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# Court of Appeal Polices Strategic Behavior in Valuation Under a Buy-Sell

A recent decision of the Ontario Court of Appeal illustrates how the doctrine of repudiation of contracts applies to buy-sell agreements. The Court found that a contract created under a buy-sell mechanism can be repudiated where one party's conduct undermines the integrity of the valuation machinery of the buy-sell.

A buy-sell agreement is an important way for parties to business relationships to disengage from each other. Parties anticipating business relationships (or, often, their lawyers) will appreciate that they may require some way of disengaging from the relationship if for some reason it breaks down, or circumstances compel one of the parties to seek an exit.

Few parties can realistically and practically foresee exactly what the end of the relationship will look like if circumstances arise that provoke its end. Differing business objectives, differing priorities, and differing levels of trust may make it impossible for parties in the middle of a disagreement to come to a fair assessment of what each party should take away from the relationship.

In the latest decision from *Leeder Automotive Inc v Warwick*, the Court of Appeal considered a bespoke buy-sell agreement in a unanimous shareholder agreement covering a closely held corporation. The buy-sell required a shareholder seeking to exit the company to offer its shares first to the corporation, and then to the other shareholders before soliciting third party offers for their shares.

In this sense, the buy-sell in *Leeder* differed from a conventional shotgun or a conventional right of first refusal. Each of these alternative structures contains a built-in mechanism for price discovery. A shotgun uses risk to discover price: a party triggering a shotgun usually names a price but assumes the risk of not knowing whether he or she will be a buyer or seller at that price. A right of first refusal or first offer, on the other hand, uses an external market to discover price through the offer that the selling shareholder obtains from a third party.

The buy-sell in *Leeder* contained an objective method of

valuing the selling shareholder's stake. The agreement provided that the company's auditors or accountants would prepare financial statements using generally accepted accounting principles ("GAAP"), the company's real estate would be appraised by an independent expert agreed upon by the shareholders, and the company's goodwill would be determined using a designated formula. The fair market value of the shares would be determined by adding up the value of the corporation's assets, including the value of its real estate and its goodwill.

The corporation's CEO asked the corporation's accountants to prepare a valuation in accordance with the unanimous shareholders agreement, and asked the company's "longstanding" property appraisers to value the real estate. The accountants prepared a valuation, excluding, at the direction of the company's CEO, an extraordinary gain achieved in a litigation settlement. The company's appraisers delivered a report confirming a past valuation of the company's real estate.

The corporation elected to buy the selling shareholder's shares at the valuation generated by this process. The selling shareholder refused to close, such that the corporation brought an application seeking an order compelling the selling shareholder to complete the transaction. The selling shareholder argued that he was not required to close because the company repudiated the buy-sell in its approach to the valuation.

The application judge agreed and dismissed the application. Finding that the agreement to sell under the buy-sell was not a separate contract but a component of the larger agreement, the application judge nevertheless found that the unanimous shareholder agreement was repudiated when the company's CEO directed the company's accountants to exclude the settlement gain and approached the company's longstanding appraisers instead of an "independent" appraiser to value the real estate.

The company appealed, arguing that the company's alleged breaches were not repudiatory and, in any event, that an agreement could not be partially repudiated. The Court of Appeal agreed that an agreement cannot be partially repudiated but held that the outcome reached by the application judge was right because the share purchase transaction under the unanimous shareholders agreement was a separate contract that the company repudiated.

Repudiation of an agreement occurs when conduct of one party so undermines the basis of their contractual relationship that it justifies the innocent party in treating the contract as at an end.

Because repudiation occurs "when the entire foundation of a contract has been undermined; where the very thing bargained for has not been provided," there can be no partial repudiation of an agreement. Accepting, however, that the contract formed by the triggering of the buy-sell was a separate contract, it was capable of being repudiated.

The Court of Appeal affirmed that "the obligations that the application judge found Leeder had disregarded were designed to generate a fair price for the sale of the shares, which was at the heart of the share-purchase agreement. It is difficult to think of anything more important than the price at which the shares will be purchased. The provisions that were designed to yield fair market value had been disregarded. They were not merely procedural; they were essential, something that the shareholders had agreed upon back in 2003."

Given the fundamental importance of price in a buy-sell, the company repudiated the sale transaction constituted under the buy-sell because the valuator chosen was not independent, and the financial statements prepared of the company's CEO did not comply with GAAP.

*Leeder* affirms the importance of exactitude and fidelity to the terms of a valuation mechanism in the setting of price under a buy-sell. While not styled as a good faith case, it illustrates that strategic conduct by a party to a buy-sell risks losing the bargain to a finding that the contract has been repudiated.