

Shareholder Agreements

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Negotiating and Drafting Major Business Agreements

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Introduction – Why Adopt a Shareholder Agreement?

- ◆ Establishing a new business or investing in an existing business, irrespective of its size, requires an assessment of the benefits and risks of ownership. Careful parties will want to put in place contractual arrangements to preserve those benefits and minimize those risks.
- ◆ An agreement between two or more shareholders of a corporation, or between a corporation and some or all of its shareholders, is a common tool used to manage these risks. Since the particular risks and the objectives of the parties will vary depending upon the situation, such an agreement is invariably a custom creation. For this reason, while many shareholder agreements have elements in common, there is less scope for reliance on precedents and more scope for creative negotiating and drafting.
- ◆ In general, shareholder agreements are more likely to be appropriate where a company has among its population of shareholders one or more significant shareholders. Although we are not aware of any comparative study having been done, it is likely that due to greater concentration of ownership among Canadian public companies, shareholder agreements are relatively more common in Canada than in the U.S.
- ◆ A well-drafted shareholder agreement will, in general, have several objectives:
 - It should set out certain baseline entitlements and obligations of the parties in relation to enterprise governance and share transfers.
 - It should attempt to anticipate reasonably likely events in the future of the corporation and its shareholders over the life of the agreement and provide for how they will be dealt with. Examples include: the approval of both recurring and extraordinary corporate events; changes in the ownership of the corporation; the need for injections of additional capital from existing shareholders or new investors; the resolution of disputes between the shareholders; and the death of individual shareholders.
 - It should provide for flexibility in dealing with unforeseen events. This may involve: maintaining the ability to make decisions rapidly and efficiently; exit provisions where one shareholder desires to terminate the relationship for whatever reason; and provisions for dispute resolution arising from a deadlock between shareholders or a question of interpretation of the agreement.
 - It should create incentives for the parties to resolve any disputes consensually, but allow for them to be ultimately determined as efficiently as possible to enable the business to continue with a minimum of disruption.
- ◆ Some issues appear with regularity in shareholder agreements – e.g., the management of the corporation or the transfer of its shares. But there are also a number of less routine arrangements between companies and their shareholders that can be documented by agreement, such as arrangements regarding the sharing of information or business opportunities, standstills and voting agreements.

Unanimous Shareholder Agreements

- ◆ A *shareholder agreement* is a contract between two or more shareholders and is treated as a regular commercial contract. It is subject to the articles and by-laws of the corporation and the provisions of the relevant corporate statute.
- ◆ A *unanimous shareholder agreement* (“USA”) is, in some respects, a creature of statute which the statute allows to be employed to restrict “in whole or in part, the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation”.¹
 - It overrides the common law rule against fettering the discretion of the directors.
 - The legal status of a USA is that of “a corporate law hybrid, part contractual and part constitutional in nature” – it forms part of the constating documents for certain purposes.²
 - Unanimous shareholder agreements are contemplated by legislation in all provinces except British Columbia, Nova Scotia and P.E.I.
- ◆ USA provisions expressly recognize the ability of shareholders to contract out of certain statutory requirements, for example:
 - by requiring a greater number of votes of directors or shareholders than that required by the Act to effect any action (CBCA s. 6(3));
 - by limiting the directors’ discretion to, among other things:
 - * issue shares (CBCA s. 25(1));
 - * make, amend or repeal by-laws (CBCA s. 103(1));
 - * appoint officers (CBCA s. 121(a));
 - * fix the remuneration of directors, officers and employees (CBCA s.125); or
 - * borrow money, give guarantees or grant security interests in the corporation’s property (CBCA s.189(1)).

¹ CBCA s. 146(1); OBCA s. 108(2). For simplicity, other references in this paper to statutory provisions will be to the CBCA only.

² In *Duha Printers (Western) Ltd. v. Canada* [1998] 1 S.C.R. 795, the Supreme Court of Canada held that *de jure* control of a corporation is determined by a review of the constating documents, including any USA but without reference to any other outside agreements. CBCA s. 20(1) is consistent with the constitutional nature of a USA, in that it provides that a corporation shall maintain at its registered office, among other things, the articles and by-laws and a copy of any USA of a corporation.

