Shareholders’ Agreement

Strategies for Entrepreneurial Success Presented by:

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- SimpsonWigle LAW LLP is a firm that provides legal services to businesses - large and small, privately owned and publicly held, not-for-profit and charities, as well as individuals who own and run these enterprises. The areas of practice keep pace with business demands and include Corporate Law, Tax Law, Commercial Litigation, Wills, Trusts and Estate Planning, Employment Law, Family Law, Immigration, Condominium Law, Bankruptcy, Insolvency and Restructuring, Succession Planning, Real Estate and Land Development, as well as Construction Law.

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  - Drafting shareholders' and other agreements
  - Buying and selling real estate
- Sits on the Hamilton Law Association Corporate/Commercial committee
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Introduction

- This presentation and Shareholders' agreements will answer five questions:
  i. How should corporations be managed?
  ii. What happens when a shareholder dies?
  iii. What happens when a shareholder is disabled?
  iv. What happens when a shareholder gets divorced? and,
  v. How do we walk away without going to court?

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Introduction

A unanimous shareholders' agreement (USA) may be the most important document that is likely not to be completed and/or signed.

- The objectives of a USA deals appropriately with two basic issues:
  - Decision making (i.e. voting control); and
  - Departing (i.e. liquidity mechanisms)
- There are 5 major reasons to implement a USA
  - Protection <u>for</u> shareholders and family;
  - Protection <u>from</u> shareholders and family;
  - Defines the rights of the shareholders as owners, managers and employees;
  - Settlement of possible disputes;
  - May provide a market for the shares.

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Liquidity Mechanisms

- **No Mechanism/Default Mechanism.** There are USA which contemplate no, or limited, liquidity mechanisms. Sometimes this is the result of lawyer negligence and sometimes it is intentional – for example a parent wants the children who inherit the business to "keep it in the family". However, if the shareholders do want to part ways, they have three options:
  - **Negotiate the Exit**
  - **Negotiate the Mechanism**
  - **Appeal to the Courts**
- **Shot-Gun**. Fast and bloody. This mechanism works best where there is a balance between the shareholders. Where there is any degree of inequality in the number of shares held, economic resources, business acumen or interest in operating the business, a Shot Gun will be titled in favour of the stronger party. This inequality can be mitigated if the weaker party finds another buyer that the business can be subsequently flipped.

Liquidity Mechanisms

- **Right of First Refusal.** This mechanism can take the form of a "hard" right or a "soft" right.
  - **Hard Right -** one or more shareholders receives an arm's-length offer from a third party. The other shareholders then have a period of time to match that offer and supplant the third party.
  - **Soft Right -** the exiting shareholder first puts the term of his/her offer to sell to the other shareholders. If the latter decline the offer, the exiting shareholder can "shop it around" to third parties.
    - works best when the shareholder has a majority interest, as buyers are unwilling to purchase a minority interest;
    - third party purchasers will not be willing to wait around
    - therefore rights of first refusal are of limited value

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Liquidity Mechanisms

- **Tag Along (or Piggy Back)** Under this mechanism, a shareholder can sell to a third party as long as the third party offer extends to the other shareholders who have the option to participate. Where there are multiple shareholders, this mechanism is not ideal to a third party offeror.
  - if only some of the shareholders participate in the Tag Along, the third party offeror could end up in the worst possible position, having to pay more then was initially intended for the core shares that the offeror wanted to buy, yet not gain control of all the outstanding shares.
- **Drag Along (or Carry Along).** This mechanism works very much like the Tag Along, with one very significant exception – the other shareholders, included the third party offer, are compelled to sell under the offer. Buyers prefer this as they are guaranteed control of the company
  - the disadvantage is that those who are compelled to sell may not be pleased with the terms, but at least they can exit the shareholding relationship.

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Liquidity Mechanisms

- **Put-Call Options**.
- **Put Option -** a shareholder can obligate one or more other shareholders, or the company itself, to purchase the shareholders interest.
- **Call Option** - a shareholder is obligated to sell his interest to one or more other shareholders or the company.

- Unlike Shot Guns, Rights of First Refusal, Tag Along or Drag Alongs, Calls and Puts do not, by themselves, determine the price which will be paid for the share. A separate calculation or formula must be grafted on (could be a multiple of an audited figure such as EDITDA, divided by the number of shares outstanding, multiplied by the number of shares sold). The alternative would be to retain a professional valuator (costly and time consuming)
- Call mechanisms are generally required to address involuntary triggering events such as death, disability, insolvency, bankruptcy, divorce or end of employment.

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Liquidity Mechanisms

- **Personal Preference** – The mechanism that works the best are those such as a Shot Gun or Drag Along, which empower the party who is interested in running the business (be it the Triggeror of the Shot Gun, or the third party offeror) to gain control. However, there should be a fairness mechanism such as a top up or earn out, which allows that selling shareholder to participate in any post-closing upside. There are other strategies for protecting these shareholders, such as pre-agreed floor or calculation for determining a floor. For example, the USA could say that any offer under a Shot Gun or made by a third party must be at least "X times the average of the five preceding annual EBITDA"

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Insurance

- A significant percentile of Canada's successful businesses are private corporations with a small number of shareholders who are often directly involved in the business aspects of the corporation. If the corporation is successful, the shares may have a significant value and represent the bulk of the wealth each of each of the shareholders. In the absence of insurance, surviving shareholders may lack the liquid financial resources needed to complete the buy-out of the deceased shareholder's interest. As a result, buy-sell provisions in USA often are build around insurance as source of funding.

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Thank you…

Feel free to contact me if you have any further questions about Shareholders' Agreements.

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