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# THE CORPORATE HONEYMOON WILL END

## Are You Shareholders Ready?



When it comes to starting a new business with partners, founders often find themselves in an entrepreneurial honeymoon phase, where decisions are made in harmony and compromises are effortlessly achieved. Unfortunately, a honeymoon phase doesn't always last forever, and in most cases neither does this period of cohesion.

As a business develops, tempers may flare, and shareholders could find themselves less willing to make concessions over even the smallest decisions. In response, prudent company owners seek to have a shareholders' agreement prepared which lays out the rights and mechanisms available to all shareholders and operational directives, thus removing a considerable amount of uncertainty from the business relationship.

In many cases, the parties to a shareholders' agreement are eager to make sure that the decision-making rights of each party are exactly equal. Yet, while this principle of having equal rights amongst shareholders evokes notions of fairness and inclusivity, it's important to recognize that this approach may not be a one-size-fits-all solution.

One of the most glaring drawbacks of having equal voting rights is the potential for decision-making deadlock. In smaller companies where voting rights are distributed amongst an even number of shareholders, an equal split in voting power can lead to frustrating stalemates when disagreements and deadlocks arise. And, in cases where there are just two shareholders, there is no difference between a majority vote and a unanimous vote. These resulting deadlocks will often require immense amounts of effort and negotiation to resolve, leading to acrimonious disputes and a tremendous amount of legal fees in suit.

In the 2020 case of *Macreanu v Godino*,<sup>[1]</sup> the Ontario Superior Court of Justice decided that the courts have the power to resolve a deadlock, but only in certain situations. These include where there has been a loss of confidence between shareholders, acrimony, and most notably, where the existence of such “makes it impossible for two 50% shareholders to continue the business as equal partners,” but only “in circumstances where the corporation’s value likely will deteriorate”.<sup>[2]</sup> In such cases, according to section 207(2) of the Ontario Business Corporations Act (or section 214(2) of the Canada Business Corporations Act), the courts can make any decision that it sees fit.

This could come in the form of a solution suggested by a shareholder, but this may also lead to the court ordering the company to dissolve outright. Clearly, even the courts can produce solutions which are uncertain and potentially disastrous for all shareholders involved.

Therefore, especially in companies with only two shareholders, it could be prudent to allocate voting rights unequally for different decisions – as simple as dividing rights on a 49/51 split so that a deadlock may never occur, or a priority right for one shareholder in the event of a deadlock.

If losing control of certain decisions is unpalatable, owners would still be well served to include a tiebreaking mechanism in their shareholders’ agreement. The exact process can vary depending on the needs of the shareholder and the creativity of the drafter, but can include procedures ranging from giving one shareholder overruling powers, to appointing a third party to act as a tiebreaker.



In any event, while a shareholders' agreement is certainly an excellent step in preventing disputes from occurring, special attention must be paid to make sure that any agreement takes into account the unique circumstances of each business and their shareholders. Though it may be unpleasant to turn one's mind to the worst-case scenario during a honeymoon phase, doing so can save shareholders an immense amount of time and energy later down the line.

RJS LAW has experience advising a diverse range of corporations and shareholders on all matters relating to corporate governance, operational and structural options, and dispute resolution. If you anticipate the need to create a company or a shareholders' agreement, or if you would like to amend your current shareholders' agreement based on the insight above, speak with one of our lawyers, who will be happy to navigate any problems and needs you or your company may face.

