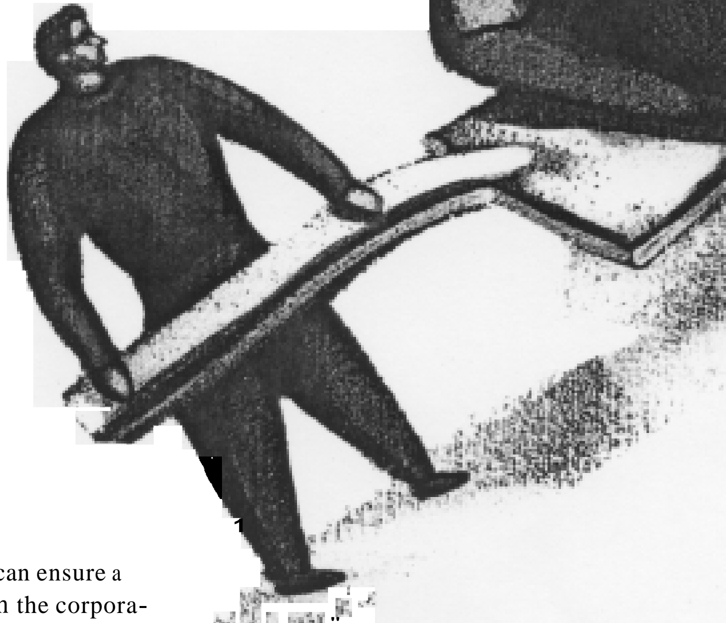
Protecting Your Piece of the Pie

Putting together an effective shareholders agreement

Whether you're a shareholder in a privately held company with two shareholders or 200 shareholders, it is usually a good idea to enter into an enforceable shareholders agreement. A shareholders agreement defines the privileges, protections and obligations of the shareholders of a company.

By Howard Johnson, CMA

A properly structured shareholders agreement serves the interests of both the minority shareholder(s) and the controlling shareholder of a company (where one exists), although typically it is more important from the standpoint of a minority shareholder. A minority shareholder is defined as one who holds 50% or less of the outstanding voting shares, and therefore cannot unilaterally control the affairs of the company. There are a number of provisions commonly found in shareholders agreements that, when activated, affect the value of the company's shares.