Unanimous Shareholder Agreements – Liability Issues

- ◆ To the extent that a USA restricts the powers of directors to manage the business and affairs of the corporation, shareholders who are given that power have all the rights, powers, duties and liabilities of a director under corporate statutes or otherwise.³
- ◆ The liabilities assumed by shareholders could include, for example:
 - Liability under corporate statutes (e.g., for 6 months wages for employees, for issuing shares for property of insufficient value, or for payment of dividends or acquisition of shares by the corporation in breach of statutory solvency tests);
 - Tax liabilities (e.g., for income tax, source deductions, GST/PST); and
 - Liability for amounts under other non-corporate statutes (e.g., *Employment Standards Act*, *Environmental Protection Act*, *Pension Benefits Act*).
- ◆ The CBCA expressly provides that the rights assumed by shareholders include any defences available to directors.
- ◆ Whether a USA will relieve directors of their statutory obligations and liabilities under non-corporate legislation will depend on the wording of the statutes in each case:
 - Some statutes expressly prevent such a result – one example is section 2(2) of the *Occupational Health and Safety Act* (Ontario), which effectively precludes the duty of directors to comply with the OHS Act being shifted to shareholders.
 - Where the two statutes are from different jurisdictions, it is necessary to interpret the two statutes to determine whether liability is shifted. In the event of a federal/provincial law conflict, this may engage the paramountcy doctrine.

³ CBCA s. 146(5).

Unanimous Shareholder Agreements – Liability Issues (cont'd)

- ◆ This principle of shifting powers and liability gives rise to a number of potential implications:
 - Creditor-Proofing of Directors. Consider a corporation founded by two individuals who are to be its shareholders and directors. They each subscribe for their shares through personal holding companies, and enter into a USA transferring all of the board's powers to the shareholders. The result, in theory, is that all of their personal liabilities as directors would be assumed by their holding companies, and their personal assets would be less at risk. However, this arrangement could potentially be subject to attack based on a "piercing of the corporate veil" argument in the event of a claim against the shareholders.
 - Foreign-Owned Corporations. A corporation with non-resident shareholders could be the subject of a USA transferring all the board's powers to the shareholders. As a result, the shareholders could appoint a board which included such number of Canadian resident directors as satisfy applicable residency requirements without such individuals assuming all of the powers and liabilities of directors. This practice may be useful for a Canadian subsidiary of a foreign-owned parent.
 - Protecting Shareholders. Where the statute giving rise to directors' liability also provides for a due diligence defence, shareholders may require an officer of the corporation to provide a certificate to shareholders (for example, that the corporation is up to date in paying employee wages or in compliance with employee source deduction legislation) to help establish such a defence.
- ◆ Conversely, if shareholders want to avoid directors' duties and obligations being transferred to shareholders, they will want to ensure a shareholder agreement is found *not* to be a USA – one option involves making the agreement non-unanimous. This could be done by means of a nominee shareholder with a single non-voting share who does not sign the shareholder agreement.

Unanimous Shareholder Agreements – Drafting Considerations

- ◆ Unanimity Requirement. A USA must be unanimous – all registered shareholders of all classes, whether voting or non-voting, common or preferred, must be parties at all times. If an agreement is not unanimous, it will be effective to the extent that it relates to the shareholders' property rights, but any purported restrictions on the powers of the directors to manage will be subject to their fiduciary duties and other obligations.

- ◆ “Deemed Party” Rule.
 - Where shares of a corporation governed by a USA are transferred, the transferee is deemed to be a party to the USA provided a reference to the USA is noted conspicuously on any share certificate representing the transferred shares.⁴ Under the CBCA (but not the OBCA), if no notice is given to the transferee in this manner or otherwise, the transferee may rescind the transaction within 30 days of becoming aware of the USA.
 - Despite these deeming provisions, it is good practice to provide in the agreement that, as a condition of any share transfer, the transferee must expressly agree to be bound by the USA.
 - Since purchasers of newly issued shares from treasury are not subject to the deemed party rule, it should also be a condition of any issuance of treasury shares that the subscriber (if not already a shareholder) agrees to be bound by the USA.

