordered that he provide a personal guarantee of the loan and that he pay or cause to be paid the difference in interest obligations that the defendant corporation had incurred through these financial arrangements for the related corporation's benefit.

Another class of cases where the oppression remedy has been applied involved the exclusion of the applicant from the operations of the corporation, more especially from employment, participation in management and remuneration. However, it may be

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323 (1977) 4 B.C.L.R. 358 (S.C.).

pointed out that exclusion per se does not attract the granting of the remedy because the various corporation statutes recognize and permit the removal of directors and officers of the corporation.[324] The courts in awarding reliefs under the remedy always look for something more than mere removal or exclusion from the operation of the corporation. On this basis, the court has granted relief in Re Ferguson and Imax Systems Corporation,[325] where it was found that the removal of the applicant from the corporation which resulted in the reduction of the applicant's role in the corporation was part of a plan ultimately to force her to leave the corporation.

A number of applications under the remedy had been brought successfully on the basis of conduct which was permissible under the relevant legislation and the corporate constitution, but which allegedly constituted a breach of underlying understanding and equitable consideration. This concept of fundamental and underlying understanding or expectation of shareholders through the use of the oppression remedy has been employed frequently in the closely-held corporation in situations involving exclusion from corporate affairs. In widely-held corporations, the expectations of shareholders are usually little more than expectations regarding a reasonable return on investment and responsible behaviour on the part of the directors and the concept of frustrated shareholder expectations is less frequently discussed by the courts in those situations. Applications under the oppression remedy have increasingly been resolved by balancing the expectation interests of the shareholders in forming or investing in the corporation with the rights of the board of directors to exercise its legal powers. Courts have often implemented the legitimate expectations of shareholders and have provided remedies in situations where those expectations have been frustrated by the conduct of the majority.

324 For example, see S.154(3) B.C.C.A.

325 (1983) 43 O.R. (2d.) 128 (Ont. C.A.).

Moreover, with the introduction of the "unfairly prejudicial act" as one of the grounds upon which an application could be brought, the courts came to recognize another category of shareholder rights based not upon the corporation's statute or Articles, but upon equitable considerations. In Diligenti v. R.W.M.D. Operations Kelowna Ltd.,[326] the participants have been in partnership before incorporation and the relationship between them was personal as well as commercial. A subsequent disagreement among the participants saw the plaintiff ousted from the exercise of any management authority and removed as a director. At the same time, the director's fees were increased to $1,000 per month and a management fee payable to the respondent's company was increased to 2-1/2% of gross sales per month. Mr. Justice Fulton noted that under the English law and earlier British Columbia oppression cases, an applicant could not complain of his removal as director because such conduct did not oppress him in his capacity as a shareholder. Fulton J. relying partly on the winding up case of Ebrahimi v. Westbourne Gallaries Ltd.,[327] held that in a closely-held corporation where participation in management is of the essence of the interest of the shareholders, removal as a director does affect the member in that capacity and the conduct was unfairly prejudicial to the applicant.

Many successful applications have involved the diversion of corporate profits or the personal use of corporate assets by those controlling the corporation.[328]

326 (1976) 1 B.C.L.R. 36 (S.C.).

327 (1973) A.C. 360. In fact, Fulton J. concluded in the Diligenti case that the words "unfairly prejudicial" empowered the court to give the broad relief contemplated by that section for the same conduct which the British courts in Ebrahimi had decided justified only a winding up order. He found the defendant company to be one that met the tests for quasi-partnerships, it having been formed out of a pre-existing partnership still being closely held by the shareholders who had been the partners and exhibiting fundamental understandings about management participation derived from its partnership history. The other shareholders could not insist upon their legal rights based on the corporate entity to abrogate these equitable rights. See also Re Sabex Internationales (1979) 6 B.L.R. 65.

328 See, for example, Palmer v. Carling O'Keefe Ltd. (1989) 67 O.R. 161 (Ont. Div. Ct.) which involved the Elders' takeover of Carling O'Keefe Ltd.

In summary, notwithstanding the lack of legislative guidance, Canadian courts have done a good job in determining what conduct will found a successful application under the oppression remedy. The courts have exhibited a general reluctance to put a gloss over circumstances which could give rise to the remedy. On the other hand, they have put some reasonable limits on the type of conduct which will give rise to a successful application.

3. Is the Conduct of the Applicant a Relevant Consideration in Granting Relief Under the Remedy?

A question discussed in a number of recent cases is what effect, if any, the applicant's conduct should have in the granting of a relief under the oppression remedy. The applicant's conduct may be relevant in one of two ways:

(a) It can either have a bearing on the question of whether oppression or unfair prejudice has been proven, or

(b) it can affect the nature of the remedy that could be granted.

A situation might arise where it is such that the applicant has acted in a way that justifies his exclusion from the corporation. For example, if the corporation has been set up on the basis that the applicant will make a contribution to the running of its affairs and he fails without cause to do so, this may justify his exclusion.[329] Thus, on the shareholder expectations approach, the conduct of the applicant is a relevant consideration under the remedy.

The relevance of the conduct of the applicant also finds sufficient support from the economic approach to corporate law. Under this approach, the participants in the corporation are seen as having contracting among themselves with reciprocal obligations and expectations from each contracting party. An applicant who had

329 See, for example, Re Wondoflex Textiles Pty. Ltd. (1951) V.L.R. 458.

engaged in some form of misconduct may justly be removed from his employment and this might not constitute unfairly prejudical conduct.

On the whole, Canadian courts have paid much attention to the reciprocal nature of obligations in corporations and have held in some cases that the conduct of the applicant should bar an application.

4. The Relationship of the Oppression Remedy with Other Remedies

The oppression remedy is the most important remedy under the Canadian corporation legislation. In contrast with other statutory remedies, the oppression remedy does not suffer much procedural hurdles, and the scope of conduct covered by the remedy is very wide. In addition, there exists in the various statutes incorporating the oppression remedy a broad range of reliefs which the courts are permitted to grant.

While the oppression remedy has gradually emerged to the forefront of the remedies available to shareholders, the other remedies have either declined in importance or have failed to achieve the expected degree of importance. For instance, the appraisal rights and the statutory derivative action have been utilized less than had been anticipated at the time of their introduction. Applications for winding-up by minority shareholders are less frequent than in jurisdictions without the oppression remedy. For example,[330] in the Ontario Reports between 1974 and 1982, there were seven reported winding-up applications. From 1982, the year the oppression remedy was introduced to 1988, there were no reported winding-up applications. There were, however, four applications under the oppression remedy.

While it is not intended to pre-empt the discussion on the adequacy of the other statutory remedies, it may be pointed out that the lack of reliance on these remedies is mainly because of their shortcomings. In the case of the appraisal remedy, for

330 Cheffins, supra, note 280 at 332.

instance, the short time limits and the compulsory complex procedure which must be religiously followed with the advice of a lawyer precludes many shareholders from relying on the remedy.

The wide scope of circumstances in which the oppression remedy applies also has diminished the importance of the other remedies. The oppression remedy, for example, covers most of the conduct which provide grounds €or a winding-up order and the courts are often less reluctant to wind up a corporation than to grant a relief under the oppression remedy. Even if the applicant's prayer is to obtain a court's order winding-up the corporation, such order could infact equally be granted under the oppression remedy.[331]

In comparison with the statutory derivative action, the oppression remedy has considerable advantages. Although the statutory derivative action has sought to give powers to members to litigate on behalf of the corporation in situations where those in control either refuse or neglect to do so, judicial construction of the procedural requirements inherent in the statutory derivative action has tended to diminish its utility as a mechanism for policing the board of directors and the senior management of the corporation.[332] The result is that shareholders have relied more on the oppression remedy than on the statutory derivative action, and this is more so, when it is acknowledged that facts giving rise to wrongs to corporations may often constitute the subject matter of an application under the oppression remedy as well as a statutory derivative action.[333] Moreover, an applicant seeking to bring a derivative action must first of all, obtain the leave of court. No leave is required to bring an application under

331 Section 224(2)(F) B.C.C.A.; Section 241(3)(L) C.B.C.A.

332 For example, it has been held that any shareholder seeking to pursue a derivative action must comply with the statutory provisions and obtain the leve of the court. Farnham v. Fingold (1973) 2 O.R. 132 (Ont. C.A.).

333 See, for example, Sparling v. Javelin Int'l Ltd. (1986) R.J.Q. 1073 (Que. S.C.), Re Peterson and Kanata Invs. Ltd. (1975) 60 D.L.R. 3d. 527 (B.C.S.C.).

the oppression remedy. In addition, the remedies available under the oppression remedy are broader in scope than under the statutory derivative action.

Some commentators[334] have stated (quite rightly) that the emergence of the oppression remedy as the most potent arsenal in shareholder protection may be a cause of concern with respect to its relationship with the other remedies. There is not much problem in its relationship with the winding-up remedy because this latter remedy has been drafted with the intention of merging the two remedies.[335] With respect to the appraisal remedy, a contioversial question is whether the right of appraisal is exclusive to other remedies and more particularly to the oppression remedy. Case law is conflicting on this matter although it appears that even after requesting that the corporation purchase his or her shares under the appraisal rights provisions a shareholder can apply under the oppression remedy. The dicta in McConnell v. Newco Fin. Corp.,[336] indicated that an oppression application could not be brought if appraisal rights had been validly exercised. However, the court held in Brant Investments Ltd. v. Keeprite,[337] that an application could be brought. In reaching this conclusion, the court stated that the remedy provided by Section 184 of the Canada Business Corporations Act (now replaced by Section 190(1)) is in addition to the remedies provided by Section 234 (now replaced by Section 241) and may be exercised concurrently with the remedies provided by Section 234.

The inter-relationship between the oppression remedy and the statutory derivative action is more of a problem because most acts or conduct of didrectors could give rise to an action both under the oppression remedy and the derivative action.[338]

334 For example, Cheffins, supra, note 280 at 334-5.

335 Dickerson Report, supra, note 279, at 150-51.

336 (1979) 8 B.L.R. 180 (B.C.S.C.).

337 (1987) 37 B.L.R. 65 (Ont. H.C.).

338 Cheffins, supra, note 280, 335.

In Johnston v. West Fraser Timber Co.,[339] the court stated that certain allegations constitute wrongs to the corporation and should not be the proper subject matter of an oppression remedy. In the same vein, Buckley and Connelly[340] have suggested that boundaries be drawn around the oppression remedy by requiring certain matters be dealt with by way of a derivative action rather than the oppression remedy.

However, using the derivative action to impose limits on the oppression remedy may influence the courts in imposing unnecessary procedural hurdles around the oppression remedy which will have the effect of reducing its efficacy as a protective remedy against corporate misconduct.

Summary

The growth of the oppression remedy has moved far beyond a simple good faith requirement and recent case law indicates that it will increasingly infringe upon the actions of the majority, incorporating such issues like the extent of legitimate shareholder expectations, the degree to which the court should intervene in internal corporate matters and review a corporation's business decisions and the scope of the minority shareholder rights. The courts, while increasingly extending the scope of the remedy have imposed sensible limits to the remedy.

On the whole, the courts have shown a willingness to carry out the mandate that the legislatures have given them to fashion remedies for shareholders who complain that they have been dealt with unfairly. Commenting on the scope of the remedy, Beck[341] rightly asserted that it is beyond question, the broadest, most comprehensive and most open-ended shareholder remedy in the common law world.

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339 (1982) 133 D.L.R. 3d. 77 (Appeal).

340 Corporations - Cases, Texts and Materials (1984).

341 Stanley Beck, "Minority Shareholders' Rights in the 1980s", (1982) Law Society of Upper Canada, Corporate Law in the 80s 311, 312.

B. The Statutory Derivative Action

Outline:

This part of the work will examine the adequacy of the statutory derivative action (as a protective remedy for the shareholders), focussing on the aims, objectives and purposes sought to be achieved by its existence. The British Columbia Company Act will be used as a model although references will be made to other statutes where differences occur. In order to do this effectively, the common law position towards derivative actions will be examined briefly to illustrate the difficulties in the common law which gave rise to the need for a subsequent enactment of a statutory derivative action. References will be made to the position in the United States where the remedy has given rise to a number of unique procedural and substantive questions. The main focus will be on the judicial interpretation of the procedural requirements of the statutory derivative action. Emphasis will also be given to the possibility of the acceptance of special litigation committees in Canada.

