CI ASSANTE
PRIVATE CLIENT

REFERENCE GUIDE

WEALTH PLANNING GROUP

SHAREHOLDERS AGREEMENT

CI Assante Private Client, a division of CI Private Counsel LP

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 managed and how the parties will work together. Advisors often advise clients that if they can not successfully negotiate a shareholders' agreement with their new business partners, then they should probably not be in business together. It is a great first test of the business relationship.

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, resignation, marriage breakdown, bankruptcy, disability or death
- protecting the interests of minority shareholders
- minimizing disputes regarding the management of the corporation by specifying who is entitled to make certain 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, you should consult the applicable legislation to determine if there are any unique requirements to be included in the shareholders' agreement.

Share transfers

Appropriate share transfer provisions in a shareholders' agreement 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 (such as children, spouses or holding companies), and restrict the ability to transfer shares to others by requiring the consent of the directors and/or shareholders to any proposed share transfers.

If a shareholders' agreement gives any shareholder the right to acquire shares of another shareholder other than on the death, bankruptcy or permanent disability of the seller (e.g. an option), then the right may associate the corporation with other corporations of the shareholders. Caution and due diligence should therefore be taken when providing a shareholder the option of acquiring shares of the corporation beyond these three situations.

FORCED BUY-OUTS BY THE CORPORATION OR BY OTHER SHAREHOLDERS

Forced buy-outs keep corporations closely held by preventing shares from being transferred 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.

The tax rules governing estates and testamentary trusts require careful attention and review when planning buy-out provisions in respect of the death of a shareholder in shareholder agreements of private corporations.

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 or drag-along 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 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 resources. For this reason, a shotgun clause works best between two shareholders with relatively equal wealth.

PUT/CALL CLAUSE

Put/call clauses in shareholders' agreements provide the corporation with the right, but not the obligation to purchase (call) the shares from a shareholder and also provide the shareholder with the right, but not the obligation, to have the corporation purchase (put) their shares. These clauses are often required if a shareholder wishes to transfer their shares to a spouse on death to take advantage of tax benefits prior to having them redeemed using proceeds from life insurance to take full advantage of the tax-free capital dividend. Professional advice is highly recommended when doing this type of planning.

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 corporate income taxes potentially triggered on the sale of the corporate 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.

- The value of the shares can be based on a mutually agreed upon formula or calculation for the admission and departure of shareholders or provision can be made to refer the valuation to an outside party, such as the corporation's accountants, to complete the valuation at the time of sale using an appropriate valuation method.

Qualified professional advice should be obtained prior to finalizing the shareholders' agreement in order to settle, in advance, on the appropriate share valuation method 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 is important to review the amount of life insurance regularly and for additional insurance to be obtained if necessary, to ensure that there will be sufficient funds when needed. The shareholders' agreement should include provisions to address the possibility that the life insurance is not sufficient at the time of the buy-out, such as having a note and security delivered that calls for a payout of the balance over a period of time, say five years, with or without interest, as appropriate. As noted, estate and testamentary trust tax rules must be reviewed when undertaking post-mortem planning in respect of shares of a private corporation.

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 or solicit customers or employees of 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.

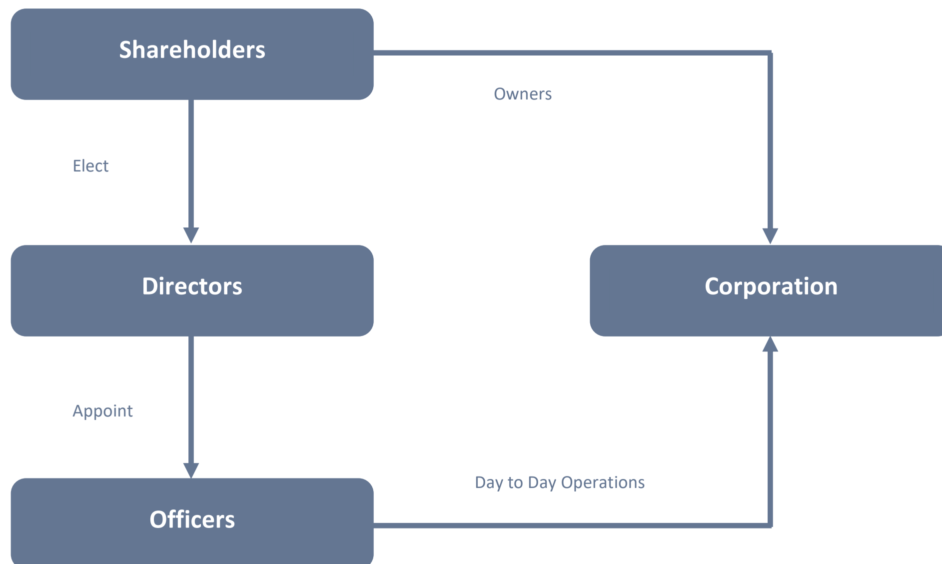
Corporate governance

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
- 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/HST and employee source deductions to the Canada Revenue Agency, 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 the day-to-day activities and operations of the corporation. 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, 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 in cases where the shareholders feel they need expertise that is not available within the group of shareholders.

SPECIAL MAJORITY FOR CERTAIN DECISIONS

A shareholders' agreement may provide that a special majority of the shareholders (for example, a super-majority such as ⅔ or ¾) 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
- 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.

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/MEDIATION

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. Other shareholders' agreements will provide that the parties to the dispute attempt mediation to resolve the issue first and then send the matter to arbitration if the mediation is unable to bring a resolution to the dispute.

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

Each shareholders' agreement needs 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.

In addition to the items discussed in this guide, there are numerous additional issues to consider when preparing a shareholders' agreement; therefore, you should seek professional advice when preparing your shareholders' agreement.

For more information, we encourage you to speak to your advisor or visit us at assante.com

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