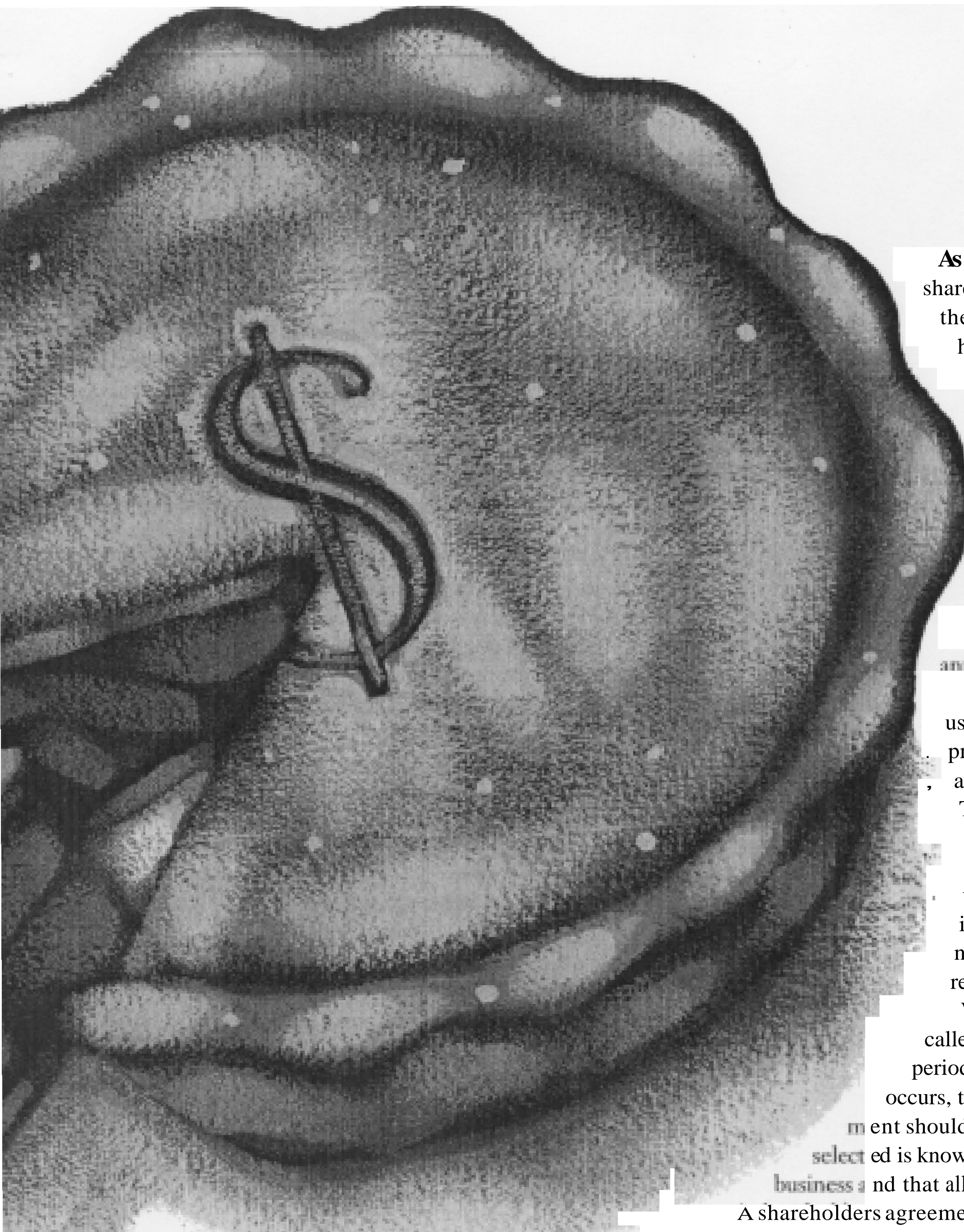


Triggering events

Shareholders agreements typically contain provisions that either permit or require the sale of individual shareholdings in various circumstances. It is important that parties to a shareholders agreement understand and distinguish the various potential future events that might affect their shareholding interests. These 'triggering events' may include the:

- death of a shareholder;
- permanent disability of an employee/shareholder;
- retirement of an employee/shareholder;
- termination of a shareholder's employment;
- marriage breakdown of a shareholder; and
- insolvency or bankruptcy of a shareholder.

When properly structured, a shareholders agreement can ensure a shareholder who is terminating his or her association with the corporation that there will be a market for his or her shares at a price he or she



As a rule, the best approach is for the shareholders periodically to agree upon the value (or values) of specific shareholdings for various purposes, and to stipulate them in writing. Where this is done, it is important that the values be updated on a regular basis, usually annually following receipt of year-end financial statements. However, this approach is often impractical due to the difficulties in getting agreement among shareholders as to appropriate annual values.

Where valuation formulas are used, they often are based on some predetermined multiple of historical accounting earnings or book value. The use of predetermined formulas may result in inequities for several reasons. In particular, business values are influenced by factors both internal and external to the business, and any given formula does not reflect such changes.

Where an independent expert is called on to determine value, either periodically or where a triggering event occurs, the parties to a shareholders agreement should be satisfied that the person or firm selected is knowledgeable about the nature of the business and that all relevant factors will be considered.

A shareholders agreement sometimes will specify the person or firm who is to perform the valuation or it may contain a list of valuation firms or individuals from which the shareholders can agree to select when required. Often, the company's auditors are precluded from acting in the role of independent valuation experts due to their real or perceived conflicts of interest with one or more of the shareholders of the company.

Value agreed by arbitration can be an expensive process, depending upon the availability of appeal from such a value determination. Further, it often is difficult for the different parties to reach a consensus regarding which valuation firm to use, although in many cases the valuation firm or list of acceptable firms is set out in the agreement. Binding or non-binding arbitration or mediation can be established such that:

- a single arbitrator is selected who in essence acts for both parties; or
- each party retains an expert who provides his or her respective opinions in a court-like environment to a single arbitrator or arbitration panel that reaches its own view based on

and all other shareholders believe to be fair. It also provides continuing shareholders with control over outside parties becoming shareholders.