Introduction:

Traditional corporate theory views the directors and other corporate managers and officers as owing some fiduciary duties towards the corporation. Where there is a breach of any of the fiduciary duties, corporate internal autonomy principle requires that the decision to sue shall be taken by the board of directors or in certain circumstances by the majority of shareholders in general meeting. It is apparently unlikely that the wrongdoers will propose instituting an action against themselves on behalf of the corporation. From the minority shareholder's position, this aspect of the corporate internal autonomy principle has often been unfortunate, for it is hardly possible to bring an action against an errant director if the wrong complained of can be classified as a wrong to the corporation.

Over the years, the concept of the derivative action developed as a guarantee which ensures that some degree of accountability and control exist over the board of directors and senior officials either directly by allowing shareholders the right to bring an action against directors or officers if they have breached their duty or indirectly by the threat of such an action if duties might be breached. Under the derivative action, the minority shareholder or shareholders sue in representative form claiming redress for a wrong done to the corporation. The wrong having been done to the corporation, the corporation is the proper plaintiff in the action but the action may be maintained by shareholders where the wrongdoers are in control and fail to seek redress for the wrong which has been done. The action is derivative because the plaintiff's right to sue is secondary in nature and is accorded him on the ground that the true plaintiff refuses or neglects to bring the action. The corporation at all times is the injured party and at all times is the true plaintiff even though shareholders are permitted to maintain the action as nominal plaintiffs.

Early Developments

(a) The Common Law Position

The common law position was succintly stated in Foss v. Harbottle[342] where it was held that the corporation itself is the proper plaintiff in an action on account of wrongs done to it. The rule is generally understood to preclude a shareholder from bringing an action on account of a wrong allegedly done to a corporation if the wrong complained of is capable of being ratified by the members in general meeting.

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342 (1843) 2 Harre 461; 67 E.R. (189).

Later, Mozley v. Alston[343] extended this rule to cover internal irregularities in the conduct of the corporation's affairs. The court in Burland v. Earle[344] re-emphasized in clear terms this cardinal procedural rule of corporate law when it stated that:

> "it is an elementary principle of the law relating to [joint stock] companies that the court will not interfere with the internal management of companies acting within their power, and in fact has no jurisdiction to do so. Again, it is clear law that in order to redress a wrong done to the company or to recover moneys or damages alleged to be due to the company, the action should prima facie be brought by the company itself."

The procedural rule in Foss v. Harbottle and other subsequent cases hardened into substantive law[345] and in so doing prevented the minority shareholders from pursuing their remedies when directors who were also majority shareholders were acting fraudulently toward the corporation. Thus, certain exceptions to the rule were formulated by the courts to mitigate any hardship which the rule had caused the minority shareholders. It came to be recognized that the rule was not applicable where:

(a) the acts complained of were ultra vires the corporation or otherwise illegal.[346]

(b) the activity could be effective only when approved by a special resolution and only an ordinary resolution was passed.[347]

(c) the action alleges an injury to the plaintiff's personal rights,[348]

(d) the acts complained of amounted to a fraud on the minority and the wrongdoers were in control.

343 (1847) 1 Ph. 790; 41 E.R. 833.

344 (1902) A.C. 83 at 93.

345 Boyle, "A Liberal Approach to Foss v. Harbottle", (1964) 27 Mod. L.R. 603, 606.

346 Burland v. Earle (1902) A.C. 83; Ashbury Rly. Coy. v. Riche (1875) W.R. 7 H.L. 653.

347 Edwards v. Halliwell (1950) 2 All E.R. 1064.

348 Pender v. Lushington (1877) 6 Ch.D. 70.

Fraud on the minority, defined widely involves an abuse of power, usually by those in control. The plaintiff must prove some abuse of power and furthermore that the conduct was not in the best interests of the corporation.[349] Some of these include instances where the majority attempted to appropriate the corporation's property to themselves;[350] where the majority sought to appropriate minority assets to themselves[351] or where the majority had been guilty of unconscionable conduct.

Although the courts indicated a willingness to intervene in any case where there is injustice and to prevent the management of corporations being so conducted as to produce injustice or injuries to any of the members,[352] generally judicial reluctance to intervene in internal corporate matters was most evident in the context of shareholder remedies. In PavLides v. Jensen[353] for example, a minority shareholder sought to bring a derivative action against a director for negligence in selling an asset of the corporation at a gross undervaluation. The action failed since the majority could have ratified the director's action nor could have decided not to sue. However, the effects of PavLides v. Jenson was ameliorated to a little extent by the case of Daniels v. Daniels[354] where in circumstances similar to PavLides v. Jenson a minority shareholder was given standing to bring an action. But the court added that to establish a fraud on the minority it had to be shown not only that a wrong was done to the corporation, but that the wrong benefitted the wrong-doing directors. Notwithstanding the decision in

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349 See L.C.B. Gower, Principles of Modern Company Law (4th ed. 1979) pp. 616-630.

350 Menier v. Hooper's Telegraph Works (1874) 9 Ch. App. 350.

351 Sidebottom v. Kershaw, Leese & Co. (1920) 1 Ch. 154, Brown v. British Abrasive Wheel Co. (1919) 1 Ch. 290.

352 Re Laugham Skating Rink Co., (1887) 5 Ch. D.669, 679.

353 (1956) Ch.565, (1956) 2 All E.R. 578 (Ch.D.).

354 (1978) Ch.406, (1978) 2 All E.R. 89 (Ch.D.).

Daniels v. Daniels, the courts expanded the rule in Foss v. Harbottle to cover cases where the wrongs complained of were in fact carried out by the directors.[355]

There are some advantages inherent in the rule. In the first place, the rule prevents a multiplicity of actions by minority shareholders who are disgruntled at the policies pursued by a legitimate majority. Secondly, the court's reluctance to interfere in internal corporate matters may have ensured that the shareholders in general meeting did have the last say in the corporation's affairs. If the irregularity was one which could be ratified, Foss v. Harbottle prevented an action being brought until a general meeting had been held to decide the issue.

(b) United States

The counterpart to Foss v. Harbottle in the United States is Hawes v. City of Oakland[356] decided by the United States Supreme Court. Many aspects of the derivative action in the United States could be traced to the decision in Hawes. In that case, the court did not adopt the rule in Foss v. Harbottle to preclude shareholder suits on behalf of the corporation. Rather, the court made use of the power vested in it to make rules of general equity jurisdiction, and established some procedural requirements for shareholder derivative actions. Those include the following:

(a) before filing an action, the plaintiff must have made a demand on the corporation's shareholders that they take action to resolve his grievance, including endorsing an action against the prospective defendants or removing them from corporate office. When the action was filed, the plaintiff's complaint must further allege that a demand was made or state the reasons that excused him from making such demands, for example, on grounds of futility.

355 For recent English cases, see Estmanco (Kilner House) Ltd. v. Greater London Council (1982) 1 W.L.R. 2, Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2) (1982) Ch.204.

356 (1882) 104 U.S. 450.

(b) the plaintiff was required to *make* another demand on the directors and could be excused on grounds of futility.

(c) the plaintiffs complaint must plead with specificity, facts showing compliance with the requirements and must allege that the derivative action has not been filed as a result of collusion among the parties to create federal jurisdiction over an action that would otherwise be litigated in state rather than federal court.

(d) the plaintiff must establish that he owned shares at the time of the breach of duty or that his shares devolved on him by operation of law.

The rule laid down in Hawes v. Citv of Oakland differs from the rule in Foss v. Harbottle. For instance, while the rule in Foss v. Barbottle precluded shareholder actions raising certain types of claims, and'enabled shareholders successfully to move to dismiss such actions, the rule in Hawes regulates derivative actions by establishing preconditions for the plaintiff's eligibility to sue but does not exclude claims from litigability.[357]

The American cases treat litigation related questions as falling within the director's business judgement if the directors act in good faith and are disinterested in the outcome of the litigation. Thus, if the directors refuse the prospective plaintiff's demand and the plaintiff then brings a derivative action, the court will dismiss the action unless the plaintiff can establish that the directors acted wrongfully in refusing the demand.

Derivative action in the United States developed into a well-established remedy after the decision in Hawes v. City of Oakland. Many elements contributed to the evolution of the remedy. We have observed above that the decision in Hawes was a product of the court's exercise of general equitable rule-making power in an era in which the United States Supreme Court actively determined rules of general federal

357 D.A. DeMott, "Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions", (1987) 11 Sydney Law Rev. 258, 262.

common law, including principles of equity jurisprudence. This era ended in 1938 with the decision in Erie Railroad v. Tompkins[358] which restricted the court's ability, through its rule making powers granted by the federal Rules Enabling Act to prescribe rules of substantive law in addition to rules regulating procedures in federal court litigation. As a result, the substantive law relating to derivative actions brought in federal court is state law, in most cases that of the corporation's state of incorporation. The federal rules of civil procedure contain a rule specifically addressing derivative suits.[359] However, the federal courts have disagreed on the question of whether the federal rules should be interpreted simply to make applicable the relevant provisions of applicable state law - such as demand requirements or whether it imposes significant regulation of derivative actions. Although the Supreme Court has not addressed this question directly, it was held in Burks v. Lasker[360] that in derivative actions raising claims under the federal securities law, state law governs issues concerning the right to control the litigation unless the state law in question conflicts with the policies represented by the provision of federal securities regulation from which the claim arises.

Few states today still require a plaintiff to make a demand on the corporation's shareholders before commencing derivative action. The decline of demand on shareholders may have been premised on the basis that the likely quality of the shareholder's decision, especially in widely-held corporations may not justify the cost of making the demand. Requiring the demand to be made if the corporation has a large number of shareholders imposes considerable burden and expense on the plaintiff.

358 (1938) 304 U.S. 64.

359 Federal Rules Civil Procedure 23.1.

360 (1979) 441 U.S. 471.

In addition to the demand requirement on shareholders, about one third of the states impose special security for expense requirements on derivative plaintiffs and many jurisdictions in the United States also have rules controlling the settlement of voluntary dismissal of derivative actions. The security for expense statutes require the plaintiff to post security, out of which the defendant's litigation costs can be paid if the action is unsuccessful. Some statutes provide that this requirement is unapplicable if the plaintiff owns more than a specified amount of shares. The security for expense provisions were enacted in response to assertions that many derivative suits were frivolous and were brought as strike suits to exact a settlement of little benefit to anyone other than the plaintiff's attorney.

The potential for disparity in economic interest between the plaintiff's attorney and the plaintiff is part of the explanation for the special treatment of voluntary dismissals and settlements of derivative litigation.[361] Although, in the United States, the parties bear their own litigation costs but a long standing convention has permitted the plaintiff's attorney's fees to be taxed. on any common fund recovered by the plaintiff on behalf of the corporation, whether created as a result of judgement after trial or through a settlement agreement. Thus, the plaintiff with little investment in the corporation may have no investment in the action if. the attorney has been engaged on a contingent fee basis. The individual defendant's interest in negotiating the agreement is to minimize their personal financial contribution and loss. These factors suggest that the mode of settlement negotiation may not adequately protect the interest of the corporation and all of its shareholders because more of the actors in the negotiating process has economic interest that are necessarily closely aligned with those of the corporation.[362] As a result, the federal rules of civil procedure and most states now

361 D.A. DeMott, supra, note 103 at 267.

362 Ibid, at 267.

require judicial approval of any settlement or voluntary dismissal of a derivative action and require the court's approval to be preceded by notice to the corporation's shareholders of the terms of the settlement agreement. The notice enables any shareholder who objects to the terms of the settlement to come forward. The court reviews the terms of the agreement, including the amount to be paid to the plaintiff's attorney and the basis on which the fee was computed.