- ◆ Conformity with Other Constating Documents. To avoid confusion, the USA should be consistent with the corporation's articles and by-laws. Corporate legislation does not state whether a USA can override contrary provisions of a by-law, so consider including a provision in both the by-laws and in the USA that in the event of any inconsistency between them, the USA will prevail.

- ◆ Indemnities for Directors. Under any circumstances involving the removal of directors' powers, the directors may still want indemnities to be in place to the fullest extent permitted by the corporate statute in case the removal of their liability is challenged or they are nonetheless named in an action.

⁴ CBCA ss. 49(8) and 146(3) & (4).

Board Representation

- ◆ Except in the case of a USA where the board is stripped of its powers, the influence of shareholders over day-to-day issues which are not subject to shareholder approval will generally be manifested through the appointment of nominees to the board of directors.
- ◆ Certain shareholders may be given the right to appoint nominees to the board. If nominees are to be appointed, consider:
 - Under what circumstances is a shareholder's right to nominate directors reduced or terminated? Examples could include:
 - * Decrease in the shareholder's proportionate ownership from an initial percentage (as a result of a transfer of shares, a failure to contribute *pro rata* on a capital call, or a subscription by a new investor).
 - * Material default by the shareholder in discharging certain specified obligations.
 - * In each case, does the shareholder lose all its nominees, or just some of them?
 - If the circumstances resulting in curtailment of the right to nominate are remedied, is the right reinstated?
 - The agreement should contain provisions which will ensure that any corporate law requirements relating to the number of Canadian resident directors are complied with by the nominating shareholders.
- ◆ Directors who are nominees of a particular shareholder are still subject to fiduciary duties to act in the best interest of the corporation, and not the shareholder who nominated them.
- ◆ An Alternative to Board Representation - Observer Status:
 - Shareholders who do not hold sufficient shares to warrant a nominee director, but for whom participation at board meetings is desirable for other reasons (e.g., suppliers, customers or those with industry expertise) may be afforded "observer status".
 - This status may enable the shareholder to receive notice of and attend board meetings, and provide input and specialized knowledge, without voting. The ability of the observer to participate in, or be excluded from, deliberations on certain matters should be considered.
 - While observers are not subject to the same fiduciary duties as directors, there is a risk that observers who regularly attend board meetings could be named by a plaintiff in an action against the directors of the corporation. Accordingly, they may wish to benefit from similar indemnification and liability insurance as directors, if this can be obtained.

Governance and Control

- ◆ Shareholders' approach to governance will depend on the particular circumstances. For example:
 - Equal partners in a joint venture may require that all decisions affecting the corporation be unanimous.
 - Venture capitalists and institutional investors are less concerned with and less able to bargain for the right to interfere with routine decisions, but may want the right to approve major events directly affecting their economic interest (e.g., by requiring a veto over amendments to the articles, business combinations, substantial sales of assets, the issuance of securities, or significant non-arm's length transactions).
- ◆ Quorum Requirements at Board and Shareholder Meetings:
 - Quorum may not simply be an absolute number of directors or shareholders present at a meeting. It may include a requirement that certain shareholder representatives be present in order for any action to be taken.
 - To make board meetings easier to organize, the agreement may entitle certain shareholders a fixed number of votes on the board irrespective of how many of their directors are actually present at a board meeting.
 - Consider allowing a meeting to proceed with less than the usual quorum after a certain number of adjournments are required due to the failure of a particular director or shareholder representative to attend. This will prevent a participant from stalling the business of the corporation simply by not attending board or shareholder meetings.
 - When designing quorum requirements for board meetings, ensure that the death of an individual director does not create a vacancy that is impossible to fill (by rendering a quorum of the board unachievable). Otherwise, an application may need to be made to a court to call a special meeting to fill the vacancy.
- ◆ Amendments to the shareholder agreement – an agreement might provide that it can be amended by a specified majority of the shareholders, although there may be questions about the enforceability of such a provision. To make the exercise of this right analogous to an amendment to the corporation's articles, and to prevent an agreement being amended by the majority without the knowledge of the minority, the agreement may provide for notice to be given in advance of any proposed amendment becoming effective.

