Avoiding Commercial Litigation

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On the prevention side, there is plenty of good advice that comes from our experience dealing with the fallout from commercial disputes.

Here are some suggestions on how to avoid commercial litigation:

1. Structure your relationship with the right documents

There are a wide variety of issues you need to consider before you get into a new partnership or decide you want to incorporate a company.

The next time you decide to get into business with someone new first talk to us about the benefits of a Unanimous Shareholders Agreement to protect you in the event that you and your new business shareholder end up not seeing eye-to-eye. Among other things, properly drafted shareholder agreements put in place the agreed method for resolving potential disputes. This saves time, money, and provides a level of certainty that does not otherwise exist.

For more information read Shareholder Agreements 101

2. Define the roles of the parties

To avoid disputes between capital and labour shareholders, it is wise to take the time to clearly define the roles of the parties and the expectations for each role. Take the example where one partner has just sold a business or inherited money and has significant capital to invest in a new company but doesn't have the time or the skills to set up and operate the new business. He finds himself a shareholder who has the time and the wherewithal to run the business but no money for start-up capital. This is a classic marriage of capital and labour.

Disputes typically arise when the parties forget to value and appreciate their respective contributions. For example, the first time a dividend is paid out the party contributing labour may think to him or herself, “Wait a minute, I've been putting in 50-60-hour weeks while my capital partner is off traveling the world and he's getting the same dividend that I am.” You may think that's not fair if you don't fully appreciate that there would be no business at all without the money that your capital partner brought to the table.

Conversely, the first time a lean year or two goes by and no dividends are paid out, if you are a capital shareholder you may be thinking, “Wait a minute, I've put in $2M and I've yet to see a dime but when I look at the books I see my labour shareholder collecting a healthy salary, driving a company car and racking up an expense account. That's ridiculous. His salary should be much

less and we should be splitting the difference as dividends." In this case, as the capital partner, you may be undervaluing what it takes to turn an investment into a going concern and turn a profit.

You can side-step this kind of typical dispute by having a good Buy-Sell clause in your shareholder's agreement that clearly defines what each person brings to the venture and what each person expects to get out of it going forward.

3. Work out the financing details in advance

A third thing to consider carefully in the start-up phase of a new enterprise is how are you going to put money into the company.

If one shareholder is putting up a lot more money than the other, because the other is contributing skills and sweat equity or they just don't have the money, but you are thinking it will still be a 50:50 split because you also happen to be good friends, you really should think that through.

One option, as a capital shareholder, is to put money into the company through a shareholder's loan. In this case, instead of going to the bank for a loan the capital shareholder provides the funds under a general security agreement and a promissory note, effectively making the capital shareholder a secured creditor. Essentially, they are treated as an independent lender but make sure it's appreciated by both sides that If the business goes sideways, the capital shareholder will have first priority over the money.

4. Include a good buy/sell provision in your shareholder agreement

A buy/sell provision is a key part of a shareholder agreement. This provision defines how shareholders can get out of the business and what they will get for their shares if certain, defined triggering events occur. These provisions also set the price for a company's shares on the occurrence of the triggering event. Triggering events might include death, disability, or retirement for example. The purpose of the clause is to provide an agreed upon pre-determined process for ensuring that departing shareholders receive a fair price, while ensuring a smooth transition of the business to the remaining owners.

It is important to understand the pros and cons of different price-setting mechanisms that may be available.

Buy/sell provisions also typically provide protections for the remaining shareholders who will be carrying on with the business. This might include things like a right of first refusal or shotgun clauses which are designed to enable existing shareholders to resist the influx of new, unknown parties into their business arrangements.

There are also situations when one or more of the shareholders wants to buy out a partner and

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carry on with the business. You can learn more about options in this post on "Corporate Divorce. Options for Dealing with Shareholder Disputes."

These four areas are not the only things to consider. Your situation is unique, and an experienced business lawyer will be able to help you take the necessary steps to make sure that your business arrangements reflect your intentions. For help with setting up your business talk to our Business Solutions group.

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