The procedural and substantive requirements which have been outlined make the bringing of a derivative action in the United States a difficult undertaking. Designed primarily to prevent strike suits in which the plaintiff may directly benefit and to limit the diversity jurisdiction of the federal court, these requirements have served to confuse an already complicated area of the law and thus diminish the utility of the derivative action as a remedy for corporate misconduct.

The Statutory Reforms in Canada

In Canada, mindful of the problems of the minority shareholders in attempting to bring directors and senior management to task for misdeed or negligence, most legislatures decided that the shareholders should be given a statutory derivative action, Ontario was the first jurisdiction to introduce the remedy in Canada. The Lawrence Committee after considering the alternatives to a Section 210 of the 1948 U.K. Company Act approach (to theextent that Section-210 was available to relieve against the rule in Foss v. Harbottle) concluded that the derivative action seemed to be the most effective remedy to enforce the statutory standard of conduct and care which was then to be imposed on the directors in the exercise of their responsibilities. The Committee was also mindful of the consequences generated by strike suits and collusive settlements by litigants in the United States but expressed satisfaction that the undesirable characteristics of the derivative action could be avoided. They finally suggested that the remedy could and should be adopted in Ontario law and practice to serve as an effective procedure whereby "corporate wrongs could be put right".[363] Other legislatures followed Ontario.[364]

Most of these provisions codified and to some extent modified the common law position. It would be instructive to set out one of these sections and the British Columbia Company Act will be most appropriate for our analysis. References to any differences with other provisions will be made where applicable.

Under Section 225 of the British Columbia Companjj Act 1973 (as modified), a member or director of the company, subject 'to four qualifications, may with the leave of the court, bring or defend an action in the name and on behalf of the corporation. An action may be brought to enforce any right, duty or obligation owed to the corporation that could be enforced by the corporation itself or to obtain damages for any breach of any such right, duty or obligation. The four qualifications are: that

(a) he has made reasonable efforts to cause the directors of the corporation to commence or diligently prosecute or defend the action,

(b) he is acting in good faith,

(c) it is prima facie in the interests of the company that the action be brought or defended, and

(d) in the case of a member, that he was a member of the corporation at the time of the transaction or other event giving rise to the cause of action.[365]

The British Columbia statute and indeed all other statutes that has provided for the remedy in Canada give a paramount role to the court. This approach may have been influenced by the existence of many strike suits and unnecessary harassment of corporations by corporate litigants in the United States about which Canadian draftsmen

363 Lawrence Committee Report, supra note 279 at 63.

364 British Columbia was the next jurisdiction to introduce the remedy. See B.C.C.A., S.B.C. 1973, C.18, S.222.

365 Section 225(3) B.C.C.A.

were most apprehensive. Leave of court appears to be the compromise struck by the draftsmen to allay the fears of those who thought imminent tragedy was approaching by the conferral of a derivative action right.[366]

While such action is pending, the court may give directions for the conduct of the action and order that the corporation pay the interim costs of the persons controlling the conduct of the action.[367] in addition, on the final disposition of the action, the court may order that the costs taxed as between a solicitor and his own client be paid either by the corporation, or by the person bringing the action.[368] No action brought or defended under Section 225 can be discontinued, settled or dismissed without the approval of the court.[369]

Subsection 225(7) goes to the issue of the majority's ability to ratify misconduct and provides that no application made or action brought or defended under the section shall be stayed or dismissed by reason only that it is shown that an alleged breach of a right, duty or obligation, owed to the corporation, has been or might be approved by the members of that corporation, but evidence of that approval or possible approval may be taken into account by the court in making an order under the section.

Subsection 225(8) was not in the original provision but was added by Section 45 of the 1976 Amendment Act. It defines a member for the purposes of the section to include

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366 Ziegel, et al, Cases and Materials on Partnerships and Canadian Business Corporations, 2d. ed. (Toronto: The Carswell Co. Ltd. 1989) at 1033. Fischel and Bradley stated that the requirement for leave of court is a recognition that the costs of a derivative action enforced by those with a small economic stake in the venture outweigh the benefits unless limitations are imposed to reduce these costs. See Fischel and Bradley, "The Role of Liability Rules and The Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis", Law and Economics Workshop Series, Number WS 11-11 University of Toronto, 1985 at 43-44.

367 Section 225(4).

368 Section 225(5).

369 Section 225(6).

(a) a beneficial owner of a share in the corporation, and

(b) any other person who, in the discretion of the court, is a proper person to make an application under the section.

Following the enactment of the statutory derivative actions, it is now settled that the provisions dealing with the remedy have abrogated the common law position so that it is no longer possible to bring an action on behalf of the corporation independent of these provisions. This was accepted in Ontario first by Famham v. Fingold[370] and later followed in Goldex Mines Ltd. v. Revill[371] and Feld v, Glick.[372] Despite an argument to the contrary, based both on the rule of statutory interpretation that changes in the common law must be expressly made (which, it was argued, was not done by S.222 of British Columbia previous Company Act) and on the differences in the wording between the Ontario and British Columbia provisions, the courts in British Columbia have reached the same conclusion.[373]

The main thrust of the statutory derivative provision is the overriding role given to the courts in determining who shall be allowed to bring an action on behalf of the corporation. Compliance with the preconditions is mandatory but once complied with, the court's opinion to grant leave is discretionary.

The adequacy of the existing statutory provisions regulating the derivative action depend to a large extent on how successful the courts have observed and interpreted the procedural requirements for the-application of the remedy. We shall therefore examine some of the procedural issues relating to the remedy and the court's response to them.

370 (1973) 33 D.L.R. (3d) 156.

371 (1974) 54 D.L.R. (3d.) 672 (Ont. C.A.). See also Slutsky, "Shareholders' Personal Actions - New Horizons", (1976) 39 M.L.R. 331.

372 (1975) 8 O.R. (2d.) 8.

373 Shield Development Co. v. Synder and Western Mines Ltd. (1976) 3 W.W.R. 44. The plaintiffs in this case argued that the Ontario provision was mandatory while the B.C. section was permissive and therefore should allow a common law action as well as the statutory one.

Procedural Requirements of the Statutory Derivative Action and the Judicial Response

1. Standing to Sue:

   (a) Contemporaneous Membership

While the Canadian Business Corporations Act[374] provides a wide range of applicants by conferring a right of application upon "complainants" (defined to include shareholders, present and past creditors, directors and any person considered proper by the court), the British Columbia Act provides a narrow range of applicants by limiting the right to apply to members and directors. Although Subsection 225(8) of the British Columbia Corporations Act purports to extend the meaning of a member to include anyone considered a proper person by the court, a member must have been such at the time of the transaction giving rise to the action.

The requirement!; of contemporaneous membership in [illegible]sh Columbia provision narrows down the scope of potential applicants who can benefit from the protection afforded by the remedy. There seems to be no justification why shareholders who discover wrongdoing or gross mismanagement which took place prior [illegible]uld be prevented from taking advantage of [illegible] remedy. Some commentators have argued that this requirement serves as a precaution to stop or prevent strike [illegible] or "bounty hunters".[375] However, these fears can be adequately dealt with by the court's supervision of settlements. The requirement of contemporaneous

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374 S.238.

375 For example, M.P. Krysinski, "Derivative Suits and the Special Litigation Committee - A Question of Balance in Michigan Law" (1982) 29 Wayne L. Rev. 149 at 153.

membership may result in inequity as between past and present shareholders, discriminating against those who actually suffer the loss. If the acts have only recently came to light, this may affect the value of all the shares held at the time the information reaches the market regardless of whether the shareholders held them at the time of the breach of duty.[376]

Judicial decisions have tended generally to limit the scope of potential applicants. Re Daon Development Corporation[377] manifests judicial reluctance to use the statutory discretion to expand the ambit of potential applicants. Here, a debenture holder was refused standing on the grounds that his remedies, if any, should arise from his debenture trust documents. Wallace J. held that to be a proper person, an applicant must have some direct financial interest in the manner in which the affairs of the corporation is conducted.

From the shareholder protection perspective, the judical reluctance to expand the ambit of applicants may seem plausible to prevent the multiplicity of litigations by throwing the floodgate of litigation open to all. There may be possible abuses of the system if a more liberal judicial approach is taken. On the other hand, there may be good reasons for extending the scope of potential applicants, for example, to the employees of the corporation, who it has been suggested,[378] stand to lose their livelihood through negligent or fraudulent management - a consequence asserted more disastrous than the direct economic loss which might be suffered by shareholders. However, employees are usually more adequately protected by their employment and trade union contracts.

376 For a judical decision allowing shareholders to recover for breach of duty which occurred prior to their purchase of shares, see Regal (Hastings) Ltd. v. Gulliver (1942) 1 All E.R. 378.

377 (1984) 54 B.C.L.R. 235 (B.C.S.C.).

378 M.A. Maloney, "Whither the Statutory Derivative Action?", (1986) 64 Canadian Bar Review, 309, 318.

Thus, there is no immediate danger in precluding them from applying under the remedy.

Unlike the Canada Business Corporations Act, the British Columbia Company Act does not extend the right of application to the Director (or Registrar of Companies). Granting the right of application to him may be premised on the market-public perspective. Most shareholders hold diversified portfolios and have tangible economic interests in ensuring honest and open corporate governance. A contrary argument may however, be that extending such right to the director may force upon shareholders the costs of enforcing socially desirable conduct; in effect, forcing subsidization of the public good.[379]

An intriguing question which arises under the British Columbia standing requirements is whether the right of application should be extended to past members. The Canada Business Corporations Act clearly contains an express provision which extends the right of application to former members. Generally, the nature of relief obtained under the derivative action and the essence of the remedy (being a vindication of corporate wrong) may negate any argument for extension of the remedy to past members. But a shareholder might have suffered a diminution of his investment interest in the corporation as a result of which he was compelled to withdraw his interests. Exiting the corporation might not have adequately compensated the shareholder for any loss suffered because of the director's breach of duty. In recognition of this fact, the Canada Business Corporations Act provides in Subsection 240(c) that the court may make an order directing that any amount adjudged payable by a defendant in the action shall be paid in whole or in part directly to former and present security

379 Fischel and Bradley, supra, note 366 at 149.

holders of the corporation. Extending the right of application to previous members may be **important for** instance, in a case where there was a wrong to the corporation, and control of the corporation had passed to new hands and the shareholders who were indirectly damnified by the wrong at the time it was committed and no longer shareholders.[380]

(b) The Bona Fide Applicant

Another standing requirement is that the applicant must be acting in good faith. The inclusion of this requirement may be justified on the ground that it prevents vexatious and malicious actions. Unfortunately, none of the statutes has provided any definition of the type of conduct that would fulfill the good faith requirement. Judicial decisions have not helped either. Courts usually adopt a negative definition by pronouncing when an applicant's conduct does not fulfill the bona fide requirement.[381] In Re Bellman and Western Approaches Ltd.[382] it was suggested that lack of bona fide may be evidenced by the fact that an applicant has available other actions with substantially the same remedies.

However, deducting lack of bona fide from the applicant's decision not to pursue alternative actions may lead to the introduction of extraneous factors in the good faith requirement. Where an alleged conduct gives rise to many causes of action, it is suggested that an applicant should have the right to choice of action or can plead them in the alternative provided that the requisite rules of court are observed. Courts should therefore look for more acceptable criterion

380 Fortunately the B.C.C.A. Discussion Paper 1991 recommends the extension of the right of application to past members.

381 See Anderson v. Anderson (1979) 105 D.L.R. (3d.) 341 at 343.

382 (1981) 130 D.L.R. (3d.) 193.

for evaluating the good faith requirement or dispense with this requirement if other procedural requirements are substantially complied with.

2. The Demand Requirement: Reasonable Efforts and Reasonable Notice.

The rationale for the demand requirement is to enable the corporation to have the first opportunity to exercise its right to sue. Although the British Columbia Corporations Act and the Canada Business Corporations Act provide that the applicant inform the corporation of alleged wrongdoings and of his intention to pursue an action, the specific provisions of the two Acts differ. While the Canada Business Corporations Act requires only that "reasonable notice" be given to the directors of his intention to apply to the court if the action is not prosecuted, the British Columbia Corporations Act requires that "reasonable efforts" be made to cause the directors to commence or defend the action.