Restrictions on Share Transfers

- ◆ Preventing shares from being transferred to unknown or undesirable shareholders is a key feature of many shareholder agreements. However, this objective must be reconciled with the desire of shareholders to maintain liquidity in their shares.
- ◆ A private company shareholder agreement will often prohibit any transfer of its shares, unless either (i) board or shareholder approval is obtained, or (ii) certain procedural steps designed to protect the interests of the seller or the other shareholders are complied with. The following procedures are common, either alone or in combination:
 - Right of First Offer. A shareholder proposing to sell his/her shares must first make an offer to sell to existing shareholders on terms he/she is prepared to accept. If the other shareholders do not accept this offer, the selling shareholder may sell to a third party, provided the terms of sale are no more favourable to the buyer than those offered to the existing shareholders.
 - * If the existing shareholders do not accept the offer, they lose control over the identity of the purchaser of the shares.
 - * To reduce this risk, the agreement may (i) attempt to identify unacceptable parties to whom a sale would be prohibited in any event (e.g., certain named parties, competitors, or buyers whose acquisition of shares would subject the corporation or any shareholder to additional regulatory requirements), or (ii) provide for piggyback rights.
 - Right of First Refusal. A shareholder proposing to sell his/her shares first obtains a *bona fide* offer from an arm's length third party that he/she is prepared to accept. The other shareholders then have a right to acquire the shares at the price and on the other terms set out in the third party offer, failing which the shareholder may sell to the third party.
 - * The terms of the third party offer must be capable of being performed by the existing shareholders.
 - * Any non-cash consideration offered by the third party should be substitutable for cash of equivalent value paid by the existing shareholders.
 - * The third party may fear being used as a stalking horse, resulting in a discounted price for the offered shares. A "break fee" arrangement between the seller and the third party may be one way to mitigate this..
 - Piggyback (Tag-Along) Rights. Rights of a shareholder to require a purchaser of another shareholder's shares to also purchase the first shareholder's shares on the same terms. Piggyback rights are often demanded by minority shareholders.
 - * All shareholders have the option of participating in an acquisition of control of the corporation by a third party.
 - * Results in an even distribution of any control premium among all shareholders instead of just to the controlling holder.
 - Drag-along Rights. The reverse of piggyback rights – a specified majority of shareholders may require that the minority's shares be sold to a third party to whom the majority sell their interest.
 - * May enable the majority shareholder(s) to command a greater premium for all the shares.
 - * To ensure fairness, the third party offer must be arm's length and *bona fide*.

Restrictions on Share Transfers (cont'd)

- ◆ Drafting Considerations:
 - Even if compelled, the transfer should be smooth – the agreement should provide for detailed transaction mechanics including time periods for all notices and actions to be taken, and details regarding closing of the sale.
 - To reduce the risk of transfers not occurring expeditiously because of a failure or refusal by a party to comply with the mechanics of transfer, provision can be made for (i) deemed transfer by the transferor upon the satisfaction by the buyer of all conditions, and/or (ii) the appointment of the buyer or the corporation as the seller's attorney to execute and deliver all required documentation.
 - Transfers should be subject to the availability of exemptions from applicable prospectus and registration requirements under securities laws.
 - Consider whether a shareholder must sell "all but not less than all" of his/her shares, or whether partial sales will be permitted.
 - Any transferee must become a party to the existing shareholder agreement.
 - The agreement should contemplate the repayment of any shareholder loans made to the seller and the assumption by the purchaser of any guarantees given by the seller of company debt in connection with a share transfer.
- ◆ Dealing With Options and Convertible Securities:
 - A corporation may have an employee option plan and convertible debt, warrants or other convertible instruments outstanding. In anticipating a sale of all the shares where a piggyback or drag-along may be invoked, consideration should be given to ensuring that these other equity interests can also be acquired or terminated for value.
 - Such provisions would need to be included in the relevant option plan document or convertible security, and should be consistent with the terms of the shareholder agreement.
- ◆ A shareholder may be allowed to transfer shares to affiliates and other so-called "permitted transferees" (such as a spouse, children, other family members, trusts and holding corporations) without giving rise to first offer, first refusal or other rights. If such a transfer will be permitted, consider whether the transferor will be required to guarantee performance of the permitted transferee's obligations.

