THE ALLOCATION OF CONTROL IN THE ORGANIZATION OF A CLOSELY HELD CORPORATION UNDER THE NEW BRUNSWICK COMPANIES ACT

Richard C. Bird†

"The various types of business units – sole proprietorships, partnerships, business trusts, corporations – all are distinctive modes of organizing business enterprise. They are modes of allocating three elements of enterprise: (1) the risk of loss, (2) the power of control, and (3) the participation in the proceeds of the business activity. In corporate enterprises it is the corporate 'capital structure' through which this allocation of risk, control, and profit is effected."[1] For instance, in a "one-man company" the shareholder who beneficially owns all of the capital stock, bears all the risk, has complete control, and is entitled to all the profits of the enterprise. But not all individuals involved in business activity can undertake or want all the risk, complete control, and all the profits. Some may want to share the risk with their business associates who in turn will want compensation for their risks in the form of some control, or some profits or some of both. Some may want to bear the risk and share or transfer control and profits either for estate tax or other reasons. It should be obvious that the three elements of enterprise: risk, control, and profits may be allocated all to one individual, each allocated to separate individuals, or each element may be shared in an infinite number of proportions for a variety of reasons.

This range is possible because the corporate capital structure is, from a practical point of view, a matter of contract and thus confers a substantial degree of freedom on the draftsman of this structure. He may use debt or equity securities and if he uses the latter they may be classed as preferred, common, or deferred or may in fact be a hybrid of any combination of them in order to achieve the allocation desired. In *Beament Estate* v. *M.N.R.*,[2] for example, a private investment holding company was incorporated where the deceased owned 2000 Class B shares and his two children each owned 12 Class A shares. The deceased and the children each paid the par value for their shares, in each case $1 per share. The Class A shares were entitled to a 5% cumulative preferential dividend (it should be noted this dividend totalled $1.20 per year) and the holders of the Class B shares to the remaining net earnings of the company arising

† Richard W. Bird, B.B.A., B.C.L. (U.N.B.), LL.M. (Columbia), of the Faculty of Law, University of New Brunswick.

1 Herwitz, *Business Planning* (1966) 44.

2 70 D.T.C. 6130 (Can. Sup. Ct.).

from income but not from capital gains. On dissolution or winding-up of the company the holders of the Class B shares were limited to receiving the par value of their shares and no more and the holders of the Class A shares were entitled to receive all the remaining distributable assets. Each Class A and each Class B share carried one vote. In summary the draftsman allocated to the deceased the risk (he contributed all the capital except for $24) and control (he owned 2000 of the 2024 voting shares), and to the children all capital gains and all profits on winding up.[3] A more common allocation occurs where a financial institution loans risk capital, looking in return for a fixed return (interest) on its investment, leaving the shareholders to manage and control the corporation.

Previously it has been mentioned that each element may be shared in an infinite number of proportions. Risk of loss can be varied by use of debt, preferred, common, and deferred stock; profits can be allocated by the use of interest rates and the drafting of dividend provisions attaching to each class of stock. Control is not as easily shared. Where a corporation's capital structure consists of only unclassified common stock, a shareholder owning fifty-one percent of the shares bears fifty-one percent of the risk of loss, is entitled to fifty-one percent of the profit, but has virtually one hundred percent control of the corporation. Subject to a few statutory restrictions,[4] he is the directing mind and will of the corporation having complete control of at least the majority, if not all, of the directors of the corporation. This anomaly, if it can be properly called such, is a result of the principle of majority rule. The person or group of persons that can muster fifty-one percent of the votes at a shareholders meeting will, without more, be in full control. He has the power to control the corporate policy which will determine the success or failure of the business.

This element of control may also affect the element of participation in the proceeds of the business activity. Earnings may be paid out in the form of dividends, but normally they

3 For similar estate planning schemes see *Barber Estate* v. *M.N.R.*, 66 D.T.C. 315 (T.A.B.) and *Fiddes Estate* v. *M.N.R.*, 70 D.T.C. 1117 (T.A.B.).

