

Decision Regret is not a cause of action for disgruntled start-up investors

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Investors in a small company may be inspired by the sales pitch of a founder with grandiose plans and descriptions of potential profits to be earned if they get in on the ground floor. As with any investment, however, there is seldom any guarantee that the profits will be realized. Start-up businesses are inherently dependent on the personal abilities and business acumen of the individuals involved. At the end of the day, the controlling owners of the business are responsible for ensuring that it is managed appropriately notwithstanding the individual failings of the company's founder.

Alcamo v. Walt, 2022 ONSC 1913 (CanLII), involved a claim for damages by the controlling shareholders against the founder of a closely-held company incorporated under the *Canada Business Corporations Act*.

In April 2017, a former IT Project manager (JW) started a business to provide consulting services to InEight Inc., a company that was developing a suite of software specially designed for the construction industry. The plan for the new consulting business was that it would establish a relationship with InEight, resell its software, and provide it with consulting services in project and change management.

JW named the consulting company Eneighbl Inc. and entered into a Master Services Agreement and Software Resale Agreement with InEight. He then searched for investors. There was little doubt that InEight's software for the construction industry appeared to be a good concept for an unfulfilled need of the construction industry around the world.

JW did not capitalize the business himself, although money was spent to protect the business name and to incorporate the business.

In October 2017, a meeting was held at JW's home with a small group of six potential investors. JW made enthusiastic and grandiose statements about Eneighbl's business prospects. The group was given copies of the agreements with InEight and a sales forecast for Eneighbl that had been prepared largely by extrapolating from information that JW had received from InEight. The sales forecast predicted profits for Eneighbl of multi-millions of dollars in the first five years.

The potential investors agreed to buy shares of Eneighbl in various amounts ranging from \$10,000 to \$72,500. After the capitalization, the six new shareholders held a total of 65% of the shares of InEight while the founder, JW, held only a 33% interest. From a corporate governance point of view, the six new investors were the majority shareholders of the start-up business. JW was appointed CEO.

The investment did not go well, however. It turned out that JW was prone to the outlandish statements of a person suffering from a mental illness.

In December 2017, JW and some of the investors travelled to Arizona to meet with InEight representatives. During the trip, JW exhibited bizarre and manic behaviour. He made a presentation to InEight that was rambling, disorganized, and alienating.

Shortly after returning from Arizona, JW suffered a psychotic episode and was involuntarily hospitalized. He was diagnosed as suffering from a Bipolar I disorder with manic features and delusions and was prescribed antipsychotic medications. JW was temporarily suspended as CEO by the rest of the shareholders.

After JW was released from hospital, a second trip to Arizona in January 2018 to meet with Eneighbl met with similarly disastrous results. Another meeting with InEight's representatives was marred by JW's poor performance as his erratic behaviour continued.

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The application judge would later conclude that the six investors knew within three months of becoming shareholders that their expectations and reliance on what JW was telling them were “just fantasies.”

Nevertheless, they continued with their efforts to do business with InEight after the failed trips to Arizona. Personal loans were made to JW by some of the investors. In May 2018, JW signed a “Shareholder Guarantee” pursuant to which he effectively promised to personally redeem or purchase the six investors’ shares at their original price for a total of \$182,500.

None of the business with InEight panned out and by the end of 2018, relationships between the shareholders of the company were in turmoil. The company never transacted any software sales or consulting. It never earned any revenue. As noted by the application judge, the business that had never managed to launch from the harbour was “dead in the water.”

JW made further promises that he would pay back the investors. However, in 2019 he was hospitalized for a second time, after which his driver’s licence was cancelled and due to his mental illness, he was no longer able to work.

The six investors then sued JW and the Eneighbl on several grounds, including fraudulent misrepresentation, breach of fiduciary duty, oppression, and breach of contract for failing to redeem their respective shareholdings.

Based on the evidence, the application judge’s view was that the investors were aware of JW’s mental health issues as of the initial trip to Arizona when they saw that he was delusional and manic, with grandiose fantastical business plans. However, they were prepared to ignore all this. Then, in the court application, they disingenuously claimed that JW had treated them oppressively and that he had the intent to defraud them.

Further, the six investors were not unsophisticated parties. They had more business credentials and acumen than JW. They made their own investigations, made their own decisions, and exercised their own judgment to take on the risks. They were in command, while JW was the minority shareholder.

Within weeks of having purchased their shares in Eneighbl, the investors knew for themselves that there were serious problems for the business. The total business failure of the company was foreseeable from the outset since Eneighbl was totally dependent on its business relationship with InEight. Within months of purchasing shares, the investors knew that the relationship with InEight ranged from disappointing and dismal to doomed.

The application judge concluded that the claims for misrepresentation against JW failed. There were “puffery and false-hope statements” but no false statements. There was no deception, no inducement, and no reasonable reliance on what JW represented.

The claims against JW for breach of fiduciary duty failed because there was no fiduciary relationship. The investors were the majority and could have controlled the company. They feigned unsophistication and pretended naivety and vulnerability, but they were not overmatched by JW. Rather, they overmatched him.

As to oppression, which turns on the investors’ reasonable expectations as shareholders, the application judge determined that their expectations were fanciful and driven by their own greed. They had no reasonable expectations. They ought to have known from the outset that JW’s statements made about the business’ prospects were a pipe dream.

The application judge found from a corporate governance point of view, through most of the start-up misadventure, the six investors were not an oppressed minority. They were the majority. They had more shares than JW. They were always aware of JW’ mental health problems and if the business was mismanaged, then the fault lay more with them.

In the result, the court found that JW was liable for the specific oral and written contracts that he had made to the shareholders for the return of their personal loans and their original investment. However, all other claims for damages were dismissed.

But for JW’s oral and written promises to repay the investors for their shares, the sorry history of the business was that of a “humpty-dumpty affair” that fell off the wall from the outset and could not be put back together again. The investors made their own decisions to move forward despite glaring warning signs. As noted by the court, “decision regret is not a cause of action.”

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