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Why You Need a Shareholders' Agreement

Discussion Paper

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It is common for two or more companies or individuals to carry on business through a company in which they are both shareholders. Because a company is a legal person distinct from its shareholders, it is usually advisable for shareholders of closely held companies to enter into a shareholders' agreement to regulate their relationships with each other and the company. It is also important that a shareholder's agreement be entered into early in to relationship, when feelings and attitudes are in harmony. If a shareholders' agreement is not in place when a dispute arises, it may be impossible for the warring factions to carry on business.

Defining a Shareholders' Agreement

The general principle of corporate governance is that the majority rules. A shareholders' agreement interferes with that principle by setting out special rules that the shareholders agree will govern how the company is operated and how their interests will be handled. A shareholders' agreement is a private contract that can, for the contracting parties, override the Articles of the company. The Articles represent the general operating rules for the company's management and the ordering of its relationship with its shareholders. The Articles and shareholders agreements are subject to the provisions of the Ontario Business Corporations Act (the "Act") and the general principles of company law that constitute a code of conduct concerning companies. A shareholders' agreement can be used to augment, expand, and provide the special details and terms of the relationships that are not covered by the Act or the Articles.

Unlike the Articles of a company, a shareholders' agreement is not a public document. A shareholders' agreement can be set up to be easily amended with the consent of all or a specified majority of the parties to the agreement. A company's Articles, however, only can be amended by the shareholders.

Preparing a Shareholders' Agreement

It is preferable that all shareholders be party to the agreement to ensure everyone is governed by the same rules. A shareholders' agreement should address the expectations and concerns of each shareholder.

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The shareholders should consider provisions regulating the voting of their shares, and such things as:

- the number of directors and who they will be;
- disposing of or acquiring substantial assets;
- major capital expenditures, major contracts, and financing;
- redemption of shares;
- repayment of shareholders' loans;
- distribution of profits;
- winding-up, re-organizing or dissolving of the company; and
- capitalizing the company with shareholders' loans.

It is also advisable to consider the remuneration and terms of employment of any shareholder. It may be appropriate to include non-competition provisions to ensure that a shareholder does not become involved in competing businesses either while a shareholder or for a specified period of time following ceasing to be a shareholder. The company's business and focus may be described, as should the directors' intention with respect to carrying on the business, and any business plans.

Financing

Once the company is incorporated, consideration must be given to the financing of the business. Will each shareholder be required to loan a certain amount? If so, how much, at what interest rate and on what terms? Or, will the shareholders be required to purchase shares and thus finance the company by equity rather than loan? What about the company's future requirements: Will they require the shareholders to make further loans? All of these basic financial questions should be considered. If financing is not available, then cash injections will have to come, usually by way of loans from private sources or existing shareholders. If financing is available, the company's principals may have to provide guarantees. The shareholders' agreement should contain provisions that set forth whether the shareholders will inject cash when needed or will grant guarantees when required by a lender.

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Transferring Shares

In a closely held company, the shareholders usually have selected each other for the purposes of achieving a common goal, and these shareholders are generally active in the company. They do not wish to become involved with a party whom they have not personally selected nor accepted. Consequently, a shareholders' agreement may contain restrictions on a shareholder's ability to transfer shares both during the shareholder's lifetime and upon death.

Common restrictions of share transfers include:

(a) requiring the approval of shareholders to transfer or charge shares and requiring new shareholders to be bound by that agreement;
(b) giving shareholders the right of first refusal to purchase the shares of another shareholder before the sale to a third party;
(c) preventing one shareholder from transferring shares without making the same offer available to the other shareholders; and
(d) in the event of a shareholders death, requiring the personal representative of the deceased shareholder to, either sell the deceased's shares to the company, or to the surviving shareholders.

Consideration should also be given to a "shotgun" clause, which is not applicable where there are two equal shareholders. Simply put, a shareholder would trigger a shotgun clause by offering to purchase the other shareholder's shares. The offer would set out the purchase price for the shares and the terms and conditions of the purchase. The receiving shareholder must either agree to sell to the offering shareholder or to purchase the shares of the offering shareholder on the same terms and conditions. If the shareholders have disproportionate share holdings or disproportionate wealth, care must be taken in structuring a shotgun clause because a wealthier shareholder may be able to determine the outcome. One benefit of such a clause that must not be overlooked is that it does create a market for the shares, albeit a restricted one.

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Valuing Shares

Events may result in shareholders wishing to remove another shareholder from the company. Such events include:

- disability;
- insolvency;
- a breach of the shareholders' agreement;
- retirement; and
- a Family Law Act application that would affect the ownership of the shares.

Where the sale of one shareholder's shares is triggered, the shareholders' agreement should contain a formula to value the shares to be sold and a schedule to pay the purchase price. A predetermined method of valuing shares can benefit minority shareholders as it can put them on the same footing as a majority shareholder. A majority shareholder may have otherwise demanded a premium for the controlling interest. Valuation methods should be updated annually or based on a formula containing variables that automatically update the calculation to current circumstances.

Death of a Shareholder

As the disposition by one shareholder to a third party during his lifetime gives rise to concern, those same concerns arise with the transfer of a deceased shareholder's interest in the company. Surviving shareholders may wish to ensure that a deceased shareholder's shares are not distributed to the deceased's heirs or sold to third parties. In addition, while the surviving shareholders will wish to obtain the deceased shareholder's interest for the least amount possible, the deceased shareholder's estate will want the interest disposed of as quickly as possible, and at a fair price. A shareholder's death may place a financial burden on the surviving shareholders, as they are required to purchase the deceased shareholder's interest. In order to reduce this burden, the deceased shareholder's investment can be acquired through a life insurance policy on the life of each of the shareholders; spreading payment of the purchase price over a reasonable period of time; or, the company could purchase the investment using either its own resources, or life insurance. If life insurance is used as the cash source for purchasing the deceased shareholder's interest, it may be preferable for the company to purchase the life insurance because its marginal tax rate is lower, the premiums may be tax deductible, and only one entity is responsible for obtaining and controlling the life insurance. In all cases, the method of acquiring a deceased or departing shareholder's interest must be considered in light of the Income Tax Act to ensure that tax disadvantages are eliminated or minimized.

A Cost-Saving Measure

A shareholders' agreement generally should operate to the benefit of all shareholders and it should promote the viability of the company. Approached from a proper business perspective, a properly structured shareholders' agreement can prove to be a cost-saving measure.

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