Neither Acts stipulate what type of conduct will constitute reasonable notice or effort. The determination of the amount of information which shall be given to the directors is very important since shareholders usually have little hard evidence to support their claims. Access to corporate information may be limited. It would therefore impose severe restraints on applicants if there was a court imposed requirement that they verify and determine with specificity the action to be pursued.

The board of directors, on the other hand, must be given sufficient information regarding the alleged wrongs to reach a reasoned decision as to whether the corporation should take action. However, they are better placed to seek out information if given a clue as to the area of the wrongdoing. It is suggested that the burden on the applicant should remain relatively light.

Courts have approached the issue with a relatively great degree of liberal disposition. The conclusion gathered from decided cases suggest that it is sufficient to identify the impugned transaction. In Re Northwest Forest Products Ltd.,[383] the court held that the applicant need not specify the exact cause of the action but merely give the board of directors sufficient facts to find an endorsement on a generally endorsed writ of summons.

Some decided cases suggest that the degree of information required from the applicant may vary depending on the expertise of the intended recipient. These cases hold that where the intended recipient has the requisite expertise to decipher with reasonable clarity the impugned transaction, no more should be required from the applicant than a general identification of the breach. In Armstrong v. Gardiner,[384] *Cory* J. considered that two letters sent by the applicant's lawyer outlining grievances without any particulars were sufficient to fulfill the requirement because of the expertise and qualification of the director (a lawyer) receiving the demand letter.

Although the effect of the court's flexibility in determining when the demand requirement is met manifests its readiness to grant leave if the other procedural requirements are satisfied, the adoption of the subjective test as done in Armstrong's case may sometimes generate uncertainty and inequities in corporate law. The case prima facie suggest that when the director-recipient is a lawyer, then no particulars of grievances may be necessary to satisfy the demand requirement. However, sight should not be lost of the fact that most if not all directors (who are not lawyers) usually consult lawyers for legal advice on receipt of demand letters. The question that arises is whether an applicant should go further than the applicant in Armstrong's case to specify particulars of wrongdoings or should he be allowed to assume that the director intends to consult a lawyer on receipt of the letter? The danger in adopting this test may be to bring into consideration extraneous factors not considered by those

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383 (1975) 4 W.W.R. 724 (B.C.S.C.).

384 (1970) 20 O.R. (2d) 648 (Ont. H.C.).

responsible for corporate law reform when the derivative action was introduced into Canadian corporate statutes. It is therefore suggested that courts should be wary in following the test laid down in Armstrong's case and other cases based on the same reasoning.

Another problem which arises under the demand requirement is with respect to situations where the directors are themselves the wrongdoers. An interesting question is whether the demand requirement should be dispensed with if it is obvious that it will be a futile attempt to ask the directors who are the very wrongdoers to initiate proceedings against themselves.[385] There is often no possibility that the directors will resolve to bring an action on behalf of the corporation against themselves. To inform them and ask them to bring such an action may lead to hostility and delay in what is likely to be a lengthy proceeding. Some commentators have expressed the opinion that in these circumstances, the demand requirement can and should be dispensed with in accordance with the futility test.[386]

Two conflicting interests can be identified to be at stake here: the right of the board to have sufficient time to decide whether an action should be brought by the corporation and the possible abuse by a hostile board of the demand requirement to delay and cause further expense to an applicant. It may be helpful in this regard to draw a distinction between cases where the board is apparently neutral and those where the board is comprised of the very wrongdoers. It is suggested that the Acts be amended to provide that the demand requirement on the directors be dispensed with if the applicant can establish that it would be futile making such demand. However, where the board is apparently neutral, it is still essential that demand be made first and

385 Some jurisdictions in the United States apply the futility test to dispense with the demand requirement on the directors in situations where the applicant can prove that it would be futile asking the directors to initiate proceedings, for example, Delaware and District of Columbia.

386 J.H. Schnell, "A Procedural Treatment of Derivative Suit Dismissals by Minority Directors", (1981) 69 Cal. L. Rev. 885, 885.

reasonable time given to allow the directors to decide whether or not to initiate proceedings.

3. The Interests of the Company

None of the statutes provides any definition of the phrase: "the interests of the company". The courts have kept the phrase fluid to deal with the changing circumstances. In Re Northwest Forest Products Ltd.[387] the court considered that the test was met if a bona fide claim against the corporation could be shown. It was not sufficient for the respondents to rebut the allegation by stating that the corporation would be prejudiced by pursuits of the claim; although the court stated that it would consider the consequences of a final order on the corporation. In Re Marc-Jay Investments Inc.,[388] the court stated that one merely had to ask whether the action was frivolous, vexatious or bound to be unsuccessful. Similarly, the court in Re Bellman Industries Ltd. and Western Approaches Ltd.[389] refused to place a heavy onus of proof on the applicant stating the he need only show that an arguable case exists.

Despite the above manifestations of judicial willingness to encourage and allow the use of the derivative action to remedy corporate wrongs, recent cases seem to impose more stringent requirements regarding the evidence needed to show that it is in the interests of the corporation that an action be brought. For instance, in Daon Development Corporation, Wallace J. required conclusive evidence that the alleged wrong had been committed or at least that the petitioner show that Daon was probably insolvent at the time the directors authorized the payment of dividends. Furthermore, Re Berenski[390] introduced two new requirements. First, the applicant has to disclose

387 (1975) 4 W.W.R. 724.

388 (1974) 50 D.L.R. (3d) 45.

389 Supra, note 382.

390 (1981) 15 Sask. R. 182.

the circumstances upon which the courts should decide that it would be in the interests of the corporation to maintain an action. Secondly, he has to disclose the financial situation of the corporation. This second requirement may have the effect of making the granting of leave to institute a derivative action to depend on whether or not the corporation has financial resources to pursue an action. Clearly this is not a requirement of any of the corporate statute and should not be read into the provisions.

Although the granting of leave to institute a derivative action is discretionary on the courts, it is suggested that the discretion should be exercised in accordance with legislative purposes and intention in introducing the derivative action as a means of policing the board. If the financial strength of a corporation is taken as a factor in granting leave, then a director or any other person who completely raided the corporate treasury may escape sanction because the corporation could not afford to pursue the action, whilst a "less daring manipulator"[391] might have to pay the full price.

The "interests of the corporation" requirement may be relevant consideration in granting leave especially if the directors put up the defence that a corporate action would be detrimental to corporate privacy or business. The possibility of such defence suggests that there are times when the cost of corporate litigation may outweigh any advantage or benefit to be derived therefrom. In such circumstances, it may be proper to assume that it will not be in the interest of the corporation to bring an action. But the severity of the wrong and its possible effect on the corporation must always be considered.

If the view is accepted that general corporate interests usually supercedes the interests of an individual shareholder, the retention of this requirement may serve to prevent shareholders from bringing actions which may not be in the overall interests of the corporation to litigate. Given the fact that corporate statutes provide avenues for

391 M.A. Maloney, "Whither the Statutory Derivative Action?" (1986) 64 Can. Bar Rev. 309, 329.

redressing personal corporate injuries suffered by shareholders (example, oppression remedy) it is desirable to retain the "interests of the corporation" requirement. However, the courts should be cautious in interpreting this requirement to avoid introducing extraneous considerations which may becloud the real intent and purpose of the requirement as one of the pre-requisites for the granting of leave to institute a derivative action.

4. The Derivative Action and Special Litigation Committees

A primary consideration of this chapter has been an examination of the adequacy of the statutory remedies available to shareholders. It is however necessary to say a few words about the special litigation committees because the consideration of extraneous factors in deciding whether to give leave to initiate a derivative action may encourage the introduction and acceptance of these committees in Canadian corporate law.

The use of special litigation committees has generated great controveny in the United States and it may be briefly stated that there are conflicting judicial attitudes to the adoption of such committees. Where adopted, such committees usually look into an alleged wrong and determine whether it is in the best interests of the corporation to pursue the matter in court. In Auerbach v. Bennett,[392] the New York Court of Appeals held that while the substantive aspects of a decision to terminate a shareholder's derivative action against defendant corporate directors made by a committee of disinterested directors appointed by the corporation's board of directors are beyond judicial injury under the business judgement doctrine,[393] the court may inquire as to the disinterested independence of the members of that committee and as to

392 (1979) 419 N.Y.S. 2d. 920.

393 A concept yet to be accepted in Canadian corporate law.

the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee.[394]

On the other hand, in Zapata Corporation v. Maldonado,[395] the Delaware Supreme Court held that the court has an overriding role to examine the decision or recommendation of such committees. The court, according to the decision, shall apply a two-step test. Firstly, it shall inquire into the independence and good faith of the committee and the bases supporting its conclusions. If the court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, it shall hold that the committee has not carried out a reasonable investigation. The second steps consist in striking a balance between legitimate corporate claims as expressed in a derivative shareholder suit and a corporation's best interest as expressed by an independent investigation committee. The court should determine, applying its own independent business judgement, whether or not it is in the best interest of the corporation that the action be maintained.

At the present, the use of special litigation committees has not been adopted under Canadian corporate law although the case of Re Bellman and Western Approaches Ltd. suggests the possibility of its adoption in the future. The facts of this case were uncomplicated. A quarrel between two control groups of Western Approaches had made corporate discussions difficult. The Bellman group brought this action alleging inter alia, that an information circular distributed by the directors of Western contained untrue statements of material facts and omitted to state material facts as required by the Federal Act and regulations, and that the directors had exercised their powers oppressively to the plaintiffs and in complete disregard of their interests. The corporation attempted to divert the action by referring the matter to their lawyers

394 See also Roberts v. Alabama Power Co. (1981) 404 So. 2d. 629 (Ala); Alford v. Shaw (1986) N.C. 349 S.E. 2d. 41 (North Carolina Supreme Court).

395 (1981) 430 A. 2d. 779.

who advised that Price Waterhouse and Company, independent auditors, scrutinize the corporate records of Western to determine whether there were any instances where directors did not act honestly or in good faith or exercise the skill and diligence of a reasonably prudent person or whether there were any material contracts to which the company was a party, in which the directors had an interest and whether such interest was disclosed. Price Waterhouse carried out the investigation apparently on a restricted basis and reported that there were no undue excessive billings. Counsel for Western advised that no action be taken against the accused directors. Accordingly, Western's board of directors decided not to commence an action as requested by the plaintiffs.

One of the issues before the court was whether or not the recommendation by the board of directors not to proceed with' the action should be taken as conclusive evidence that such an action would not be in the interests of the corporation. The court held that that decision by the board of directors not to prosecute an action was not impartial. Four directors were not independent because they had been elected by the Duke group, the people under investigation. Although their decision was based on the independent reports of accountants and outside lawyers, the court considered that the limited scope of these investigations was insufficient to determine the decision, one way or another.

The decision of the court in this case apparently presupposes that if in fact the board of directors who took the decision not to pursue the action could have been shown to have been independent and impartial, their refusal would have decided the issue. Unfortunately, no other Canadian reported case addresses the issue of whether a disinterested board of directors can determine with finality whether a proposed action is in the interests of the corporation.

There is no unanimous opinion among academic commentators on the issue either. Some are of the opinion that such committees reflect an optimum solution to balancing the conflicting interests of corporation and shareholders, or a means by which firms can contract around or opt out of derivative suits.[396] Others see it as tolling the death knell of the derivative action.

The advocates of the special litigation committees have put forward reasons to justify its introduction into the corporate process. They save time and expense to corporations. By allowing a committee to make its own determination, a proper result will be reached with lower transaction costs.[397] Special litigation committees are also advocated because they are considered able to allocate risk efficiently.[398] Derivative actions distribute risks ineffectively by placing the entire risk upon directors rather than the more efficient risk bearers (shareholders). This may have undesirable side-effects encouraging management to become less risk averse and less effective and productive. Shareholders, it is argued, will benefit more by spreading the risk among themselves.