4 There are limitations on the power of control of a shareholder who owns only 51 percent of the shares. Some matters under the New Brunswick Companies Act, R.S.N.B. 1952, c .33, require approval of two-thirds, and sometimes three-fourths, of the votes of the shareholders, e.g., s. 30A (amalgamations), s. 38 (change of head office), s. 42 (supplementary letters patent), s. 47 (compromises and arrangements), s. 64 (changes in capital structure), s. 80 (borrowing), s. 86 (change in number of directors), s. 87 (appointment of an executive committee). Under s. 91, minority shareholders in certain circumstances may elect directors.

5 See New Brunswick Companies Act, R.S.N.B. 1952, c. 33, s. 95(1)(b).

need not be.[5] They may be retained to finance future expansion or they may be paid out to select officers and employees (who are often the majority shareholders) in the form of increased salaries, bonuses, fringe benefits and sometimes excessive travel and entertainment expenses.[6] Thus, from the position of a minority shareholder, the allocation of control by a division of unclassified stock may be unsuitable. While fairness may demand that one who provides fifty-one percent of the capital and bears that proportion of the risk of loss should also receive fifty-one percent of the profits, it does not follow that a majority shareholder should have virtually absolute control of the corporation.

There are several reasons why a minority shareholder may rightly want to restrict the power of control of the majority. Minority shareholders of closely held or close corporations are of two types: (i) those who view their ownership in the corporation merely as an investment, and (ii) those who view their ownership in the corporation as an integral part of their participation in the management of the corporation and look to the corporation for their chief source of income. Where it is considered an investment, a minority shareholder probably anticipates two things: (i) dividends and (ii) capital gains. However, generally the board of directors need never declare a dividend. The majority, who will in most cases be managing the corporation, may find it more profitable to declare bonuses to themselves rather than pay dividends. This way they receive 100 percent of the earnings rather than their mere majority interest. Potential dividends may never be forthcoming. Nor will capital gains be in the offing. Capital gains presuppose a sale of the investment at a profit which in turn necessitates the finding of a buyer. The market for shares representing a minority interest in a close corporation is negligible, if not non-existent. Few people want to buy shares in a close corporation if there is little prospect of dividends ever being paid. The corporate advantage of free transferability of interests in these circumstances is often a myth, as may be capital gains.

For the minority shareholder who must look to the corporation for his chief source of income, the problem is more acute. Control of the corporation by the majority could mean the loss of employment and income in the future if he is subject to the whims of the majority which, as a general rule, he is. There is also the problem of financial support for his family should he die. Without a salary, a favourable dividend policy, or a ready market for the shares, his family may experience financial difficulties.

---

6 See Elson, *Shareholders Agreements, A Shield for Minority Shareholders of Close Corporations* (1967), 22 Bus. Law 449, at p. 450, for a list of hazards that face minority shareholders in a close corporation.

One solution might be to advise our friend, the minority shareholder, not to place himself in this precarious position. We might insist on a partnership rather than a close corporation. The voice of a dissenting partner may be stronger (depending on the terms of the partnership agreement) than that of a minority shareholder or even director. A partner has a right to withdraw his proportionate share of the profits each year. He need not wait for a declaration by an obstinate majority. In addition, if he does not like their managerial policies or merely wants to retire, he may force a dissolution of the partnership and obtain the return of his investment. But a partnership too has its disadvantages. Potential unlimited liability is always a concern. Withdrawal of all the earnings of the business may seriously affect the financing of possible future expansion. There are often unfavourable tax consequences in using the profits of a partnership to finance expansion when compared with the corporation. And, of course, the potential threat of a forced dissolution, which could result in a liquidation of the business, is often seen as out of proportion with the risk taken by a minority investor.

The task is apparent. What is needed is a hybrid form of business organization with taylored features of both corporation and partnership law: one that will adequately protect the interests of both the majority and the minority; one that might rightly be called an "incorporated partnership". It is submitted that the "closely held" or "close" corporation may legally be organized to fufill that need. A close corporation will have the characteristics of any other corporation. However, it is necessary to restrict the power of the majority to determine executive compensation and dividend policies in order that the just expectations of the minority shareholder will be met. One may also want to "create a market" for his shares at a fair price on the happening of certain specified contingencies, e.g. death or retirement.

