Focus BUSINESS LAW

Keeping the financial crisis in perspective

Bart Dziarski

A recent decision in a case alleging shareholder oppression confirms that business realities remain a fundamental consideration for the courts in shareholder oppression matters. The decision also indicates that a series of events culminating in a shareholder's interest being diluted may not necessarily trigger the oppression remedy.

In *Southpaw Credit Opportunity Master Fund LP v. Asian Coast Development (Canada) Ltd.* [2013] B.C.J. No. 214, a shareholder oppression proceeding was advanced by Southpaw, under s. 241 of the Canada Business Corporation Act, pursuant to Asian Coast Development (ACDL) obtaining financing on terms that ultimately diluted Southpaw's interest in ACDL by more than 95 per cent. Southpaw argued that the officers and directors of ACDL breached their duty of care to existing shareholders by allegedly failing to use best efforts to secure financing for ACDL on more favourable terms.

Southpaw also advanced a claim against another investor and eventual lender in ACDL, Harbinger Group, alleging the company forced ACDL to procure financing from them and that one of Harbinger's intents was the dilution of other shareholders.

Background

ACDL is a real estate development company focusing solely on the development of luxury casinos and resorts in Vietnam. Harbinger was ACDL's first institutional investor (April 2007), securing preferential rights to protect its interest in ACDL. Southpaw was ACDL's second institutional investor (June 2007) and signed a subscription agreement acknowledging that ACDL may obtain additional financing that could be dilutive to Southpaw's shareholdings.

ACDL was not immune to the effects of the economic downturn, which commenced in 2008. The company required additional financing several times to achieve construction milestones and the lack of available credit negatively impacted its ability to do so.

Despite ACDL's efforts to secure financing from parties that included external investors and Southpaw, Harbinger ultimately provided financing in October, 2009 and January, 2010. The financings, directly or indirectly, provided Harbinger with warrants to purchase shares of ACDL at a nominal value. The warrants were exercised in May, 2011, reducing Southpaw's 8.4-per-cent interest in ACDL to 0.4 per cent.

The decision

The core of the oppression claim was whether the reasonable expectations of Southpaw were breached with regards to the financing provided by Harbinger in October, 2009, and January, 2010. B.C. Supreme Court Justice Carol Ross found that the actions of ACDL's officers and directors breached the reasonable expectations with the October, 2009 loan, but not the January, 2010 loan.

However, given the circumstances that ACDL faced when obtaining the requisite financing, Justice Ross found that ACDL's officers and directors made reasonable business decisions, including canvassing external lenders and Southpaw.

Consistent with *Maple Leaf Foods Inc. v. Schneider Corp.* 42 O.R. (3d) 177, Justice Ross observed that the duty of a board of directors is to make reasonable business decisions, based on a set of reasonable alternatives, otherwise known as the "business judgment" rule. In *BCE Inc. v. 1976 Debentureholders* [2008] 3 S.C.R. 560, the Supreme Court of Canada affirmed the "business judgment" rule and its importance in shareholder oppression matters.

Consequently, Justice Ross dismissed the claim advanced against ACDL on the basis that Southpaw failed to establish a link between a breach of Southpaw's reasonable expectations and the alleged oppressive consequences with respect thereto. Justice Ross also dismissed the claim advanced against Harbinger primarily on the basis that the claim advanced against ACDL failed.

Business valuation considerations

Harbinger's receipt of warrants to purchase shares of ACDL at a nominal value as part of a financing arrangement highlighted the business realities at the time. Investing in ACDL was noted as being particularly risky because of, among other factors, Vietnam's unstable economy and high corruption rate and the risk of the development project being completed even with the requisite financing. Justice Ross found that, given the risks surrounding ACDL, an investor would conclude that providing financing to the company was not attractive.

We have worked on similar engagements where, based on the current and prospective risks surrounding a company seeking financing, the value of the company was nominal. In these cases, it is not unreasonable for dilution to occur in financing rounds that an investor does not participate in. A mitigating factor to consider is that ACDL is scheduled to complete the development project sometime this year, resulting in Southpaw having a diluted interest in a successful project rather than a larger interest in an unsuccessful project.

Conclusion

Justice Ross's decision is noteworthy because ACDL was trying to obtain financing during the economic downturn, a time when credit markets seized up. Companies who faced situations similar to ACDL may have also obtained financing on terms that subsequently diluted certain classes of shareholders. Her decision confirms the importance of considering business realities when determining whether an oppression remedy is appropriate for the diluted shareholders.

Bart Dziarski is an associate with Cohen Hamilton Steger & Co. Inc. in Toronto, specializing in business valuation, damage quantification and forensic accounting matters primarily in a litigation support context.