Dealing With Involuntary Share Transfers

- ◆ Existing shareholders will want to ensure that unwanted parties do not become shareholders involuntarily as a result of any of the following events:
 - * Death of an individual shareholder;
 - * Bankruptcy of a shareholder or the exercise of creditor remedies, such as seizure and sale of property, which result in the creditor becoming a shareholder; or
 - * Transfer of assets in the event of a division of net family property in matrimonial proceedings.⁵
- ◆ The requirement in the articles of most closely-held corporations that the directors must approve a transfer of shares will not always prevent such involuntary transfers from being effective. Court-ordered transfers may override such restrictions, and an unreasonable refusal by directors to approve a transfer may be open to challenge.
- ◆ Other alternatives for managing involuntary share transfers include:
 - * Requiring approval by the shareholders (who are not subject to any duty to act in the best interests of the corporation) of any such transfer.
 - * Providing that unless a transfer is approved in accordance with the agreement or the new shareholder falls within a particular class of person, he/she may not vote, receive dividends or exercise the usual rights of ownership.
 - * Rights of other shareholders to acquire any shares transferred involuntarily for a fixed period following such transfer.
- ◆ Any of the above alternatives will be most effective if included in a USA because of the “deemed party” rule.

⁵ In general, courts are reluctant to require a transfer of ownership of shares of a closely-held corporation as part of a division of matrimonial assets. However, if a holder of shares is required by a court to make an equalization payment and has few other assets of value, such a transfer may be the only way to satisfy the payment.

Indirect Transfer of Shares

- ◆ Preventing Indirect Transfers.
 - Consider a beneficial shareholder who owns shares in a corporation indirectly through a holding company. If the holding company is prohibited by a shareholder agreement from selling the corporation's shares directly, but the beneficial owner is not prohibited from selling the shares of the holding company, the other shareholders may not be sufficiently protected against a change in ownership.
 - The courts may afford some protection against a failure to address this specific circumstance in a shareholder agreement, in order to prevent a shareholder from doing indirectly what the parties had bargained that he should not be able to do directly. However, more certain protection would involve making the ultimate beneficial shareholder a party to the shareholder agreement and expressly prohibiting any transfer of beneficial ownership, not just legal ownership. This could include any effective transfer by sale, merger, amalgamation, or other similar event.
- ◆ Tax Planning for Individuals. If an individual beneficial shareholder, holding the corporation's shares through a holding company, has not made full use of the \$500,000 lifetime capital gains exemption, a sale of his/her interest in the corporation via a sale of the shares in the holding company will allow him/her to shelter some or all of any capital gain. A direct sale of the corporation's shares by the holding company would not permit this tax benefit to be achieved. In providing for sales of the shares of the holding company:
 - Both the individual and the holding company should be parties to the shareholder agreement.
 - The agreement should permit the shareholder, at his/her option, to sell shares in the holding company where the holding company would otherwise be entitled to sell the corporation's shares.
 - Any purchaser will need to ensure that the holding company is clean except for the shares of the subject corporation. The shareholder agreement should contemplate the representations and warranties to be given by the shareholder in any purchase agreement entered into with another shareholder.
 - To minimize risk to eventual purchasers of the holding company, there should also be conduct restrictions on the holding company while it is a shareholder, for example:
 - * Prohibition on acquiring any assets other than the corporation's shares, or incurring any liabilities.
 - * Prohibition on carrying on any business other than the holding of the corporation's shares.
 - * Covenant to pay all taxes when due.