The Close Corporation

(a) Agreements Restricting the Powers of the Board of Directors

Since executive compensation and dividend policies are *prima facie* determined by the Board of Directors, one might consider an agreement among all the directors binding themselves and thier successors to pursue policies set out in the agreement. Such an agreement might specify that existing salaries, etc., are not subject to change without the approval of all the parties to the agreement and that a specified portion of profits are to be paid out in the form of cash dividends. However, the usefulness of such an agreement depends on its validity.

The board of directors is responsible for the management of the corporation.[7] With few exceptions, once elected, the directors are even beyond the control of the majority of shareholders.[8] Because directors act in a fiduciary capacity and must exercise their discretionary powers and judgment in good faith,[9] generally, any agreement restricting this managerial power is void, being against public policy and express statutory provisions.[10]

(b) Shareholders' Agreements

On the other hand, an agreement among shareholders contractually binding them to vote their stock in a specified manner on corporate issues is valid.[11] Generally, a shareholder may vote his stock in his own interest, owing no fiduciary duty to his fellow shareholders when voting on corporate issues.[12] Thus, for example, ensuring the election of the parties to the agreement to the board of directors is a valid contractual object.[13] Of course, in many instances, this result could be achieved by enacting cumulative voting-by-laws.

In *Ringuet* v. *Bergeron*[14] a provision in a shareholders' agreement ensuring the election of certain individuals as officers at stated and agreed salaries was upheld. The provision was not construed as tying the hands of the directors and compelling them to exercise the power of management in a particular way.

> It [was] no more than an agreement among shareholders owning or proposing to own the majority of the issued shares of a company to unite upon a course of policy or action and upon the officers whom they will elect. There is nothing illegal or contrary to public orders in an agreement for achieving these purposes.

---

7 New Brunswick Companies Act, ss. 86(1), 95(1).

8 *Automatic Self-Cleansing Filter Syndicate Co. Ltd.* v. *Cuninghame,* [1906] 2 Ch. 34 (C.A.) (directors refusal to carry out a resolution, passed by a majority of votes of the shareholders, requesting the sale of the undertaking); *Denault* v. *Steward, Denault & Co.* (1918), 54 Que. S.C. 209 (C.A.). (dividend declared by the board of directors could not be set aside by the shareholders in the absence of special provisions in the letters patent).

9 *In re City Equitable Fire Insurance Co.,* [1925] 1 Ch. 407 (C.A.).

10 See *Motherwell* v. *Schoof,* [1949] 4 D.L.R. 812 (Alta. Sup. Ct.); *Rinquet* v. *Bergeron,* [1960] S.C.R. 672.

11 *Motherwell* v. *Schoof,* [1949]) 4 D.L.R. 812, (Alta. Sup. Ct.); *Rinquet* v. *Bergeron,* [1960] S.C.R. 672.

12 See *Northwest Transportation Co.* v. *Beatty* (1887), 12 App. Cas. 589 (P.C.).

13 *Motherwell* v. *Schoof,* [1949] 4 D.L.R. 812 (Alta. Sup. Ct.); *Rinquet* v. *Bergeron,* [1960] S.C.R. 672.

14 [1960] S.C.R. 672.

> Shareholders have the right to combine their interests and voting powers to secure such control of a company and to ensure that the company will be managed by certain persons in a certain manner.[15]

Generally, the appointment and remuneration of officers is a power conferred on the board of directors.[16] Here, there was at least a slight impingement on this power which appeared to be immaterial to the Supreme Court of Canada. It is submitted that, following *Rinquet* v. *Bergeron*, shareholders may effectively determine executive compensation policies by agreement. *A fortiori*, increased salaries, bonuses, fringe benefits, and excessive travel and entertainment expenses may be prohibited by agreement among shareholders. This of course is not far from existing statutory directives which require confirmation of executive compensation policies by a majority of shareholders.[17]

It is submitted that a provision regulating dividend policy is also valid. As long as the rights of creditors are adequately protected, it does not appear that such provisions are contrary to any public policy. In the case of memorandum of association companies, "the terms on which [dividends] are payable, and the method of declaring them, depend entirely on the provisions in the articles."[18] Likewise, provisions in the letters patent should also prevail. In addition, "probably no court would deny the validity of an agreement which curtails directorial discretion by forbidding the declaration of dividends under specified circumstances. A decision to the contrary would seriously affect billions of dollars of bond indentures already in existence which rely on just that limitation."[19] The converse is probably also true. If this is so, shareholders may effectively predetermine dividend policies.