For each triggering event, the shareholders agreement should set out how the transaction is to be effected (i.e. purchase of shares by the other shareholders, or by the company and subsequently cancelled), the method of determining the transaction price, and the terms of payment.

Alternative ways to determine 'value'

Shareholders agreements sometimes specify how fair market value (or some other definition of value) is to be determined. The most common methods of establishing value are: (1) agreement by the shareholders; (2) predetermined formula; (3) independent expert; (4) arbitration; or (5) a combination of the latter two where there is disagreement among experts.

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the information presented; or

- each party retains an expert who provides his or her respective opinions to a single arbitrator or arbitration panel which, based on the information presented to it, selects one of the views presented without alteration (a so-called 'baseball arbitration').

In some cases, the decision of an arbitrator may be overturned if it can be proven that all of the relevant facts were not considered.

Buy/sell provisions

In addition to the triggering events discussed above, shareholders agreements often provide one or more shareholders with the right, or the obligation, to put (sell) their shares to the other shareholder(s), or to call (buy) the interest of the other shareholder(s). Similar to other triggering events, a put or call option will allow the transaction to be effected at a pre-established price, a predetermined formula, by independent expert, or arbitration when exercised.

A shareholders agreement may also provide for reciprocal buy/sell provisions, often called a 'shotgun' clause. Shotgun clauses most often are encountered in situations involving two equal (50/50) shareholders, and stipulate that one shareholder can offer to sell his or her shares to the other shareholder at a price and on terms specified in the offer.

The shareholder receiving the offer must either: accept the offer and acquire the shares of the offering shareholder at the price and terms specified in the offer; or reject the offer, which requires the shareholder receiving the offer to sell his or her shares to the offering shareholder at the price and terms specified in the offer.

Whichever course of action is adopted by the shareholder receiving the offer, it results in a binding agreement of purchase and sale between the shareholders. Assuming the shareholders are of relatively equal negotiating strength, a shotgun clause tends to ensure the liquidity of each shareholders interest. Consequently, it establishes what the parties believe to be a fair price for the shares.

Issues may arise in a shotgun clause where the shareholders have materially different negotiating strength. This might include circumstances where one of the shareholders has access to greater financial resources, or where only one of the shareholders is actively involved in the business, and therefore is more knowledgeable about the operations and future prospects of the company. In some circumstances, particularly in the case of small businesses, one shareholder may enjoy 'personal goodwill' — being the benefit that accrues to the business by virtue of the good name, reputation, knowledge, and so on, of a particular shareholder, and which is not transferable by contract or otherwise. Accordingly, the business may be worth considerably more to a shareholder that has personal goodwill compared to a shareholder that does not.

Right of first refusal

Shareholders agreements often include right of first refusal provisions. Among other things, these provisions allow continuing shareholders to accept or reject proposed new shareholders. There are two distinct ways right of first refusal clauses can be drafted. In the first approach, sometimes referred to as a 'hard' right of first refusal, the shareholder wishing to sell solicits third party offers. The shareholder(s) holding the right of first refusal is then presented with the best third party offer received and is given the opportunity to purchase the selling shareholders' interest based on the price and terms of that offer. If he or she elects not to purchase the shares within an agreed period of time, the selling shareholder can then sell his or her interest to the party making the offer on those same terms.

In the second approach, sometimes referred to as a 'soft' right of first refusal, the shareholder wishing to sell his or her interest establishes a price and terms of sale, which is presented to the shareholder holding the right of first refusal. If he or she elects not to acquire the shares within an agreed time period, the selling shareholder is fi-ee to sell his or her interest in the open market at a price and on terms that are no less favourable than what was offered to the other shareholder(s).

The hard right of first refusal typically is preferable from the point of view of the person holding the refusal right. Third party purchasers rarely will spend a significant amount of time assessing a potential share acquisition in the face of an overriding right of first refusal. The soft right of first refusal typically is better from the vendor's perspective. Although it forces the prospective vendor to be disciplined when establishing the initial price and terms offered to the shareholder holding the first refusal right, in the event the offer is not accepted, the vendor is able to deal with third party purchasers unencumbered by a first refusal right.

