

**SHARE CAPITAL DESIGN  
CASE STUDY**

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## SHARE CAPITAL DESIGN

### CASE STUDY

#### Part A

- Mr. and Mrs. X respectively own 60% and 40% of the common shares of Widgetco which are the only issued shares of that company and which were acquired for a nominal amount when Widgetco was first incorporated.
- Mr. and Mrs. X are the sole directors of Widgetco, although Mrs. X is a passive director and is not active in the business carried on by Widgetco.
- Mr. and Mrs. X's shares have a value of \$6,000,000 and \$4,000,000, respectively.
- Mr. and Mrs. X wish:
  - (a) to implement an estate freeze in favour of their son, who is active in the business;
  - (b) to have Mr. X retain control of Widgetco during his lifetime and to have control pass to the son thereafter;
  - (c) to leave the shares that they each receive on the freeze to the other upon their respective deaths; and
  - (d) to receive dividends on their shares as and when they so desire.
- Accordingly, it is proposed that:
  - (a) Mr. X exchange his common shares of Widgetco for 6,000,000 Class A shares. The Class A shares:
    - (i) will have a paid-up capital equal to the nominal paid-up capital attributable to Mr. X's common shares;
    - (ii) will be voting;
    - (iii) will be redeemable and retractable for \$6,000,000 (being the fair market value of the common shares for which they are exchanged);
    - (iv) will have a right to receive such dividends as the directors of Widgetco may in their discretion determine to the exclusion of the other classes of shares; and

- (v) will provide that the net realizable value of Widgetco's assets will not be reduced to an amount that will be less than the amount necessary to redeem the Class A shares outstanding at any time.
- (b) Mrs. X exchange her common shares of Widgetco for 4,000,000 Class B shares. The Class B shares:
- (i) will have a paid-up capital equal to the nominal paid-up capital attributable to Mrs. X's common shares;
  - (ii) will be non-voting;
  - (iii) will be redeemable and retractable for \$4,000,000 (being the fair market value of the common shares for which they are exchanged);
  - (iv) will have a right to receive such dividends as the directors of Widgetco may in their discretion determine to the exclusion of the other classes of shares; and
  - (v) will provide that the net realizable value of Widgetco's assets will not be reduced to an amount that will be less than the amount necessary to redeem the Class B shares outstanding at any time.
- (c) The terms of each of the Class A shares and the Class B shares will include a price adjustment clause that will provide that should the fair market value of the common shares for which each such class of shares was exchanged ultimately be determined to be an amount that is greater or lesser than the aggregate redemption amount attached to each such class of shares, such redemption amount will be increased or decreased, as required, effective from the date that such shares were issued, and appropriate payments or repayments will be made between the company and the shareholder to reflect such increase or decrease with respect to previous dividend payments and redemptions.
- (d) The terms of the Class A shares will provide that any such shares as are owned by Mr. X will cease to have any voting rights upon the death of Mr. X.
- (e) Son will subscribe for 100 Class C shares of Widgetco for \$100. The Class C shares:
- (i) will be voting; and
  - (ii) will have a right to receive such dividends as the directors of Widgetco may in their discretion determine to the exclusion of the other classes of shares.

## Part B

- The estate freeze has been implemented, Widgetco's business is expanding, and Mr. and Mrs. X's Class A and Class B shares have been redeemed.
- Widgetco needs money to finance its expansion and is negotiating with Ventureco, a venture capital corporation, for such financing.
- Ventureco, which is 60% owned by a Canadian chartered bank, agrees to lend Widgetco \$1,000,000 in exchange for a \$1,000,000 interest-bearing note.
- Ventureco also wants an "equity kicker" for having agreed to lend the \$1,000,000.
- Accordingly, it is proposed that:
  - (a) Ventureco acquire Class D shares (having a \$10,000 value) of Widgetco for a nominal amount;
  - (b) the following terms and conditions be attached to the Class D shares:
    - (i) fully participating with the Class C shares but with a minimum 12% preferential cumulative dividend right. The dividend rights attached to the Class C shares will then be amended to provide that, after the 12% dividend has been paid on the Class D shares, the Class C shares will be entitled as a class to a cumulative dividend equal in amount to the dividend paid on the Class D shares (the "Equalization Dividend") and thereafter the Class C and D shares will share *pro rata* in any further distributions from Widgetco;
    - (ii) retractable after 5 years for an amount equal to the fair market value of such shares, determined at the time of retraction, but without regard to any discount for minority interests or illiquidity; provided, however, that such retraction right can only be exercised for so long as, and with respect to, Class D shares that are owned by Ventureco;
    - (iii) redeemable after 4 years for an amount equal to the fair market value of such shares, determined at the time of redemption, but without regard to any discount for minority interests or illiquidity; provided, however, that there be a minimum 20% rate of return to the Class D shareholders on any such redemption; and
    - (iv) no voting rights.

- An agreement will also be entered into by Ventureco and the other Widgetco shareholders pursuant to which:
  - (a) Ventureco will have the right to tag along on any sale of the Class C shares to a third party;
  - (b) the holders of the Class C shares will have the right to drag along the Class D shares on any sale to a third party;
  - (c) Ventureco will have the right to sell its shares to a third party but only after it has first offered such shares for sale to son and son has not agreed to purchase such shares within thirty days; and
  - (d) Ventureco will have the right to put its shares to son in the event that Ventureco exercises its retraction rights but Widgetco is precluded by law from redeeming such shares.