However, whatever may be the argument in justification of the use of special litigation committees, there may be sound reasons for its non adoption. In the first place, such committees may effectively destroy the real utility and purpose of the derivative action. The purpose of the derivative action is to serve as a deterrent, ensuring that directors carry out their fiduciary duties. It ensures that shareholder remedies do not remain illusory. Secondly, there may be problems with the selection of the members of the committee. The possibility that they will have ties, social or economic with insiders and-perhaps the wrongdoers themselves, cannot be ruled out. Such close relationship may affect the soundness of any decision or recommendation made by the committee. The result will be that many wrongdoing by directors and other corporate officers will be prevented from coming into full public view.

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396 For example, Fischel and Bradley, supra, note 366.

397 Fischel and Bradley, supra, note 366.

398 Ibid.

Under Canadian corporate law, the procedural requirements for initiating a derivative action is a matter of statutory provision. Courts are given the mandate to decide whether it is in the interests of the corporation to allow an application for derivative action. Conferring such a decision making power to a special litigation committee or any other committee appointed for that purpose will amount to an abdication of judicial responsibility which may have undesirable corporate consequences especially for the minority shareholder. Furthermore, it requires legislative intervention to confer upon a body other than the courts the power to declare that an action is not in the best interests of the corporation.

It is therefore suggested that if such a committee is set up and does investigate an individual complaint, the court should consider this as information which might aid its own decision and not conclusive of the matter.

6. Costs and Indemnity in Derivative Action

We shall conclude our discussion by briefly examining the statutory provision in the British Columbia Company Act as it relates to costs on the final disposition of a derivative action. Subsection 225(b) grants the court the discretion to impose the costs of the action on the plaintiff or other person controlling the conduct of the action.

Given the costs of litigation today, this provision may be a very effective deterrect to a shareholder bringing a derivative action. The essence of derivative action is that it is brought on behalf of the corporation by minority shareholders on the basis that they are its representatives to obtain redress on its behalf. That being so, the applicant is in a position of an agent acting on behalf of the corporation and as such, should be entitled to be indemnified by the corporation against all costs and expenses reasonably incurred by him.

This has been the position adopted by the English Court of Appeal in Wallerrsteiner v. Moir (No. 2)[399] where Lord Denning stated that

> "if the minority shareholder had reasonable ground for bringing the derivative action - that it was a reasonable and prudent course to take in the interests of the company - he should not himself be liable to pay the costs of the other side, but the company itself should be liable, because he was acting for it and not for himself. In addition, he should himself be indemnified by the company in respect of his own costs even if the action fails. It is a well-known maxim of law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails. This indemnity should extend to his own costs taxed on a [solicitor and client] basis".

Shareholders should not be inhibited from commencing derivative actions by the fear of being ordered to pay the costs of litigation even if the action eventually fails. The risk of strike suits and frivolous actions is obviated by the presence of other statutory preconditions for commencing a derivative action: a shareholder must obtain leave of the court; he must prove that he is acting in good faith and that it is prima facie in the interests of the corporation that the action be commenced.

It is therefore suggested that once the shareholder has satisfied the preconditions and obtained leave of court, the position as to costs and indemnity should be exactly as stated by Lord Denning.

The Appraisal Remedy

Introduction

Generally speaking, a dissenting shareholder has available to him two courses of action other than the appraisal route, He may go along with the majority and hold his shares or he may sell his shares in the market (if the corporation in which the shares are held is a widely-held corporation). But where he chooses to exercise his appraisal

[399] (1975) 1 All E.R. 849.

right, it will be assumed that he considers the right more beneficial than the other options open to him. As a remedy provided for the shareholders, the usefulness and adequacy cf the appraisal right depends on the ease and efficiency of the appraisal procedures. If the appraisal remedy entails substantial costs or if the shareholder is required to hang in uncertainty for a protracted period, then the game of appraisal may not be worth the candle.

Questions which may be relevant in examining the adequacy of the appraisal remedy include the following: How long will the procedure take to collect on a claim under the appraisal statute? Who is to pay for the expenses of appraisal; the claimant or the corporation? When does the dissenter have to make up his mind about filing the claim and does he forfeit other remedies if he files? When does the dissenter cease to be a shareholder for purposes of dividends, notices, suit and other matters? Once he has undertaken the route to dissent and claim, may he change his mind and rejoin the corporation? These questions and many more are relevant in assessing the adequacy of the statutory provisions which confer the right of appraisal on shareholders. Space may not permit us to touch on all the issues relevant to our evaluation but an attempt will be made to highlight the more important onces.

The discussion shall be divided into four sections. The first-section considers the origin and rationale for the introduction of the appraisal right in Canadian corporation laws.

Section II examines the statutory provisions regulating the appraisal procedure. The procedural requirements are highlighted since they will form the basis for examining the adequacy of the current form of appraisal right. Since most Canadian corporate statutes contain provisions relating to the appraisal right, it would be most imprudent to set all of them out. For this reason, the C.B.C.A. representing the federal provision will be used as a model for our analysis. References will be made to other statutes where differences necessitate.

In Section III, the practical problems of designing and administering an effective appraisal right are considered. It is suggested that the current form of the appraisal remedy is far from being adequate. In fact, it is bridled with many problems which include the allocation of the burden of costs, taxation of the award, questions of procedure, and lack of precise method of valuation. Suggestions for improvement are also made in this section.

Section IV examines the important question concerning the exclusiveness of the appraisal remedy. The determination of this may give us some insight into the extent to which the appraisal right affords protection to the minority shareholder. It is noted that while the federal model contains two conflicting subsections which render the issue ambiguous and unresolved, the British Columbia Companies Act is silent on the issue. Recent judicial and academic opinions are examined. It is suggested that the appraisal remedy ought not to be an exclusive remedy. Suggestion for legislative intervention to clarify the issue is equally offered.

I The Origin of, and Rationale for Introducing the Right of Appraisal in Canadian Corporate Law

The introduction of statutory appraisal rights in Canadian corporate law, which permit shareholders to request, upon the occurrence of certain events, that the corporation buy their shares was intended to alter the balance of rights between majority- and minority shareholders on fundamental corporate changes.[400] The Dickerson Committee which recommended the introduction of the appraisal remedy

[400] For general overview of the origin of appraisal rights, see J.C. MacIntosh, "The Shareholder's Appraisal Right in Canada: A Critical Reappraisal", (1987) 24 Osgoode Hall Law Journal 201. The first modern appraisal provisions applying to a variety of fundamental changes in widely-held corporations were adapted in the British Columbia Companies Act, S.B.C. 1973, C.18, S.228. Prior to this period, the province of Ontario had adopted an appraisal right in respect of closely-held corporations in The Corporations Act, 1953, S.O. 1953, C.19, S.99. In 1975, following the recommendation of the Dickerson Committee, the appraisal right was enacted in the Canada Business Corporations Act (C.B.C.A.) S.C. 1974-75, C.33, S.184. The C.B.C.A. provision was modelled after similar provisions in New York's Business Corporation Law Ch.4, Consolidated Laws, Law 1961, Ch. 855.

into the Canada Business Corporations Act was much influenced by the reluctance of courts at common law to intervene to protect minority shareholders where there was no fraud or bad faith. They concluded that the state of the common law was "at best unsatisfactory, at worst downright unjust".[401] The appraisal right was intended to strike a new balance between majority and minority shareholders - while the majority could "if they go through the proper formalities and if they pay any dissenting shareholders, effect almost any fundamental change with impurity",[402] the minority would have the right to opt out of the enterprise on the undertaking of the change and if enough shareholders dissented, the further ability to block the fundamental change altogether. According to the Committee, the result is a resolution of the problem that protects minority shareholders from discrimination and at the same time preserves flexibility within the enterprise, permitting it to adapt to changing business conditions".[403]

Discrimination was not the only problem to which the appraisal right was addressed. The Committee observed that the remedy could perform another function: allowing the minority to escape fundamental corporate changes that "change fundamentally the nature of the business in which the shareholder invested".[404]

The appraisal remedy thus seeks to strike a balance between the interests of the majority and minority shareholders of the corporation. On the one hand, traditional corporate legal theory recognizes the ability of the majority shareholders, if they obtain the requisite consent, to undertake fundamental corporate changes. In a world of

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401 R.W.V. Dickerson, J.L. Howard and L. Getz, Proposals for a New Business Corporations Law for Canada, Vol. 1 (Ottawa: Information Canada, 1971) at 114-115. (Otherwise called the Dickerson Report).

402 Dickerson Report, supra, note 3 at 115.

403 Ibid.

404 Ibid.

changing business and commercial environment, a great deal of corporate flexibility is necessary to meet changing conditions of business. Such changing environments may, for example, require an alteration of the capital structure of the corporation, alteration of the rights attached to different classes of shares in the corporation or even the creation of new or elimination of existing classes of shares. Changes in the business environment may in addition necessitate rescaling the enterprise either by corporate combination or by reduction in the size of the enterprise.

On the other hand, the minority shareholders desire protection against fundamental corporate changes resulting either in an alteration of the risk of the business or impairing enterprise value and thus reducing the market value of the firm's securities. Similar protection may be needed against changes in the rights attached to various securities of the corporation which may have the effect of diminishing the value of those securities.

In general, the appraisal remedy recognizes the power of the majority shareholders to effect fundamental changes in the corporate structure while at the same time, giving any dissenting shareholder the right to insist that his shares be purchased by the corporation.

II: The Statutory Provisions

What triggers the appraisal rights are fundamental corporate transactions. Most corporate statutes in Canada give the shareholders the right of appraisal in the event that a triggering transaction occurs. For instance, Section 190(1) of the Canada Business Corporations Act enumerates a number of fundamental changes in which a shareholder may insist on an appraisal as a matter of rights. These include:

(a) an amendment under Section 173 or 174 of the Articles of Incorporation to add, change or remove any provisions restricting or constraining the issue, transfer or ownership of shares;

(b) an amendment under Section 173 of the Articles of Incorporation to add, change or remove any restrictions upon the business that the corporation may carry on;

(c) a resolution under Section 188 to continue the corporation under the laws of another jurisdiction;

(d) the sale, lease or exchange of all or substantially all of the corporation's property under subsection 189(3); and

(e) an amalgamation with another corporation otherwise than under Section 184.[405]

In that Act, in two other contexts, an appraisal may arise not as of rights but pursuant to a court adjudication of entitlement.[406] Under the oppression provision the court may, as a remedial tool, order the corporation or any security holder to buy the shares of the complainant.[407] Similarly, where a statutory arrangement is undertaken, the court has authority to order that any shareholder or shareholders may dissent under Section 190.[408]

The appraisal procedure as contained in the different statutes is highly technical,[409] with several distinct steps to be completed in limited time periods. In the first place, the appraisal rights do not arise unless the shareholder dissents or abstains at the meeting and sends a written objection to the corporation at or before the shareholder meeting. The appraisal remedy is not triggered by this written objection and the shareholder must still send a demand for payment to the corporation within a

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405 Section 231 of the B.C.C.A. contains similar provision but goes further to provide appraisal rights in circumstances enumerated under S.127 B.C.C.A. (company giving financial assistance for the purchase of its shares) and S.268 (conversion of specially limited company into a company having a Memorandum of Association).

406 Although we are concerned with situations where the shareholder can claim appraisal as of right.

407 Section 241(3)(f); See also Section 224(2)(c) B.C.C.A.

408 Section 192(4)(d) C.B.C.A.

409 See generally C.B.C.A. Section 190(3)-(16); B.C.C.A. Section 231(2)-(4).

20-day period[410] before it has a duty to repurchase the shares. Dissenting shareholders must also return the share certificates within 30 days thereafter.[411]

If an offer is made by the corporation, the shareholder has 30 days to accept it. If no offer is made, or if the offer is rejected, the corporation can bring the matter to court, failing which the shareholders has a 20 day period to do so.[412] After the demand for payment is sent in, the dissenting shareholder loses any rights to participate in the corporation.[413]

The failure to perform one step in the allotted time may mean that appraisal rights are lost. However, the courts sometimes do not interpret these requirements strictly.[414] The courts are also given the power to determine the value of the shares where the Corporation and the dissenting shareholders fail to do so.