Coattail and mandatory sale provisions

Many acquirers of privately held company shares will close a transaction only if 100% share ownership is delivered. Ln such circumstances, the controlling shareholder will not want to have a transaction thwarted by one or more minority shareholders. Therefore, shareholders agreements frequently stipulate that if an offer is received for all of the outstanding shares, which is acceptable to a specified majority of shareholders, that all shareholders are obliged to tender to the offer on the same terms and conditions. These 'mandatory sale provisions' protect the liquidity of a controlling shareholder or a group of shareholders that represent control.

At the same time, a shareholders agreement should ensure minority shareholders the opportunity to sell into a third party

offer at the same price and terms as accepted by the majority. These 'coattail' provisions protect the liquidity of all shareholders in the event of such an offer.

Participation in a subsequent sale

In some cases where a shareholder disposes of his or her interest to other shareholders of the company, the acquiring shareholder(s) realizes a windfall profit shortly thereafter pursuant to an en bloc (i.e. as a whole) sale of the company to a third party acquirer. To alleviate such perceived unfairness, shareholders agreements sometimes provide that during a specified time period after the departing shareholder disposes of his or her interest, he or she is entitled to participate pro rata in any gain on the en bloc sale of the business to a third party. Such provisions can prevent one shareholder within a company from actively consolidating the interests of other shareholders with the intent of delivering the company en bloc to a third party acquirer, and profiting as a result.

Value terms in a shareholders agreement

The provisions of shareholders agreements pertaining to the valuation of a particular equity interest are frequently inadequate. General terms such as 'value' or 'fair market value' are not sufficiently clear, and leave open the possibility of differences in interpretation that can materially affect the derived value of a particular shareholders interest. Therefore, it is important that the shareholders agreement clearly define how value is to be determined for each triggering event. In particular, the shareholders agreement normally should address at least the following with respect to value:

- whether the en bloc equity value of the company should be determined on an intrinsic (i.e. 'stand-alone') basis, or whether so-called 'special interest purchasers' should be taken into account. A special interest purchaser is one that believes it can realize post-acquisition synergies by combining the acquired company with its existing operations, and therefore may be willing to pay a premium over the intrinsic value of a company. *As* a practical matter, in the absence of open market negotiations, the quantification of post-acquisition synergies is highly speculative, and intrinsic value normally is adopted as the appropriate value term;
- whether or not a minority discount should apply. A minority discount is a reduction from the pro-rata portion of en bloc fair market value that sometimes is applied to a minority interest given that a minority shareholder cannot unilaterally control the company. For example, if the en bloc equity value of a company is $5 million, it does not necessarily follow that a 20% equity interest in that company is worth $1 million. In some cases, a minority interest may be worth significantly less, depending on the circumstances. However, shareholders agreements often specify that a particular equity interest is to be valued as a pro-rata portion of en bloc fair market value (commonly referred to as 'fair value');
- where the shares of the departing shareholder are to be acquired by the company, an assumption should be stated with respect to the source of funds. The en bloc value of the shares of a business (and consequently the pro-rata value of any interest therein) may be affected depending on whether a transaction is financed using funds within the company or from outside of the company. Specifically, where the business must forego necessary operating expenditures or growth opportunities in favour of payments to a departing shareholder, the en bloc value of the shares may suffer as a result; and
- where the shareholders agreement is activated due to the death of a shareholder, and the purchase of the deceased's shares is to be financed by life insurance held in favour of the company, the Shareholders agreement should clarify whether the life insurance proceeds are to be accounted for as a component of en bloc value. Where life insurance proceeds are excluded, the surviving shareholders may realize a benefit that would not have occurred in the absence of a shareholder's death.

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For each triggering event, the shareholders agreement should set out the terms of payment for the acquired shares. The definition of fair market value contemplates a cash-equivalent transaction. Where payment is made over time, and market rates of interest are not paid on the outstanding balance, such factors normally should be considered in the determination of value. From the selling shareholders' perspective, it is important to consider the covenant and security attached to any amounts owing either by the company or the acquiring shareholders.

When entering into a shareholders agreement, shareholders should ensure that it adequately documents their collective intent with respect to the terms and conditions of the transactions it provides for, and that the value terms adopted in the agreement are carefully defined. As circumstances change over time, it is important to periodically review and modify, if necessary, the provisions of a shareholders agreement, and to consult legal, valuation, and other financial advisors as needed.

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