Exit Alternatives

- ◆ A shareholder agreement will often provide for multiple means for shareholders to exit (or be required to exit) the corporation. The following is a menu of commonly used provisions.
 - Sale to a Third Party Subject to Rights of Other Shareholders. See previous discussion regarding rights of first offer, first refusal, piggybacks and drag-alongs.
 - Put or Call Options. These rights can be exercisable at any time, after a period of time, or upon the occurrence of specified events. The obligation to purchase under a put could fall to all other shareholders on a *pro rata* basis, but it could alternatively be the corporation's obligation to purchase the shares for cancellation. The right to trigger a call may reside (i) with a single shareholder with a particular interest in acquiring the seller's shares, (ii) more generally with all the other shareholders based on some group decision to exercise the call, or (iii) with the corporation.
 - * Events which may cause the put/call to be triggered may include the death, incapacity, bankruptcy or insolvency of a shareholder, the retirement or other termination of employment of an employee shareholder, or a material breach by the shareholder of the shareholder agreement.
 - * Consideration should be given to who is the appropriate buyer – the corporation or the remaining shareholders. This choice is generally driven by cash availability and tax considerations.
 - * Any purchase by the corporation will be subject to compliance with applicable solvency requirements and covenants in loan agreements or other contracts, so the availability of this remedy may be limited in any event.
 - * A repurchase by the corporation has the effect that all shareholders are indirectly funding the buyout – it may be more equitable to provide for a *pro rata* purchase by those shareholders who actually want to acquire the departing shareholder's shares.
 - Right to Invoke Dissolution Proceedings. Sometimes used as the ultimate remedy in the event of deadlock between the shareholders.

Exit Alternatives (cont'd)

- Shotgun Clause. A shareholder delivers both (i) an offer to buy the shares of another shareholder, and (ii) an offer to sell his/her shares to such other shareholder on identical terms; the other shareholder receiving both offers must decide which of the two to accept.
 - * This remedy is most often used in cases involving two 50/50 shareholders. Where a corporation has more than two shareholders, the drafting of a shotgun becomes more complex.
 - * The uncertainty for both parties acts as an incentive to reach a negotiated solution to any disagreement.
 - * The apparent fairness of this remedy can be diluted by inequalities in (i) ability to finance a purchase of the other's shares, (ii) access to information needed to determine whether the price is fair, or (iii) ability to carry on the business following a sale if only one of them is involved in the day-to-day management of the corporation.
 - * The effect of these inequalities can be lessened through creative drafting – differences in funding ability can be partially dealt with by providing for payment of the purchase price over time, and a minimum offer price equal to one at which the selling shareholder at least recovers its initial investment can reduce the risk of a low-ball offer.
- ◆ In the event of a proposed exit involving a sale of shares to a third party, existing confidentiality arrangements between the shareholders may serve as a barrier to effective due diligence by the third party. In such event, special provisions may be appropriate which would overcome these confidentiality restrictions:
 - The seller may be released from confidentiality provisions to the extent reasonably necessary to facilitate the buyer's due diligence.
 - Other shareholders and/or the corporation may be required to disclose confidential information if reasonably required.
 - The seller could be required to assume the risk of any disclosure by third parties of its own or other shareholders' confidential information – this serves to create an inherent discipline on the provision of confidential information by the seller.

