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SHAREHOLDERS' AGREEMENTS: A PRIMER

The contents of this Memorandum relate, generally, to shareholders' agreements in the Province of Ontario, Canada. It is not intended to be relied upon to provide legal advice for any particular set of circumstances, and liability for any such use is disclaimed. Always consult a lawyer qualified to practice law in the Province of Ontario, Canada, for legal advice with respect to shareholders' agreements generally and specifically with respect to the creation of a shareholders' agreement for your business.

ONE SIZE FITS ALL?

The purpose of this memorandum is to provide you with some information relating to the preparation of a "Shareholders' Agreement" for your corporation. At the outset, we would like to stress that there is no "one size fits all" form of shareholders' agreements and that your agreement should be specifically designed to suit the individual needs of your company. Your corporation is commonly referred to as a "limited company" which means that as a shareholder the only money that you are liable to lose should the business not succeed is your actual investment. As a shareholder, you are not personally liable for the debts of the company beyond your actual investment made or to which you are legally committed to making. Upon making your investment in your corporation, it is probable that you will have been issued shares in the corporation which shares represent your ownership interest in the corporation.

What is a Shareholders' Agreement

A Shareholders' Agreement is a form of contract that the shareholders of a corporation, or limited company, use to clarify and/or formalize their relationships, duties, obligations and investment in the corporation that they have created. As its name implies, a Shareholders' Agreement is necessary only when there is more than one shareholder involved in a corporation. Such agreements are common within closely held private corporations where there are a limited number of shareholders. As a corporation grows, potentially becoming public in nature and being regulated by applicable security laws with either over-the-counter trading or trading on public stock exchanges for its shares, many of the important issues that a Shareholders' Agreement address become less relevant. For this reason and the fact that it becomes practically difficult or impossible to develop an agreement with larger numbers of shareholders (a company such as Bell Canada Enterprises will not have such an agreement) Shareholders' Agreements are common principally in smaller private corporations.



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Shareholders' Agreements are provided for in both the Ontario Business Corporations Act and the Canada Business Corporations Act. In these acts, the shareholders of a corporation are permitted to provide for the affairs of the corporation through the use of a Shareholders Agreement. An important aspect of both of these acts is that they both provide that in the event that the shareholders of the corporation remove any aspect of the operation of the corporation from the Directors of the corporation, they will then be liable for those aspects of the operation of the corporation as if they were the Directors. This is a very important limitation on the limited liability of the shareholders of a corporation and should be carefully considered when contemplating or preparing a Shareholders' Agreement.

Without a Shareholders Agreement, there are numerous issues which may arise during the existence of your corporation which could negatively impact on the value of or liquidity of your shares. A well considered and properly prepared Shareholders' Agreement is the best form of protection for your investment when or should these issues arise. Obviously, as in any form of agreement between individuals, not every circumstance or eventuality can be contemplated or planned for in advance. However, experience has shown many of the most common situations which may arise and can therefore be planned for in advance. The following are some of the most common issues that can be/are dealt with in a shareholders' agreement.

Liquidity and Buy Out Agreements - The "Shot Gun"

As there is no public market for your shares in a private corporation, your ability to dispose of or transfer your shares should you wish to do so may be difficult or impossible without a previously agreed upon process to effect the desired transfer. Alternatively, the success of your corporation and the value of your shares may also be highly dependent upon the continued involvement of certain individuals who are co-shareholders and you may wish to regulate their ability to leave the corporation in order to protect your own investment.

Within a Shareholders' Agreement there can be provisions which stipulate mandatory buy outs of one shareholder by another (most commonly referred to as "shot gun" provisions), provisions for determining share values on buy out, rights of first refusal for existing shareholders to purchase new shares or shares of other shareholders who wish to sell their shares, tag along rights which allow a shareholder to force the purchaser of other shares to buy their shares as well (particularly important when a key individual in the corporation wishes to end their involvement in the corporation and the remaining shareholders do not wish to carry on without that person) and drag along rights which allows a shareholder who has found a buyer to force other shareholders to also sell if the purchaser wishes to buy additional or all the shares of the company. In drafting these provisions, it is also important to insure that the disposition, transfer or issue of new shares is not done in such a way as to unfairly alter the distribution of ownership in the corporation (for example changing a corporation from four shareholders with 25%, 30%, 30% and 15% to a corporation with three shareholders with 25%, 60% and 15% where the proportionate power of the two minority shareholders has substantially declined).

Death

When starting a new business, it is not common for most business men to think about the consequences of a death of one of the shareholders. Yet this is a serious issue that should be contemplated. Aspects that need to be addressed in this situation involve determining whether the remaining shareholders wish to have the deceased's estate involved in their business. Being involved in business with Bill or Sally may be one thing but do you want to be in business with their spouse or children? Similarly, the estate may need to liquidate the investment that the deceased shareholder held in the corporation in order to meet the financial obligations of the estate. The deceased shareholder may also be a key individual whose untimely and unexpected death could effectively cripple the business unless a suitable replacement can be quickly recruited to carry on the business. Provisions in a shareholders agreement can be designed to deal with these

shares in the event of death and mandatory provisions requiring the estate to sell the shares. There can also be insurance to provide the corporation with funds to hire a replacement individual to pick up the responsibilities of the deceased individual. There can also be provisions establishing the price shares will be sold at and payment provisions which will allow the corporation time to pay for the shares out of cash flow instead of by way of lump sum payment.

