

SHAREHOLDERS' AGREEMENTS

Shareholders of privately-held corporations that have more than one shareholder should have a Shareholders' Agreement to set the framework and ground rules for how the corporation will be run and how the parties will work together.

This Reference Guide sets out some of the important issues typically addressed in a Shareholders' Agreement.

Shareholders' Agreements generally have several important objectives. These may include:

- ❖ Maintaining a proportional share ownership between or among the shareholders;
- ❖ Restricting the transfer of shares to outside parties;
- ❖ Ensuring a market for a shareholder's shares and an orderly transition on the withdrawal of a shareholder, which may occur in the event of a sale, disagreement, retirement, disability or death;
- ❖ Protecting the interests of minority shareholders; and
- ❖ Minimizing disputes regarding the management of the corporation by specifying who makes the decisions and how decision makers are elected and appointed.

Each party to a Shareholders' Agreement should obtain independent legal advice before executing the agreement, so that each is aware of their respective rights and obligations under the agreement. In certain provinces, the failure of one party to obtain independent legal advice (even if they decline) may result in an agreement not being enforceable against that party or their heirs and may thereby thwart the parties' intentions.

Tax advice is also important to ensure that the agreement is tax-efficient and does not inadvertently create unintended negative tax consequences.

Note that since corporations are governed by the provincial or federal legislation under which they are incorporated, the applicable legislation must also be consulted to determine if there are any unique requirements.

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1. SHARE TRANSFERS

Appropriate share transfer rules can facilitate a smooth transition where a shareholder disposes of his or her shares, retires, becomes disabled or dies, and can protect the interests of minority shareholders by creating a means to liquidate their shares. Some common share transfer considerations include the following:

❖ Restrictions on the Transfer of Shares

Shareholders of closely held corporations often prefer to maintain shared control over the admission of new shareholders. This might be to keep the business in the family or to ensure that the shareholders would not be forced to become “partners” with strangers.

To accomplish this, Shareholders’ Agreements often allow the transfer of shares to only certain permitted transferees, and restrict the ability to transfer shares to others by requiring the consent of the directors and/or shareholders to any proposed share transfers.

❖ Forced Buy-outs by the Corporation or by other Shareholders

Forced buy-outs keep corporations closely held by preventing shares from going to an “outsider” which might otherwise occur as a result of an event such as a shareholder’s death or bankruptcy or the breakdown of a shareholder’s marriage or common-law relationship.

It may also be desirable to trigger a buy-out in the event of a shareholder’s disability, retirement, or voluntary withdrawal where each shareholder is expected to actively participate in the corporation’s affairs.

Similarly, other events can impact a corporation profoundly. For example, if a shareholder becomes a non-resident of Canada, resulting in control of the corporation being outside Canada or a majority of the shares being held by persons resident outside Canada, the corporation will lose its status as a “Canadian Controlled Private Corporation”. This may increase the tax rate applicable to the corporation’s active business income and may have other negative consequences.

For these reasons, a Shareholders’ Agreement will typically include mechanisms for the buy-out of the shares of a shareholder, which may be structured in different ways depending on the circumstances. In some situations, for example, a Shareholders’ Agreement may contemplate an acquisition of the shares by the remaining shareholders. In other cases, the agreement may provide for an acquisition of the shares by the *corporation* (by way of a redemption of the shares or a purchase of the shares for

cancellation). Since the tax consequences related to such buy-out strategies may vary significantly, tax advice should be obtained when structuring the buy-out provisions of a Shareholders' Agreement.

❖ **Right of First Refusal**

Shareholders' Agreements sometimes give existing shareholders the right to match a share purchase offer made by a third party. If more than one shareholder matches the offer, they each will generally be entitled to purchase the shares in proportion to their relative holdings.

❖ **Piggyback Clause**

Shareholders' Agreements can provide minority shareholders with the right to require that a third party purchaser of some or all of the shares of the majority shareholder must also offer to purchase some or all of the shares owned by a minority shareholder for the same price and on the same terms. The minority shareholders then have the option to accept or decline the offer.

A reverse piggyback clause may allow a majority shareholder to force minority shareholders to sell their shares to a third party purchaser where a proposed sale transaction is conditional on the purchaser acquiring all of the shares of the corporation.

❖ **Shotgun Clause**

In a typical shotgun clause (also called a "buy-sell clause"), one shareholder may trigger the clause by offering to buy the shares of the other shareholder for a certain price or by offering to sell the triggering shareholder's shares at that price. The shareholder receiving the offer then has the option to either sell the shares to the triggering shareholder, or to buy out the shares of the triggering shareholder at the same price and on the same terms as in the offer.

This mechanism provides an incentive for the triggering shareholder to make a fair offer at a fair price because the triggering shareholder may be forced to sell at that price and on the same terms. However, it could also enable a wealthier shareholder to take advantage of a shareholder with more limited financial means. For this reason, a shotgun clause works best between two shareholders with relatively equal wealth.