Exit Alternatives – Valuation Issues

- ◆ There are several methods which can be used in a shareholder agreement to determine the exit price.
 - Periodic Agreement Among the Shareholders. The parties commit to agree upon a value from time to time, for example on an annual or semi-annual basis.
 - * While theoretically attractive, this option has practical difficulties: (i) parties often lapse in agreeing on a value, with the result that the last agreed value becomes stale; or (ii) the parties may fail to reach agreement.
 - * Because of these difficulties, it may be advisable to provide for arbitration or for a default calculation (e.g., periodic adjustment based on some relevant market index or inflation index).
 - Calculations Based on a Formula. These could be based upon book value measures, a multiple of earnings or cash flow, or any other appropriate basis.
 - * Accounting advice is critical in fixing the formula.
 - * Any formula should be designed to exclude the effect of any non-recurring extraordinary events on earnings or cash flow.
 - Determination by a Third Party. The parties may agree to have value determined by an independent accountant, investment banker or other business valuator.
 - * One difficulty is that the purchase price may not be known until after the exit has been triggered – this can lead to uncertainty in financing the purchase.
 - * Participants must agree to be irrevocably bound by the independent valuator's determination.
 - * The agreement must provide clear instructions to the valuator if certain items are to be excluded in determining value.
- ◆ It may be appropriate to take into consideration control premiums and minority discounts so the price might not be the same for all shareholders.

Funding Arrangements

◆ Capital Call Provisions

- Shareholders can bind themselves in a shareholder agreement to contribute additional funding to the corporation in proportion to their interests if and when the board makes a capital call. Contributions can be by way of subscriptions for additional shares, loans (secured or unsecured) or property. A similar provision could require shareholders to guarantee obligations of the corporation to third parties in proportion to their interests.
- These obligations give rise to additional risk for shareholders – a capital call is more likely to be made when the company is performing poorly and so compliance will increase the shareholders' downside exposure in the event of business failure.
- Enforcement – The consequences of default by a shareholder in contributing funds can include:
 - * Dilution – The other shareholders can make the defaulting shareholder's contribution themselves.
 - * Event of Default – May entitle other shareholders to terminate the agreement or seek other available remedies.
 - * Loss of Control/Participation – This may include, among other things, (i) loss of the shareholder's right to vote at shareholder meetings, (ii) loss of one or more nominees on the board, or (iii) loss of his/her observer status at board meetings.

In each case, it needs to be determined whether the consequences are permanent, or whether the defaulting shareholder can remedy the default and reverse the consequences by making the contribution at a later date (perhaps with penalty interest).

- In determining the price for shares subject to a capital call, similar issues of valuation arise as in exit alternatives – the price of any shares to be issued will determine the extent of dilution suffered by a shareholder if he/she defaults and the others contribute his/her portion.

◆ Pre-Emptive Rights & Anti-Dilution

- Shareholders may want to guard against possible future dilution by providing for pre-emptive rights to purchase treasury shares on a *pro rata* basis in the event of an equity financing. These clauses could alternatively provide for:
 - * Preservation of interest – Any shares not subscribed for initially are to be sold to third parties.
 - * Increase in interest – If a shareholder does not exercise its pre-emptive rights, the other shareholder(s) can increase their ownership interest by purchasing the unsubscribed-for shares, again on a *pro rata* basis, until all shareholders decline to purchase any more shares.
- The existence of such a clause imposes discipline on the process of admitting additional shareholders.