Matrimonial Separation

Similar in nature to the issues which arise in the case of a death of a shareholder, when a shareholder separates from a spouse, there will often be issues of support and division of property which arises between the shareholder and their spouse. The shareholders investment in the corporation may be a significant component of their property and be subject to division on the marriage breakdown. Again, while you may want to do business with Bill or Sally, do you want to have their spouse become a shareholder in the corporation by way of divorce? Provisions can be included which provide for these issues in one of a number of ways depending on the preferences of the shareholders involved.

New Capital Requirements

In many corporations, there may also be a need in the future for additional capital to be invested in the corporation. This can be accomplished through provisions requiring existing shareholders to invest additional capital in proportion to their initial investment, by providing for the issue of new shares with rights of first refusal for existing shareholders or for issuing shares to new shareholders provided that they agree to become parties to the existing shareholders agreement.

Operation of the Corporation

The roles, responsibilities and obligations of the various shareholders may also be provided for in a Shareholders' Agreement. Issues such as who will be the Directors or officers of the corporation, whether certain persons will be full time, part time or silent partners in the business, if specific people will have specific roles such as sales, administration, management, etc. can be provided for in the agreement. The financial record keeping of the corporation, accountant, major contracts or limitations on contracting authority may also be dealt with in a shareholders' agreement if desired.

Provisions dealing with confidentiality and non-competition by shareholders may also be included in such an agreement to provide for the non disclosure of company secrets and to prevent a leaving shareholder from directly entering into immediate competition with his old company.

Insurance Requirements

A shareholders' agreement may also provide for insurance requirements that either the shareholders themselves or the corporation is required to maintain for defined circumstances. As discussed above, the death of a shareholder is a situation in which it may be very useful to have provided for insurance coverage with which to repurchase shares from the estate or hire someone to fulfill the obligations of the deceased shareholder. A shareholders' agreement may also provide for disability coverage of shareholders who are involved in the key operations of the company, or insurance on property or assets which may be subject to destruction or loss. This may be particularly important in a situation where a shareholder is not actively participating in the operation of a company but has a significant capital contribution invested in the corporation which could be devastated by loss by mishap.

Contributions and Indemnity Agreements

These agreements may be useful where certain shareholders are making contributions or commitments on behalf of the corporation for which they will be personally responsible either directly or through guarantees. In this type of a situation, it may be prudent for the shareholder making the contribution or guarantee to obtain a contribution and indemnity from the other shareholders so that he/she may seek to recover from the other shareholders a share of any liability incurred.

Taxation

The operation of a corporation and the treatment of payments to and from the shareholders will trigger tax consequences for the various shareholders. Receipt of income in the form of dividend income, salary or bonus or repayment of capital contributions are all treated in different ways when viewed from the tax perspective. Also, as the value of the corporation increases or decreases, there are tax issues in the form of capital gains or losses which must be considered. Clearly, what is tax effective for one shareholder may not be attractive to other shareholders and consideration of these consequences may become important issues to resolve amongst shareholders. Ultimately, shareholders may also enter into complex estate planning discussions which will require the approval of other shareholders subject to conditions to protect the core interests of a shareholders agreement while facilitating valid estate planning objectives.

Winding Up and Distributions of Assets or Capital

While one always hopes that a business venture in which the parties have invested a significant amount of resources and time will succeed, many business ventures in fact have limited life times or ultimately fail. In these situations, issues of the distribution of assets or the return of capital may become important, particularly if one party has made a particular contribution which they have expressed an intention to receive special treatment for. Other issues which may become of particular importance is the distribution of some assets which are difficult to value, such as intellectual property (trademarks, copyrights, patents, goodwill, etc.).

Summary

As you may be able to observe, our opening comments that shareholders' agreements are not "one size fits all" documents is perhaps an understatement of the breadth of issues that may be dealt with in such an agreement. These agreements are frequently in excess of 50 pages in length and represent negotiated positions arrived at between shareholders at a time in their relationship when they are communicating well and working together without the hostility and distrust that often accompanies the breakdown of shareholders relationships. By providing ground rules and road signs to steer a course to a shareholders agreement assists shareholders in working their way through turmoils which are likely to arise in the future.

You may also have noted that as a negotiated instrument, a shareholders agreement will also frequently represent the fine balancing of the interests of the existing shareholders. As such, it is not possible for one lawyer to act as counsel for each shareholder. Ultimately, independent legal advice will be required by each individual shareholder to insure that they independently understand the agreement that they are entering into. While most small companies are reluctant to have one lawyer draft the agreement and then have each shareholder take the draft document to other lawyers of their own, this expense is more than recovered if a dispute ever arises and a party wishes to avoid the binding effect of any provision of the agreement. The costs of preparing a shareholders' agreement will obviously vary with the degree of complexity that you wish to include in the agreement and the situations you wish to provide for.

We would be happy to meet with you to discuss any of the foregoing in the context of your needs.