III: The Adequacy of the Appraisal Provisions in Canadian Corporate Law

Whether or not giving the minority shareholders an appraisal right is an effective means of protecting them in the corporation depends largely on whether the right of appraisal can be designed to meet the needs of the shareholders (the object of the protection) and also on the extent of the cost of the exercise of the right to the shareholder and the corporation against which the right is being exercised.

The current form of statutory provisions regulating the exercise of the appraisal remedy raise basic questions about the value of the right to shareholders. It is

410 S.190(7) C.B.C.A. In B.C.C.A. jurisdiction, he is required to do this within 14 days (S.231(3) B.C.C.A.).

411 S.190(8) C.B.C.A. Only 14 days is required in the B.C.C.A. S.231(3).

412 S.190(16) C.B.C.A.; Section 231(4) B.C.C.A. provides no time within which an application could be made.

413 S.190(11) C.B.C.A.; S.231(7) B.C.C.A.

414 See, for example, Re Douglas Inc. (1980) 13 B.L.R. 135 157-58 (Que.).

worthwhile to take a closer **look** at some of the problems and see what suggestions could be made for a more adequate and effective appraisal right.

(a) Problem of Taxation

The current income tax treatment of the proceeds of dispositions arising from the exercise of an appraisal right is far from being satisfactory. While the exercise of the appraisal right by a dissenting shareholder triggers a taxable event for him, the fundamental corporate change dissented from often does not result in any taxable event for the non-dissenting shareholder who chooses to stay on with the corporation.

A decision on whether to exercise the appraisal right or not will invariably depend on, inter alia, the relative tax treatment accorded dissenting and non-dissenting members. On the one hand, a less favourable tax treatment for dissenters may create an artificial disincentive to the exercise of the appraisal right and thus extenuate the protection that the remedy affords minority shareholders. On the other hand, a preferential tax treatment of dissenters may result in shareholders exercising the appraisal right only for tax reasons, "a clearly wasteful and unproductive use of social resources".[415] It will be improper to accord dissenters more favourable treatment than non-dissenters and vice versa.

A solution therefore lies in fashioning a tax rule which while not having the effect of diminishing the utility of the appraisal remedy, does not, however, create a reason for exercising the appraisal right. This implies that a balance should be struck in the tax treatment of dissenters and non-dissenting shareholders. In this regard, I suggest that dissenters should receive the same tax treatment that non-dissenting shareholders will receive under the terms of the fundamental corporate change. More specifically, if the fundamental transaction is such that will create taxable consequences

415 Ibid, at 250.

for non-dissenters, then any shareholder who dissents from the transaction should be subjected to the same tax treatment. This approach will invariably remove the tax system as a consideration either for or against exercising the appraisal right, and allowing the decision to be made purely on the basis of the nature of the fundamental corporate change.

(b) Cost of Re-Investment

Most minority shareholders often reinvest the proceeds arising from the exercise of an appraisal right into one corporation. Where this is the case, one of the burdens which the shareholder has to bear is the brokerage and reinvestment costs. The thought of bearing this extra burden on the exercise of this appraisal right may create a disincentive on the minority Shareholder who may consider the game of appraisal not worth its merit. This has led some commentators to suggest that any brokerage fees or other reinvestment costs be added to the appraised value of the shares. Such an approach seems feasible. It has the potential of alleviating the hardships which may confront the minority shareholder after exercising his right of appraisal in one corporation.[416]

However, as in the case of tax costs, the objective should be to ensure equal treatment of dissenters and non-dissenters in order to eliminate any artificial incentive to exercising (or not exercising) the appraisal right. To prevent any anomaly in the treatment of both groups of shareholders, some academic writers have suggested that the problem of brokerage fees and other re-investment costs may be avoided by "awarding re-investment costs according to a pre-determined schedule, computed and revised from time to time on the basis of industry averages, and awarding a constant fraction of these costs determined by computing a mean present value of future

416 At least to compensate for his involuntary loss of "ownership" - to make up for the fact that the sale is in his eyes, a forced sale.

investment costs (based on a mean shareholder horizon to disposition in the normal course of events)".[417]

This approach may be the ideal one but it apparently involves some computations which will render more confusing; an already technical area of corporate law. Pending the adoption of a legislative solution to the problem, the minority shareholder still has to bear any brokerage costs generated by the re-investment of the proceeds of appraisal. This is no doubt, at some cost to the efficacy of the appraisal right.

(c) Procedural Problems

The not-encouraging procedural provisions of appraisal statutes in Canada has led to the assertion that the statute(s) require a litany of notices, counter-notices and deadlines, and the shareholder who fails to comply strictly with these provisions may be disentitled from exercising his appraisal right. The provisions increase the possibility of fatal technical ships.

One wonders then what purpose is sought to be achieved by these technical procedural requirements: to protect or to diminish the interests of the minority shareholder? The court is empowered on the application of the corporation or the shareholder to determine a fair value for the shares. No indication is given as to who has the burden of proving fair value. No provision is made for pleadings or discovery.[418]

417 MacIntosh, Ibid.

418 Under the C.B.C.A. S.190(21), although the court may in its discretion appoint one or more appraisers to assist the court in fixing a fair value for the shares, no provision is made with respect to who bears the cost of the court appointed appraiser. The B.C.C.A. does not contain a similar provision but only provides that the court shall determine the fair value of the shares on the application of the corporation or the dissenting member. It is suggested that where the court decides to appoint an appraiser to help it in fixing a fair value, the problems as to the burden of cost of appointing the appraiser equally arises.

Fortunately, cognizant of the reasons which weighed on the minds of those responsible for corporate law reform in Canada, the courts have indicated willingness to manifest great flexibility in interpreting the procedural requirements of the appraisal statutes. In Neonex International Ltd. v. Kolasa[419] Bouck J. converted the dissenter's application to determine fair value into an "action" to give the claimant the benefits of pleadings and discovery. In order that the corporation bear the burden of proving the fair value of the shares, the court ordered the corporation to stand as plaintiff and the applicant as defendant in the reconstituted action. Similarly, in Robertson v. Canadian Canners Ltd.,[420] the Ontario High Court directed a trial of the issue of fair value, complete with pleadings, discovery, and production with the corporation standing as plaintiff. And in Jepson v. The Canadian Salt Company Ltd.,[421] the dissenting shareholder appeared to have failed to comply with the statute in a number of important respects that might have proved fatal to his appraisal application with a less sympathetic judge.[422]

Notwithstanding these judicial benevolence to the minority shareholder, it is still clear that the present procedural requirements are far from being satisfactory. More could be achieved by legislative drafting to take care of the procedural difficulties.

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419 (1978) 2 W.W.R. 593.

420 (1978) 4 B.L.R. 29. At page 292, the court stated "the Act casts upon the directors an obligation to fix a fair value of the shares and to show by accompanying statements how it was determined. We read this provision as casting upon the directors an obligation, in the first instance, to justify the fair value . . .".

421 (1979) 7 B.L.R. 181 (Alta. S.C.).

422 See also Douglas Inc. v. Jarislowsky, Fraser and Co. (1980) 13 B.L.R. 135 (Que. S.C.); Alexander v. Westeel-Rosco Ltd., (1978) 4 B.L.R. 313.

(d) Financial Costs of Exercising the Appraisal Rights

Two major issues confront the adequacy of the appraisal remedy with respect to the financial costs of exercising the right. The minority shareholder who intends to exercise his appraisal right ought not encounter financial cost problems that would prevent him from doing so and destroy the utility of the right. On the other hand, rules relating to the financial cost of appraisal ought not invite the minority shareholders to abuse the appraisal rights for its nuisance value.

Under Canadian corporate law, courts have usually adopted the rule that costs follow the event; in this case it follows the relative success of each party in establishing a claim in respect of fair value. The uncertainty that attends the determination of fair value and the degree of potential costs may deter an average risk-averse shareholder from exercising the appraisal rights. If the corporation is compelled to bear the cost of the appraisal right, the burden of the costs will be shifted to other shareholders. This invariably removes costs as an obstacle to the exercise of an appraisal right. But this generates its own problems: shareholders may exploit the appraisal right for its nuisance value.

A solution may be found in imposing the costs of valuation on the corporation subject to the court's discretion to order otherwise if the applicant exercises the appraisal right, bargains for a-resettlement or proffers a valuation in bad faith.

(e) Lack of Precise Valuation Method

Another problem which may diminish the efficacy of the appraisal right as a minority shareholder right is the lack of any precise method of evaluating the appraisal shares. Under the C.B.C.A. and B.C.C.A. (and even in cognate statutes), the court is empowered, on the application of the corporation or the shareholder, to fix the fair value of the shares. In the C.B.C.A., the court may appoint an expert valuer to help in doing this. The B.C.C.A. does not contain a similar provision but states that the price to be paid to a dissenting member for his shares shall be their fair value as of the day before the date on which the resolution was passed including any appreciation or depreciation in anticipation of the vote on the resolution.

Although the B.C.C.A. provision appears more promising, both Acts leave open the important questions of what constitutes a "fair value" and what criteria are to be used in establishing it? The meaning to be assigned to fair value is very important as dissenting shareholders must be able to assess the utility of dissenting and seeking appraisal. Where there is a considerable minority, this assessment may be crucial for, if there are a large enough number of dissenters and the fair value to be assigned to their shares is likely to be higher than current market, the costs of the proposed transaction may become prohibitively high and cause its abandonment. In addition, lack of precise valuation method may lead to uncertainty in the anticipated amount to be awarded.

As the determination of fair value becomes a matter for judicial discretion in each instance, it also gives rise to multiplicity of decisions and interpretations by courts. A minority shareholder uncertain about the amount the court may consider that his shares are worth may be skeptical exercising the appraisal right, even in the face of a fundamental corporate change which he considers value-decreasing. The result is that the efficacy of the appraisal right as an avenue whereby the minority bail-out of the corporation in the event of a triggering transaction is further diminished.

Courts have confronted this problem. An extensive examination of the jurisprudence in the area is contained in Re Wall and Redekop Corporation,[423] where Mr. Justice MacFarlane declined to hold that fair value must mean market value. He

423 (1974) 50 D.L.R. (3d) 733.

agreed that it is one of the factors to be weighed but it is not the sole or only factor and that it could rarely be taken to be representative of fair value in expropriation cases.

In more recent cases, the courts have interpreted the phrase "fair value" in a manner which advances the remedy provided by the appraisal right. For instance, in Domglas v. Jarislowsky, Fraser and Co.,[424] a case which arose out of an amalgamation squeeze out under Section 190 of the C.B.C.A. , Greenberg J. noted that

> "the appraisal remedy should be construed and applied in a fair, large and liberal manner, so as to achieve its primary purpose of protecting and benefitting the dissenting shareholders".[425]

He went on to conclude that a "fair value" would be one which was just and equitable. The terminology contained within itself the concept of adequate compensation consistent with the requirement of justice and equity.[427]

Notwithstanding above willingness on the part by the judiciary to interpret what constitutes a "fair value" in a manner that advances the remedy offered by the appraisal right, the basic appraisal provisions could stand some improvement by a legislative intervention containing a more precise evaluation method.

Summary

Whatever the potential attractions inherent in the appraisal right, unless it can be made to work in practice, it cannot fulfil its functions. Many procedural and other limitations inher the adequacy of the right in its current form.

424 (1980) 13 B.L.R. 135 (Que. S.C.); affd. (1982) 138 D.L.R. (3d) 521.

425 Ibid, at 13, B.L.R. 162.

427 Of particular interest to Greenberg J. was the fact that while the expression "fair value" appears eight times in S.190, the first five tinies it is preceded by the definite article "the" and on the last three occasions, by the indefinite article "a". "The" fair value implies that there is not one, but rather several possible fair values. There existed a range within which the value could be fixed by the court. To Greenberg J.'s mind, this was no accident nor coincidence. "Parliament must be assumed to have intentionally and deliberately distinguished between those instances where "the" fair value is used and those where "a" (fair value) is employed". at p. 165.