The type of agreement contemplated was upheld by the Supreme Court of Illinois in *Galler* v. *Galler* in 1964.[20] The agreement recited as its purpose the provision of income for the support and maintenance of the families of two brothers who were the main shareholders. The essential features of the agreement were as follows:[21]

---

15 *Ibid.*, at p. 684.

16 New Brunswick Companies Act, s. 96(1)(d); see also Quebec Companies Act, R.S.Q. 1964, c. 271, s. 88(2)(d); Note (1961), 39 Can. Bar Rev. 469.

17 New Brunswick Companies Act, s. 95(2).

18 Gower, *Modern Company Law,* (3rd ed., 1969), at p. 353.

19 Hornstein, *Stockholders' Agreements in the Closely Held Corporation* (1950), 59 Yale L. J. 1040, at p. 1045. See also Fraser, *Canadian Company Forms,* (3rd ed., 1947), at p. 733; MacKelcan, *Canadian Bond Issues* (1952), 30 Can. Bar Rev. 325, at p. 332.

20 (1964), 203 N.E. 2d 577.

21 *Ibid.*, at pp. 580-1; see also Elson, *supra.*, note 6, at pp. 454-5.

1. The by-laws of the corporation would be amended to provide for a board of four directors; a quorum would be three.

2. The shareholders would cast their votes for the two brothers and their wives as directors.

3. In the event of death of either brother, his wife would have the right to nominate a director in place of the decedent.

4. After the death of either brother, annual dividends of $50,000 would be declared if retained earnings exceeded $500,-000, along with additional optional features.

5. During the lifetime of the brothers, the then officers of the corporation would continue to be elected by the directors.

6. The corporation would enter into a salary continuation contract with respect to both brothers, under which the corporation would be authorized to pay the widow of each deceased brother or his children certain monthly payments.

It is submitted that, following *Rinquet* v. *Bergeron*,[22] a similar agreement would be legal in Canada. In the words of Underwood J., "There is no reason why mature men should not be able to adapt the statutory form to the structure they want, so long as they do not endanger other stockholders, creditors, or the public or violate a clear mandatory provision of the corporation law."[23]

There may be an advantage in expressly providing for shareholder control of executive compensation and dividend policies in the letters patent.[24] Letters patent is a grant from the state. As such, the powers conferred on the shareholders in the charter cannot be attacked without making the Attorney-General a party, and when it is shown that the provisions are contrary to law.[25] The powers of the board of directors (including executive compensation and dividend policies) set out in section 95 of the New Brunswick Companies Act are subject to the letters patent. Thus, it is submitted, that such provisions are not contrary to law.[26] Further, courts are less apt to invalidate executive grants than a shareholders' agreement.

---

22 [1960] S.C.R. 672.

23 *Galler* v. *Galler* (1964), 203 N.E. 2d 577 (Ill. Sup. Ct.).

24 See Notice of Supplementary Letters Patent, Eastview Investments Ltd., The Royal Gazette, January 2, 1969, Vol. 127, p. 10, where it is stated: "a limitation has been provided respecting the amount of salary or other payments which may be paid to any director or officer of the company or to any employee who is a shareholder . . ."

25 *Galbraith* v. *Madawaska Club* (1959), 18 D.L.R. (2d) 424, at p. 437 (Ont. High Ct.).