❖ **Determining Share Price for Share Transfers**

It is advisable to include a share valuation method in the Shareholders' Agreement, as this can help to facilitate a buy-out and prevent disputes regarding valuation methods when the buy-out occurs.

There are different methods for valuing the shares of a corporation. For example:

- The value of the shares of an investment holding company is approximately equal to the net realizable value of its assets. There may, however, be some disputes over whether and how the share value should reflect taxes potentially triggered on the sale of the assets.
- The valuation of operating corporations raises complex issues, and various techniques may be used. The shares of corporations carrying on an active business may be valued in part on the basis of a multiple of earnings. For example, if a corporation has net annual earnings of \$500,000, the goodwill associated with the corporation may be valued at twice the earnings, so the value would be \$1,000,000. The earnings multiple often varies depending on the type of business and on the strength of the goodwill attached to the business.

Qualified professional advice should be obtained prior to finalizing the Shareholders' Agreement in order to settle, in advance, on the appropriate share valuation methods that will apply.

❖ **Corporate Life Insurance**

A shareholder's death is one of the most common events triggering a buy-out of a shareholder's shares. Shareholders' Agreements often require a corporation to purchase life insurance on the lives of its shareholders to fund a future buy-out triggered on a shareholder's death. The use of corporate-owned life insurance facilitates a smooth transition and provides liquidity to enable the corporation to acquire the deceased's shares.

When relying on life insurance to provide funds for a buy-out of shares, it would be important for the amount of life insurance to be reviewed regularly and for additional insurance to be obtained if necessary to ensure that there will be sufficient funds when needed. Provisions should also be included in the Shareholders' Agreement to address the possibility that the insurance is not adequate at the time of the buy-out.

2. NON-COMPETITION

In some cases, such as where shareholders are also employees or key personnel of a corporation, a Shareholders' Agreement may include provisions restricting the right of those shareholders to compete with the corporation while they are shareholders and for a certain period of time after they cease to be shareholders. This provision must be reasonable and must be carefully drafted to ensure that it will be enforceable.

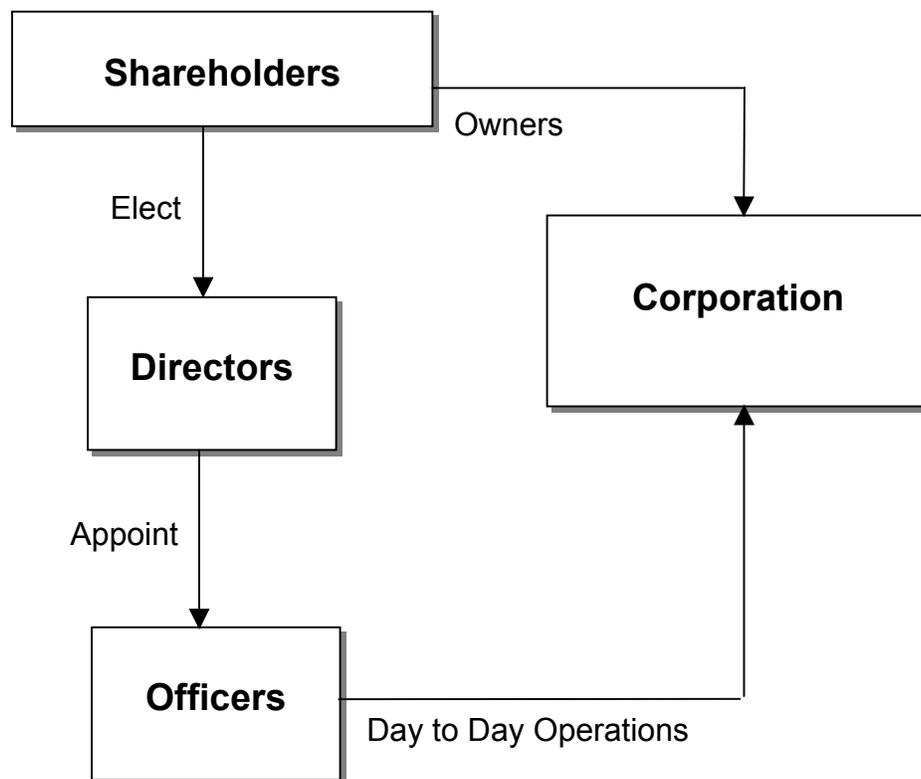
3. CORPORATE GOVERNANCE

A Shareholders' Agreement typically also contains provisions regarding the governance of the corporation.

General Comments

As illustrated in the diagram below, the governance of a corporation involves the shareholders, the directors, and the officers, who each play a particular role in the corporation.

The following diagram depicts the structure of corporate governance:



The Shareholders

As the owners of the corporation, the shareholders elect the directors, appoint or waive the appointment of auditors, and approve financial statements.

