



Feltmate Delibato Heagle LLP

L A W Y E R S

The Fine Print

This quarterly newsletter contains general information on developments in the law and other matters of interest to the clients of Feltmate Delibato Heagle LLP.

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Government Priority in Distress Sales

A landlord has certain rights under the *Commercial Tenancies Act* (Ontario), referred to as a right of distress, to seize a tenant's assets to satisfy rent arrears.

We have recently become aware of important information regarding the liability of landlords and bailiffs when exercising rights of distress against the assets of a defaulting tenant.

Both the Federal and the Ontario Government have a "super" priority right for payment of any amounts owing by a tenant in respect of employee source deductions, Goods and Services taxes and provincial sales taxes. These arrears create a security interest in the tenant's assets which security interest is in priority to the rights of any other creditor, including the landlord. Furthermore, this priority for payment is operative **notwithstanding that the arrears have not yet been assessed.**

A landlord or bailiff exercising a right of distress who fails to remit outstanding amounts to the appropriate governmental authority when distributing the proceeds of a distress sale will be subject to a civil claim for payment. The amount of the claim will be the lesser of the full amount due on account of the arrears and the gross proceeds of the distress sale.

In this regard, the Canada Customs and Revenue Agency has advised as follows:

In order to avoid liability in these circumstances, it is incumbent on landlords and bailiffs to determine the extent of the liability of the delinquent tenant on account of the employee source deductions or GST arrears prior to distributing the proceeds of sale. This would involve providing written notification of the distress proceedings to the local Canada Customs and Revenue Agency Tax Services Office and requesting details of any amount payable.

If you have any questions or would like further details regarding this priority claim, please contact us and we would be pleased to discuss it with you further.

The Importance of Shareholders' Agreements

By Lawrence A. Rotenberg

The importance of a shareholders' agreement is often not fully addressed when partners decide to go into business together. A shareholders' agreement should deal with those matters that are important to the parties, both at the time that the agreement is entered into and into the future when circumstances may have changed. Each shareholders' agreement will be unique in order to reflect the nature of the corporation's business, the characteristics of the shareholders themselves and the interaction of these two factors.

A shareholders' agreement can provide for matters of day-to-day administration of the corporation. For example, whose signature is required to authorize a cheque or the maximum amount a cheque can be issued for, without requiring multiple signatures. Indeed any other issue important to the success of the business and to protecting the interests of the shareholders should be dealt with.

While it is wise to provide in a shareholders' agreement for corporate governance, it is crucial that a shareholders' agreement provide (at least to a limited extent) what is to be done when it is no longer appropriate for one party to remain as a shareholder of the corporation. There are a multitude of ways in which shareholders' of private companies leave their corporation. These include death, disability, retirement and fundamental shareholder disagreements. Whether all or most of these are addressed in the shareholders' agreement will to a large extent govern its length and complexity.

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The Importance of Shareholders' Agreements

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The most common situation addressed in a shareholders' agreement is what is to be done on the death of a shareholder, particularly when the shareholders are all active participants in the business. There is an essential conflict between the interests of the shareholder selling its interest in the corporation (the "departing shareholder") and those who remain (the "continuing shareholders"). The departing shareholder wants to be paid as quickly as possible and expects the payment to not only reflect the existing assets of the business but also the corporation's potential. The continuing shareholders, while they are anxious to eliminate the shareholding of the departing shareholder, tend to be concerned with the impact of a quick payment by the corporation on its solvency and tend to take a dimmer view of the corporation's future, in part because of the loss of the services previously provided by the departing shareholder. In order to resolve this impasse, the parties have to determine the mechanics for establishing the fair market value of the Corporation. While it is simple to state what fair market value is, deriving that valuation is more of an art than a science. Even experienced valuers, familiar with a specific industry, may come up with significantly

different valuations, particularly if one is hired by the departing shareholder and the other hired by the continuing shareholders.

Other matters which can be addressed in a shareholders' agreement include restrictions on the shareholders' transferring their shares, shareholders' requirements to make additional capital contributions and a means of resolving fundamental differences which may arise between the shareholders, particularly as the business of the corporation evolves. What is to be done if the shareholders' cannot get along and the business of the corporation begins to suffer? The mechanics of a buy-sell can become complex, particularly if there is an inequality of bargaining power or one shareholder has much deeper pockets than the other. There are a variety of mechanisms that attempt to deal with this inequality in financial position. A valuation mechanism can be established and made part of the buy-sell provision, thus guaranteeing that the price offered may be reflective of the value of the company.

While a private corporation with no shareholders' agreement is an unsatisfactory state of affairs, an agreement that does not properly address all necessary matters can sometimes make matters worse.

Future Issues

The following topics will be discussed in future issues of **The Fine Print**:

- Employment Law
- PIPEDA – Personal Information Protection and Electronic Documents Act
- ISO 9000 Certification
- Trade-Marks
- Deferring Capital Gains Taxes

If there are any topics of particular concern that you would like to see discussed, please let us know.

Franchising Your Business – What You Need to Know

By Debi M. Sutin

Franchising, as a means of distributing goods and services, is booming. The Ontario government reports that franchised businesses across Canada account for almost \$90 billion in annual sales while, in Ontario alone, sales from franchised businesses total \$40 to \$50 billion each year or 40 cents of every retail dollar.¹

If you have ever thought of franchising your business, there are some important things you need to know. But first, a primer on what franchising really means.