Amendments can be made to the procedural provisions that could improve its efficacy. Any change in this direction would definitely have the effect of reducing the uncertainties currently associated with the exercise of the remedy. Minority shareholders would benefit more from any improvements which make appraisal right more attractive.

IV: Is the Appraisal Right an Exclusive Remedy?

A further problem which the existence of the appraisal right gives rise to, is that of the exclusiveness of the remedy. The resolution of this problem will help one to evaluate the adequacy of the right as a remedial option to the minority shareholders. Any provision which does not advance the remedies afforded minority shareholders should not be considered an appropriate one. If the appraisal right is an exclusive remedy the exercise of which forecloses other types of relief, it will be of little value to a minority shareholder for whom merely exiting the corporation might not be an adequate relief. Furthermore, taking into consideration the uncertainties in the current form of the appraisal remedy with a catalogue of procedures which demand religious adherence, a minority shareholder stands the risk of losing his entire rights if he fails to obtain relief under the appraisal provision on grounds of non-compliance with procedures.

But if the remedy is not an exclusive one, the minority shareholder can file an application under the appraisal remedy simultaneously with another relief. In that situation, if the appraisal claim fails, he would be able to pursue the other remedy. In another sense, such a course would appear beneficial to the minority shareholders: claiming more than one relief in the same course of action reduces the litigation costs involved in filing different claims.

In the United States there exists some confusion over the effect of the existence of appraisal upon other course of action open to a dissenting shareholder. While in some jurisdictions, the statute expressly states that appraisal is the exclusive right of the shareholder if the prescribed triggering transactions are implemented,[427] in others the statute is silent.[428]

In Canada under the Canada Business Corporations Act, the appraisal right is stated to be in addition to any other right which the shareholder may have.[429] This implies that he may bring an action under S.190 simultaneously with another; for instance, under the oppression remedy or derivative action. However, the matter does not end here, because subsection 190(11) provides that upon sending a demand for payment to the corporation, the dissenting shareholder ceases to have any rights as a shareholder other than the right to be paid the fair value of his shares.

An interesting issue which arises from the combined effects of those two provisions is whether a shareholder is precluded from seeking any other relief from the court since it is evident that the corporation has paid him off. Does it make any difference at all if his allegation is that he did not receive a fair value for his shares? Clearly this cannot be asserted to be the aim of the appraisal remedy because such an interpretation would give many corporations an incentive to force any value on a dissenting shareholder.

Although the statutes try to mitigate this problem by providing right of application to the court for the determination of a fair value for the shares, another important question arises: what happens if, during the interval when the shareholder is awaiting a court's ruling on the determination of what constitutes a fair value for his

427 For example, the California Corporate Code, S.1312 (1988); New York Corporation Law, S.623(e) and (k) (Consol. 1977).

428 The Delaware Corporate Code is silent.

429 S.190(3).

shares, the corporation decides to issue bonus shares or pays dividends to other members excluding the dissenting shareholder? Again, one cannot tow the line of argument that once a demand is made on the corporation, the rights of the dissenting shareholder as a member extinguishes. Ideally, the rights attached to membership of the corporation should run until the receipt of a fair value for the shares. Prior to this time, it will be unfair on the minority shareholder *to* deny him any entitlement[430] merely on the basis that he indicated "an intention" not to go along with the corporation with respect to certain fundamental corporate changes.

The British Columbia Company Act does not contain any more elaborate provision but simply states that every dissenting shareholder who has given a notice that he requires the corporation to purchase his shares may not vote, or exercise or assert any rights of a member in respect of the shares for which notice of dissent has been given.[431]

Judicial opinion is divided on this issue. In McConnell v. Newco Financial Corporation,[432] minority shareholders brought a petition under Section 241 challenging the passing of an extraordinary resolution consolidating the company's shares on a basis of 1,000 to one. The petition was challenged by the company because long before Section 241 action was commenced, the minority had sent notice under Section 190 requiring the company to purchase their shares at a fair value. The company argued that the shareholders had ceased to have any rights other than the right to receive a fair value for their shares. The shareholders were allowed to continue with the action under Section 241 on a technicality. The notices sent under Section 190 were held invalid; and did not therefore bar the availability of the oppression remedy.

430 Which includes the right to seek legal redress for corporate management misconduct which affects him in his personal capacity.

431 S.231(7)(a).

432 (1979) 8 B.L.R. 180 (B.C.S.C.).

While this decision avoided the question of the exclusiveness of the appraisal remedy, the matter was dealt with in Re Brant Investments Ltd. v. Keeprite Inc.,[433] A meeting was called to vote upon Keeprite's proposal to purchase substantially all of the assets and business of I.C.G. Manufacturing Ltd. for approximately $20 million. I.C.G. coincidentally was the owner of 65% of the outstanding shares of Keeprite. Brant Investments, owner of 28% of Keeprite's shares voted against the resolution and then exercised its right to dissent under Section 190. There was a disagreement on the fair value of the shares and an application was brought to the court. While the determination of fair value of the shares was pending, Keeprite decided to issue a rights offering, proceeds of which would finance the asset purchase. Brant brought a motion for interim and permanent relief alleging that the proposed acquisition of I.C.G. was for an amount in excess of fair market value and without full disclosure. Keeprite urged Subsection 190(11) upon the court.

While acknowledging the force of that Subsection, the court stressed that Subsection 190(11) must be interpreted in the light of the object and purpose of all the provisions of Section 190. The appraisal remedy is a contingent remedy, since the corporation would only be permitted to pay the dissenters if it met the liquidity and solvency requirements of the Section. If it could not meet those requirements, the dissenting shareholders have the right to withdraw their dissent and retain their rights as shareholders. Further, Subsection 190(3) states that appraisal is in addition to any other right the shareholder may have. A remedy with such characteristics, it was reasoned, was not intended to preclude the broad rights referred to in Section 241. The court stressed the very short period of time within which the shareholder was required to send in his demand for payment of fair value. He could not reasonably be expected

433 (1983) 44 O.R. (2d) 661.

to make an intelligent choice between Section 190 and Section 241 remedies in such a short time.

It is submitted that the reasoning in this case is reflective of sound judicial interpretation of this aspect of the appraisal provisions.[434]

Academic opinion is in favour of non-exclusiveness of the appraisal remedy. Professor Vorenberg in his leading article succinctly summarized the disadvantages to the dissenting shareholder in relying exclusively on the appraisal remedy.[435]

> ". . . resort to appraisal will, even under the best of the statutory procedures, often give the stockholder less than his stock is worth. Failure to comply with statutory provisions . . . may deprive him of his appraisal rights altogether. Inevitably, the procedure involves delay and uncertainty, with expenses which may cut into his recovery. The valuation process itself may involve a significant financial sacrifice . . .. The nub of the problem is that an absolute freeze-out right would mean that those in control rather than the stockholder himself would decide when he should sell his stock . . .. Far more difficult is ensuring to departing stockholders the benefit of improved prospects, where, at the time of appraisal, the evidence of improvement is more intuitive than tangible . . .. The appraisal process will tend to produce conservative results where the values are speculative, and the majority's power to pick the time at which to trigger appraisal may encourage them to move when full values may be temporarily obscured."

The better view, in my opinion, therefore, is that the appraisal remedy ought not to be considered exclusive and that it should be looked upon as merely one option that is available to an aggrieved minority shareholder. Legislative amendments may be necessary in this regard, to clarify the ambiguity created by Subsections 190(3) and 190(11) of C.B.C.A., and in the case of the B.C.C.A., to expressly amend the existing provisions to the effect that the appraisal right is not an exclusive remedy. No doubt such legislative move will enhance the adequacy of the appraisal remedy.

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434 Recently, in the United States, the Delaware Supreme Court considered the pursuit by a shareholder of the concurrent remedies of appraisal and a challenge of the terms of a cash-out merger on the basis of breach of fiduciary duty. The decision of the court is the first which recognizes that a shareholder may pursue independently, appraisal and fraud actions. See Cede & Co. v. Technicolor Inc. (Cede & Co.) (1988) 542 A. 2d. 1182.

435 Vorenberg, "Exclusiveness of the Dissenting Shareholder's Appraisal Remedy", (1964) 77 Harv. L. Rev. 1189 at 1201-2.

Conclusion

The introduction of the appraisal rights into Canadian corporate law was designed to supplement existing remedies and to strike an appropriate balance between majority and minority shareholders. Obvious reasons exist why the minority shareholders would derive the protection afforded by the appraisal right, Such protection is needed against unwise business decisions that threaten to diminish security values and also against the effects of discriminatory treatment of the shareholder.

However, the desirability of having an appraisal right cannot be divorced from a host of practical considerations. An ideal appraisal provision should in practice be designed to meet the needs of the minority shareholders. The current form of the statutory appraisal remedy in Canadian corporate law suffers from procedural, cost, taxation and other operational difficulties that render it a less attractive remedial option than it might be. More specifically, the current tax treatment of the proceeds of dispositions resulting from an appraisal is not entirely satisfactory. Legislative reform is therefore needed to improve the efficacy of the appraisal remedy. It is also imperative that legislative amendments be introduced to specify expressly that the appraisal remedy is not an exclusive remedy. This approach is necessary in view of what I have said earlier on.

D. The Just and Equitable Winding Up

The last of the minority shareholder's statutory remedies, I shall discuss is the court's power to order a winding-up on the just and equitable ground. This is an extreme remedy and indeed one of desperation whose utility is apparently only real in the closely-held corporation. Two issues are relevant to my discussion: (i) the general nature of the relief which includes the circumstances under which it would be granted, and (ii) the adequacy of the protection offered by the remedy.

Both the B.C.C.A. and the C.B.C.A. contain provisions which give the court a discretion upon the application of a member, to order that the corporation be wound up, if it thinks it just and equitable to do so.[436] My main emphasis is to explore the general nature and circumstances in which the court can wind up the corporation on the just and equitable ground. An examination of the case law on this subject is relevant since the granting of the remedy is based on judicial discretion. It will be canvassed that although principal categories have emerged from judicial decisions, the facts rendering it just and equitable that a corporation be wound-up cannot be resolved into precise categories. Cases upon the subject merely manifest the widespread nature of circumstances justifying the exercise of the court's discretion.

Thereafter, I shall look into the relative utility of the remedy to a minority shareholder. My observation is that the efficacy of the remedy may be diminished by many factors which include the presence of an open-ended oppression remedy that covers most situations under which a winding-up order could be made.

When Will a Winding-Up Be Just and Equitable?

In Chapter One of this work, I documented the vulnerability of the minority shareholders to majority oppression and misconduct. Absent any protective provisions in the corporate constitution, the minority shareholder can be removed from any salaried position that he holds in the corporation or from his office as director; can be deprived of a return on his investment by a refusal of the corporation to declare dividends and will be unable to liquidate his investment either because of the director's

436 B.C.C.A. Section 295(3); C.B.C.A. 214(1)(b)(ii).

refusal to register a transfer of his shares or because of his inability to find a purchaser for his interest in the corporation.

A minority shareholder who finds himself subject to this type of oppressive treatment can apply to the court for an order to wind up the corporation on the just and equitable ground. In exercising the powers conferred by this relief, the courts have not limited their discretion but have felt free to consider in the "widest possible terms what justice and equity require".[437] The courts have also adjured that the facts rendering it just and equitable that a corporation should be wound up cannot be resolved into categories and that the tendency to create categories or heading is wrong; the general words of the section should remain general and not to be reduced to the sum of particular instances.

In recognition of the special nature and needs of the closely-held corporations, the courts have expanded the relief into new areas as fresh circumstances and situations have arisen. In Loch v. John Blackwood Ltd.,[438] Lord Shaw stated that the court ought to proceed upon a sound induction of all the facts of the case and should not exclude but shall include circumstances which bear upon the problem of continuing or stopping courses of conduct which substantially impair those rights and protections to which shareholders both under statute and contract are entitled.