The Directors

The directors are responsible for the overall operation of the business and affairs of the corporation. Subject to limitations that may be agreed to by the shareholders in a Unanimous Shareholders' Agreement (discussed below), the directors make a number of very important decisions including:

- Declaring dividends;
- Setting salaries and directors' fees; and
- Approving important contracts.

The board of directors reports to the shareholders and is ultimately responsible for the actions of the corporation.

Directors, in their capacity as directors, are not involved in the corporation's day-to-day operations, although they are ultimately accountable. The day-to-day activities and operations are delegated to the corporation's officers (e.g. the President, Secretary, and Treasurer) and to the employees.

In some circumstances, directors will be personally liable for corporate actions. For example, if the directors fail to be diligent in ensuring that the corporation remits GST and employee deductions to the Canada Revenue Agency (the "CRA"), the directors may be personally liable for these amounts. Similar liability may arise under provincial tax legislation. Directors may also be personally liable for six months of unpaid wages to the corporation's employees, for environmental damage caused by the corporation, and for other specific items as set forth by statute.

The Corporate Officers

The officers of the corporation (including the President, Secretary, and Treasurer) are responsible for day-to-day matters. A corporation can have as few as one officer or as many as desired. The office of Secretary must be filled, since under corporate law, only the Secretary can certify documents and carry out certain other functions.

Voting Considerations

Election of Directors

In the absence of a Shareholders' Agreement, directors are elected by a majority of all voting shares. Consequently, the person or group holding the majority of the voting shares can choose the entire board of directors.

Often Shareholders' Agreements change this method of electing directors and set out how directors are elected. For example, where directors are to represent their nominating shareholder's interests, the Shareholders' Agreement may give each shareholder the right to nominate and elect a director (who could also be the shareholder).

By determining how directors are elected, a Shareholders' Agreement can give minority shareholders the ability to have their interests represented and protected. Without a Shareholders' Agreement, minority shareholders can be left

out of the decision-making process and be limited to suing to prevent oppressive actions against their interests.

The Shareholders' Agreement may also deal with the number of directors to be appointed and the quorum required for meetings of the board of directors and of the shareholders.

In some cases, the agreement may also contemplate including independent directors on the board, which may be appropriate for a very successful business.

Special Majority for Certain Decisions

A Shareholders' Agreement may provide that a special majority of the shareholders (for example, a 'super-majority' such as $\frac{2}{3}$ or $\frac{3}{4}$) or even unanimous consent of the shareholders is required to adopt certain important decisions to be taken by the directors, such as:

- ❖ Amount of director's salaries/fees;
- ❖ Appointment of officers;
- ❖ Declaration of dividends;
- ❖ Changing the corporation's business and/or investment policy;
- ❖ Hiring key employees or non-arm's-length employees;
- ❖ Share redemptions, other than those specified in the agreement;
- ❖ Selling all or substantially all of the corporation's assets;
- ❖ Changing the number of directors; and
- ❖ Amending the corporation's by-laws and articles.

Unanimous Shareholders' Agreement

A Unanimous Shareholders' Agreement ("USA") is a form of shareholders' agreement that is signed by all of the shareholders of the corporation as well as the corporation itself.

Depending on the intentions of the parties, a USA, which is binding on the corporation, can override the corporation's articles of incorporation by restricting or taking away certain powers typically exercised by the directors and stipulating that these powers are instead to be exercised by the shareholders. This may include important directors' decisions that have potentially significant consequences for the corporation and its shareholders.

Note that this can have serious implications for the shareholders, as they can face potential ‘directors liability’ when they take over certain aspects of the management and supervision of the corporation that would normally be the responsibility of the directors.

A USA may also require a special majority with respect to votes taken by the shareholders in certain circumstances.

4. DISPUTE RESOLUTION

Shareholders’ Agreements often set out dispute resolution methods designed to reduce or avoid the need to use the court system. This can be useful in settling disputes regarding factual matters (such as share value) or regarding the meaning or the application of the Shareholders’ Agreement or other matters arising under the agreement. Some dispute resolution methods include:

❖ Arbitration

Shareholders’ Agreements sometimes stipulate that an arbitration process is to be used to resolve disputes. For example, the shareholders might agree to refer disputes to a mutually agreed upon arbitrator. If the shareholders are not able to agree on the selection of the arbitrator, the Agreement might then stipulate that each party to the dispute is to appoint an arbitrator, and the two appointed arbitrators would then select a third arbitrator, with the decision of the majority of the arbitrators to prevail.

❖ Shotgun Clause

Disputes of a fundamental nature, such as the nature and direction of the corporation’s business, may also be resolved by triggering a “shotgun clause” as described above.

CONCLUSION

There are numerous issues to consider when having a Shareholders’ Agreement prepared, and this Reference Guide covers only some of these issues.

Each agreement will need to be tailored to the unique circumstances of the shareholders and the corporation’s business and should be carefully drafted to ensure that it is both effective and tax-efficient.