26 Contra, Fraser & Stewart, *Company Law of Canada* (5th ed., 1962), at pp. 529-30.

Opposing this view, one might argue that, if a power conferred on a board of directors must be exercised in a fiduciary capacity, likewise shareholders must exercise the same power in a fiduciary capacity. However, one writer[27] contends "that this doctrine does not apply in the case where the wishes of all the shareholders of a company are *known to the directors.* In such a case the directors should give primary consideration to the fulfillment of those wishes *even if they are different from* what the directors conceive to be in the best interests of the *company.* As a necessary corollary, agreements made by directors binding the future use of their discretions are valid where all the shareholders of the company are parties to the agreement or otherwise consent thereto." Note, however, if reliance is to be placed on this contention, all the shareholders must be a party to the agreement.

In sum, it is submitted that Canadian Courts have closely followed their United States counterparts. ". . . [T]here has been a definite albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis.* Several shareholder-director agreements that have technically 'violated' the letter of the Business Corporation Act have nevertheless been upheld in the light of the existing practical circumstances, i.e., no apparent public injury, the absence of a complaining minority interest, and no apparent prejudice to creditors . . . [C]ourts have long ago quite realistically . . . . relaxed their attitudes concerning statutory compliance when dealing with close corporate behaviour, permitting 'slight deviations' from corporate 'norms' in order to give legal efficacy to common business practice."[28]

(c) Sale of Shares of a Close Corporation

Rather than provide for the payment of dividends or a salary continuation agreement following the death or retirement of a shareholder, a minority shareholder may prefer to sell his interest in the business. We have already seen that the market for minority interests in a close corporation is limited, there being few buyers. Sometimes the market is even further restricted by special provisions in the letters patent relating to the transfer of shares or by the enactment of special close corporation by-laws.

Section 77 of the New Brunswick Act specifically provides for the creation of a close corporation and consequent restrictions on transfer by bylaw. However, the provision is severely

---

27 Howard, Note (1959), 37 Can. Bar Rev. 490, at p. 492.

28 *Galler* v. *Galler* (1964), 203 N.E. 2d 577, at p. 584 (Ill. Sup. Ct.). Compare *Motherwell* v. *Schoof,* [1949] 4 D.L.R. 812 (Alta. Sup. Ct.) and *Rinquet* v. *Bergeron,* [1960] S.C.R. 672.

limited in application. All section 77 authorizes is the creation of a close corporation in which the shares are not transferable to a person who is not already a shareholder without the consent of the board of directors. No provision for the purchase of those shares may be imposed under this section.[29] Section 77 was intended to give the directors of a close corporation an opportunity to select their associates as in the case of a partnership. It was not intended in any way to afford protection for minority shareholders.

More elaborate restrictions, and in some instances, provisions more beneficial to the minority shareholder, may be inserted in the letters patent in New Brunswick. Section 37 of the New Brunswick Companies Act recognizes the validity of restrictions on the transfer of shares in the letters patent, e.g. options to purchase and rights of first refusal.[30]

More beneficial, however, is a shareholders buy-sell agreement.[31] A buy-sell agreement binds a shareholder to sell and others to buy his shares at a determinable price in the event of specified happenings, e.g. death or retirement. Thus a buyer for the minority shareholder's interest is guaranteed.

Conclusion

It is submitted that a well-drawn shareholders' agreement entered into by all the shareholders contemporaneously with the formation of a corporation should be an effective means of protecting the minority shareholder.[32] The focal points in such an agreement are the appointment and remuneration of officers and directors, the determination of divided policy, and the provision for the sale of shares. While it is submitted that there is authority in Canada for the above conclusion, it must be remembered that the validity of the answers suggested to the problem is not certain. Until further judical development or legislation reform, one must proceed cautiously.

---

29 *Emerson* v. *Provincial Secretary-Treasurer,* [1941] 2 D.L.R. 232 (N.B.C.A.).

30 E.g., Notice of Letters Patent, W. E. Hale Associates Limited, The Royal Gazette, July 3, 1968, Vol. 126, p. 364.

31 The buy-sell agreement is extensively dealt with by Huberman, *Buy and Sell Agreements for Canadian Close Corporations* (1963), 41 Can. Bar Rev. 538.

32 See also Elson, *supra.*, note 6, at p. 457.