The English and Canadian cases where a winding-up order has been granted appear to fall into one or more of three categories, although as observed,[439] "care must be taken that categorization not lead to ossification". These categories include the following:

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437 Re Davis & Collett Ltd. (1935) Ch.693, 698; Per Crossman J.

438 (1924) A.C. 783.

439 Per Wilberforce in Ebrahimi v. Westbourne Gallaries (1973) A.C. 360 (H.L.).

(a) Deadlock:

Deadlock may imply either an inability to elect directors or an equal split among an even number of directors on fundamental corporate policy which makes it impossible to carry on the corporation's business. It also arises where there is constant fighting among the owners whose corporation is necessary for the conduct of business. Refusing to meet on matters of business, continued quarrelling and such a state of animosity as precludes all reasonable hope of reconciliation and friendly cooperation are sufficient to justify a dissolution. It is not necessary in order to induce the court to interfere to show personal rudeness on the part of one member to the other or even any gross misconduct as a member. All that is necessary is to satisfy the court that it is impossible for the members to place that confidence in each other which each has a right to expect and that such impossibility have not been caused by the person seeking to take advantage of it.

In Re Yenidje Tobacco Co. Ltd.[440] the voting shares of a corporation were equally divided between W and R, who were also the sole directors. The Articles of Association of the corporation provided for the settlement of all disputes between W and R by arbitration. Use was made of this arbitral procedure but R refused to abide by its outcome. Relations between W and R eventually deteriorated to the point where they refused to communicate with each other directly, invoking the offices of the corporation's secretary for this purpose. W successfully petitioned for a winding-up. Of particular concern to the court was the fact that the only two directors were not on speaking terms, that the so-called meetings of the board of directors had been almost a farce or comedy; the directors would not speak to each other on the board, and some

440 (1916) 2 Ch. 426.

third person had to convey communications between them which ought to go directly from one to the other.

In Bondi Eetter Bananas Ltd.,[441] the plaintiff and defendant held equal shares in a private (closely-held) corporation which together with one share each held by their wives comprised all the issued share capital of the corporation. After the second World War, the corporation declined and disagreement arose between plaintiff and defendant which led to their refusal to cooperate; continued and abusive quarrelling and deadlock in the conduct of the corporation's business. The Ontario Court of Appeal held that it was just and equitable to order that the corporation be wound up. The court found that this would be in the interests of the shareholders.

(b) Justifiable Lack of Confidence in the Directors and Management

This has been the commonly asserted although less commonly successful ground for winding-up. Claims on this ground usually assert that the management has demonstrated a lack of probity in the conduct of the corporate affairs. As stated by Lord Clyde in Baird v. Lees,[442]

> "a shareholder usually puts his money into a company on certain conditions. One of these is that the business shall be carried on by certain persons elected in a specified way. Another is that the business shall be conducted in accordance with certain principles of commercial administration defined in the statute, which provide some guarantee of commercial probity and efficiency. If the shareholder finds that these conditions or some of them are deliberately and consistently violated and set aside by the action of a member and official of the company who wields an overwhelming voting power, and if the result of that is that, for the extrication of his rights as a shareholder, he is deprived of the ordinary facilities which compliance with the Companies Acts would provide him with, then there does arise a situation in which it may be just and equitable for the court to wind-up the company".

441 (1952) 1 D.L.R. 277.

442 (1924) S.C. 83 at 92.

The leading case in this area of corporate law is Loch v. John Blackwood,[443] the facts of which manifested series of abusive practices by an entrenched management intent upon destroying minority claims. A testator had instructed his executors to incorporate his business and to distribute half of the shares to his sister and one quarter to each of his niece and nephew. One of the executors was the sister's husband. He incorporated the business and distributed half of the shares to his wife and slightly less than one-quarter each to the niece and to the nephew. He gave the remaining few shares to his own nominees, thus guaranteeing that he and his wife could always outvote the other two. Under the husband's management, the corporation was highly profitable. The husband took an enormous salary for himself, but no dividends were ever paid, no shareholders meeting were ever held, and no financial accounting was ever made to the niece or nephew. After the nephew's death, the husband sought unsuccessfully to enlist the niece's aid in a scheme to purchase the shares from the nephew's estate at a grossly inadequate price. The niece's petition to have the corporation wound up was granted. In the course of its judgement, the court observed that:

> ". . . at the foundation of application for winding-up, on the just and equitable rule, there must be a justifiable lack of confidence in the conduct and management of the company's affairs. But this lack of confidence must be grounded on conduct of the directors, not in regard to their private life or affairs, but in regard to the company's business. Furthermore, the lack of confidence must spring not from dissatisfaction at being outvoted on the business affairs or on what is called the domestic policy of the company. On the other hand, wherever the lack of confidence is vested on a lack of probity in the conduct of the company's affairs, then the former is justified by the latter, and it is under statute just and equitable that the company be wound up".

In the Canadian case of Re R.C. Young Ins. Ltd.,[444] the Ontario Court of Appeal held that before a winding-up of a company at the instance of a shareholder will be ordered, there must be a justifiable lack of confidence in the conduct and management of the

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443 Supra, note 4.

444 (1955) O.R. 598.

company's affairs by the directors indicating lack of probity, good faith or other improprieties on their part.

(c) The Partnership Analogy

Winding-up has been ordered in situations where the corporation is deemed an "incorporated partnership" and there has been an irreversible breakdown in mutual trust and confidence. The court adopted a more expansive approach in determining the rights of the members of an incorporated partnership in Ebrahimi v. Westbourne Gallaries Ltd.,[445] and forged the winding-up remedy into a highly effective mechanism for remedying minority shareholder oppression. The court stressed that the function of the winding-up provision is to enable the court to subject the exercise of legal rights to equitable considerations which are of a personal character arising between one individual and another and which may make it unjust or inequitable to insist on legal rights.

Canadian courts have applied the principle laid down in Ebrahimi v. Westbourne Gallaries. In Re Rogers and Agincourt Holdings Ltd.[446] the Ebrahimi principle was applied to a case where two partners incorporated a company on the basis that the shareholdings were to be split 70-30. The corporation carried on business on this basis for a number of years when the majority shareholder took the position that Rogers did not, in fact, have a 30% interest but had merely been a salaried employee. There was a trial of an action and ultimately Rogers was issued 30% of the shares in a corporation that held the land. The majority shareholder was unhappy with the judgement and took action to ensure that Rogers was excluded from the board of the corporation, and another corporation that was used an operating corporation. The

445 (1973) A.C. 360 (H.L.) - The facts of the case has been discussed earlier. See supra note 21.

446 (1977) 14 O.R. (2d) 489.

court, following Lord Wilberforce in Ebrahimi, used the partnership analogy in characterizing the relationship between the two shareholders. There was clearly an understanding that the two would participate in the conduct and management of the corporation's affairs and that is what took place when they shared the trust and confidence of one another. When that trust and confidence broke down, the majority shareholder excluded the minority holder from participation and treated him as an employee. Although the situation could not be characterized as one of deadlock, the exclusion from management came within the Ebrahimi rules and winding-up on the just and equitable ground was ordered.

The judgement of the court of appeal in this case makes it clear that in appropriate circumstances, winding-up can be a very effective remedy for a minority shareholder.[447]

However, it is not every dispute between shareholders in a closely-held corporation that will call for a winding-up on the just and equitable ground. There must be a real departure from the understanding upon which the enterprise was founded and upon which the shareholders agreed to participate such that the interference of the court exercising its equitable jurisdiction is called for. There must be something more than mere unhappiness or dissatisfaction at being a minority shareholder.

Adequacy of the Protection Offered by the Remedy

Notwithstanding the court's willingness to grant a winding-up order whenever the circumstances of the case gives rise to such an order, a fundamental proposition runs through most cases under the just and equitable rule. There seems to be a general reluctance on the part of some courts to interfere in the internal affairs of the corporation. These courts have often asserted that while the words "just and equitable"

447 See also Re Dunham and Apollo Tours Ltd. (No. 2) (1978) 20 D.R. (2d.) 9.

are clearly intended to be elastic in their application in order that as the case arise, injustice and inequity may be prevented, a very strong case must be made to justify its interference in the internal management of the corporation's affairs.

The utility of a winding-up order as an effective remedy is diminished by many factors. In the first place, the remedy could result in a disadvantage to the minority shareholder who wishes to continue his investments and maintain the business enterprise as a viable entity. Moreover, the proceeds from dissolution might not in any way reflect the damage already allegedly inflicted upon the minority shareholder's investment. The proceeds could also be small compared to the earnings potential of the business especially where the only buyers for the shares are the alleged oppressors.

Finally, the wide spread of circumstances in which the oppression remedy applies has also contributed to diminish the importance of the remedy. The oppression remedy covers most of the conduct which provide grounds for a winding-up order and the courts are often less reluctant to wind-up a corporation than to grant a relief under the oppression remedy. This is buttressed by the fact that under Sections 296 and 224(2)(f) of the B.C.C.A.,[448] the remedies may be given in the alternative. If a winding-up is sought, the court is not only given power to order that remedy but to order a remedy under the oppression section if it considers it to be more appropriate. The result is that in most cases, a minority shareholder would apply for relief under the oppression remedy than for a winding-up order.

448 Section 214 C.B.C.A.

CONCLUSION

This study has been concerned with the examination of the adequacy of selected statutory remedies for the protection of minority shareholders in the corporation. In essence, the study has examined the potential efficacy of these statutory remedies vis-a-vis private contractual and market forces. Attention was focused on the two leading schools in corporate law: the traditional (corporate) legal approach and the economic approach. Two kinds of corporations were also examined: the closely and widely-held corporations.

While the traditional legal theory depicts the position of minority shareholders as one of helplessness, hence the need for state intervention in the form of regulation or facilitation of shareholder litigation. Economic analysts suggest that their position is not precarious otherwise no one would invest in the corporate form of organization. They point out that market forces and contractual devices play important roles in ensuring that the managers' interests are aligned with that of shareholders.

In the closely-held corporations, shareholders often enter into contractual arrangements which define the course of conduct of the business. Such arrangements make-up for the lack of control over corporate-affairs which the minority shaeholders are usually subject to.

In the widely-held corporations, shares are freely traded and carry voting rights. This facilitates efficient risk bearing, accumulation of large blocks of shares and transfer of control while ensuring that management have incentive to maximize the value of the firm. Compensation agreements also link changes in managers' wealth to the performance of the firm.

However, notwithstanding the adoption of these contractual mechanisms and the development of the economic approach to corporate law, it is still desirable that minority shareholders be offered the protection provided by the statutes. First, the utility of most contractual mechanisms is impaired either because of the inherent inability of the human mind to foresee every future contingency which may give rise to friction in the corporation or by costs of drafting. Furthermore, the market forces aciing alone will not produce an optimal solution to agency costs inherent in the corporate form of organization. This is partly due to the fact that some monitoring institutions and incentive mechanisms that seem theoretically desirable in a frictionless model entail substantial transaction costs such as the cost of acquiring information. In addition, market forces may be inadequate to deal with last-period or one time divergencies where the agent concludes that the benefits of the one time use of discretion is worth whatever penalties that may be forthcoming in the employment market for the agent's services.

Corporate law and the statutory provisions play an active role here. By providing mandatory statutory remedies, the law enables the minority shareholders to rectify any actual or prevent any threatened abuse of corporate power by those in control. For instance, the corporate fiduciary duty provides an indispensable backdrop to corporate relationships, including protection against actions permitted by statute but nevertheless inequitable or overreaching. The breach of fiduciary duty is usually remedied by corporate action against the defaulting directors or by a derivative action in situations where those in control neglect or refuse to initiate proceedings on behalf of the corporation.

But the operation of these remedies generate their own costs. The effect is that in some situations, a minority shareholder might find it cost effective to rely on the protection offered by the market. Moreover, given the fact that both the closley and widely-held corporations have different economic structures, the application of these remedies may produce different results depending on the type of corporation. This suggests that none of the protective mechanisms (legal or market based) acting alone will adequately take care of the problems faced by minority shareholders. A combination of these contractual devices and statutory remedies may ensure a more realistic protection for the minority shareholders.

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