Despite what many people think, franchising is not a business or even an industry. It is merely a method of distributing goods or services in the marketplace. The two most common franchise arrangements are what have come to be known as the “product distributorship” and the “business format franchise”.

Distributorship franchising has been in use for many years and is often referred to as the “traditional” form of franchising. Auto dealers, auto parts aftermarket retailers and soft drink bottlers typically fall into this category. Under a product distributorship, a distributor or dealer is licensed by a manufacturer or a supplier to sell trade-marked goods within a defined territory. Although a few controls are imposed on the distributor relating to his use of the trade-marks, he is generally perceived by the public as being an independent business, linked to the manufacturer only through the brand name of the products being distributed.

The business format franchise, on the other hand, involves the licensing not only of a trade-mark, but of an entire methodology and system for conducting business. Since so much know-how is licensed in order to achieve the same level of quality and service, these types of franchises require the imposition of extensive controls on the franchisee that are designed to achieve consistency and uniformity. Well-known examples of business format franchises are fast food outlets, hotels/motels and real estate brokerages.

Business format franchising is a mutually dependent relationship with significant advantages to both the franchisor and the franchisee. Among the benefits to the franchisor are the ability to expand a business system rapidly without the franchisor having to use its own capital and the ability to spread the risk involved in the business venture. From the franchisee’s viewpoint, benefits include the recognition that is associated with the trade-mark, volume purchasing power and, of course, investing in a proven system or concept. Although the franchisee is in business for itself, it is the franchisor that has had to endure the “learning curve” of operating a new business.

The franchise agreement plays a vital role in the over-all blueprint for the franchise system. Its preparation requires both a thorough understanding of the applicable legal principles and an analysis of the particular franchise system. A properly drafted franchise agreement will protect the interest of both franchisor and franchisee, and will encourage the high standard of fair dealing between the parties that is essential to any long-term commercial relationship. Accordingly, while the franchise agreement must be fair and benefit both parties, it will contain a multitude of covenants by the franchisee designed to ensure that he abides by quality and uniformity standards.

The franchise agreement must also provide the franchisor with appropriate remedies if the franchisee fails to follow the system requirements. The franchisor must have the ability to terminate a franchisee who is in breach of its obligations. For this reason, the franchise agreement will contain a list of causes permitting termination of the relationship. In addition, a properly drafted franchise agreement will allow for the franchisor to operate the business in order to avoid disruption to the continued operation of the business until a new franchisee is found.

Finally, those wishing to franchise their business should be aware of both laws of general application which apply to any commercial relationship and of laws directed specifically to franchising. In Canada, there is no federal legislation directed specifically at franchising. At the provincial level, only the provinces of Alberta and Ontario have enacted laws regulating the sale of franchises. Failure to comply with such franchise-specific legislation can result in civil liability for a franchisor and its senior management and can as well provide the aggrieved franchisee with a right to cancel his arrangement and recover damages from the franchisor.

Proper legal counsel by those experienced in franchising can assist in the successful establishment and long-term success of a franchise program for your business.

¹ Government of Ontario statistics.

Tenant's Lien May Bind Landlord

By Steven Follett

A lien for unpaid work at a tenant's premises can only be made against the tenant's interest in the leased premises if notice, in the form prescribed by the *Construction Lien Act* (Ontario) (the "Act") has been given to the landlord. However, the landlord can avoid liability for payment for the work at the premises if it immediately notifies the contractor of that intention.

In *Venneri Engineering Ltd v. Zonenward Lesser Management Inc.*, a 1994 Ontario Court decision the contractor which had been retained by the tenant to undertake certain construction notified the landlord in writing prior to commencing the construction. The landlord acknowledged the notice in writing but did **not** expressly state in the notice that it intended to disclaim liability for any non-payment by the tenant. The tenant subsequently went bankrupt and the contractor sought payment from the landlord for its construction work at the tenant's premises.

The contractor failed to seek proper legal advice prior to commencing construction which ultimately resulted in its claim for payment from the landlord being dismissed. The Court found that the form of notice sent by the contractor to the landlord did not meet the statutory requirements of the Act. The Act requires that the following key elements be included in any notice to a landlord if a contractor intends to hold the landlord responsible for payment:

- (1) details of the work to be performed at the tenant's premises;
- (2) notification that the landlord is potentially liable for payment pursuant to the Act;
- (3) a clear statement of intention that the contractor intends to hold the landlord liable for any non-payment by the tenant; and
- (4) the ability of the landlord to disclaim responsibility by written notice by notice to that effect to the contractor.

Two more recent Ontario decisions, *Williams & Prior Ltd. v. Taskon Construction Ltd.* and *Sloot Construction-Design Ltd. v. North Maple Mall Ltd.*, also resulted in unsuccessful claims made against a landlord for payment for work done at a tenant's premises. In both cases, the contractor's lien against the premises named the landlord of the premises as "owner". Under the Act, the party that contracts for the work, in these cases being the tenant, is the "owner". The Courts refused to consider this mis-naming as a minor or technical error under the Act and dismissed the contractors' claims for payment.

Accordingly, a contractor who wishes to have the benefit of the Act, and have its lien for payment attach to the landlord's interest in the premises, must give notice to that effect in proper form. A landlord who receives such a notice must immediately disclaim any liability if it does not intend to assume responsibility for work undertaken at the tenant's premises. This responding notice by the Landlord must also meet the requirements of the Act.