Dispute Resolution

- ◆ Disputes among shareholders are inevitable and can range from minor disagreements on day-to-day matters to deadlocks at the board or shareholder level that render it impossible for the corporation to conduct business.
- ◆ A shareholder agreement should provide mechanisms for the resolution of disputes – the appropriateness of any particular mechanism may depend on the disagreement it is intended to resolve. The following are examples of dispute resolution procedures, in increasing order of severity:
 - Unilateral Decision By One of the Parties. Disputes with respect to day-to-day business matters could be resolved by one or the other party having a casting vote at board meetings. Overall fairness can be achieved in cases of 50/50 equal ownership by rotating the casting vote periodically between the shareholders.
 - Discussion/Negotiation. Some agreements initially provide for a formal process of discussion between the parties, including a timetable for holding meetings and progressing discussions. While parties who are truly at an impasse may simply “go through the motions” in complying with these requirements without any real attempt to reach a settlement, the process may nevertheless prove valuable in less severe cases of deadlock.
 - Mediation. The parties bind themselves to undergo formal mediation. Drafting issues include identifying how the mediator will be selected and the procedures to follow in conducting the mediation. The required procedures may be incorporated by reference from a statute, or set out specifically in the agreement – common areas to be dealt with include delivery of documents, powers of the mediator to request document production or to interview witnesses, the binding nature of the result, and restricting access to the courts while mediation is ongoing.
 - Referral of Specific Issues to a Neutral Third Party. Often used where the parties cannot agree on a numerical amount such as a determination of value. In such a case, the agreement may provide for the appointment of an accountant, valuator or investment banker to conclusively determine the relevant amount.
 - Binding Arbitration. As with mediation, the key is setting the limits on the process in advance. In particular, consider the scope of the arbitrator’s remedial powers – will he/she be limited to determining monetary damages only or will it be open to him/her to tailor appropriate remedies, including the kinds of relief available under the oppression remedy?
 - Shotgun. Once triggered, one party will end up exiting the corporation, while the other will remain.
 - Sale of the Business. The most drastic remedy, in which both parties commit to an auction process to sell the entire business. Sometimes this is done by providing for the engagement of an investment banker to conduct the auction (in which the parties themselves might be permitted to bid). The threat of this remedy as a last resort may serve to bring the parties together at an earlier stage. Care must be taken so that the investment banker has all powers necessary to conduct the sale, including the power to obtain and disclose confidential information concerning the corporation to prospective bidders.
- ◆ To avoid conflict between procedures, ensure a sequential process so that the parties can only be engaged in one dispute resolution method at a time (e.g., no shareholder can trigger a shotgun while arbitration is ongoing).

Shareholder Agreements and the Oppression Remedy

- ◆ The oppression remedy gives a court broad remedial powers where the result of any acts or omissions of a corporation, or the manner in which the business or affairs of the corporation are conducted or the powers of the directors are exercised, is oppressive or unfairly prejudicial to or unfairly disregards the interest of a complainant.⁶
- ◆ These powers include, in particular, the power to make orders relating to the following:
 - * Restraint of impugned conduct;
 - * Issuance or purchase of securities of the corporation;
 - * Variation of any contract to which the corporation is a party (including the power to amend a USA); and
 - * Appointment of directors.
- ◆ Courts have shown a strong tendency to give effect to provisions in a shareholder agreement which provide for arbitration of disputes as opposed to resort to the courts:
 - In *Armstrong v. Northern Eyes Inc.*, a shareholder agreement provided for arbitration to resolve all disputes. Following a disagreement, one shareholder requested that the court instead assume jurisdiction over the dispute. The court rejected this request. The fact that the range of remedies available to an arbitrator under the agreement was narrower than those available to a court under the oppression remedy did not constitute sufficient grounds to override the private remedy chosen by the parties in the agreement. The court held:

*It is open to shareholders, by agreement, to choose arbitration as the sole means of resolving their disputes and thus, absent extraordinary circumstances..., to oust the jurisdiction of the court to entertain oppression remedy proceedings under the OBCA....When shareholders make this kind of choice, the courts will ordinarily hold them to their agreement.*⁷
 - The court in *Armstrong* distinguished the facts from *Deluce Holdings Inc. v. Air Canada*, in which a majority shareholder terminated the employment of the minority shareholder in order to benefit from a provision entitling it to buy out the minority shareholder's shares. Although the agreement provided for arbitration, the arbitration was limited to a determination of the value of the shares and therefore did not go to the heart of the dispute. The court in *Deluce* that courts are entitled to intervene "where oppression is such that it destroys the very underpinning of the arbitration structure".⁸
- ◆ But while courts may be reluctant to determine a final outcome where a dispute resolution procedure has been agreed upon by the parties, they may nevertheless grant temporary injunctive relief pending the resolution of an arbitration proceeding.

⁶ CBCA s. 241.

⁷ *Armstrong v. Northern Eyes Inc.* (2000), 48 O.R. (3d) 442 (Div. Ct.), aff'd [2001] O.J. No. 1085 (C.A.).

⁸ *Deluce Holdings Inc. v. Air Canada* (1992), 12 O.R. (3d) 131 (Gen. Div. – Commercial List).

Special Cases Involving Shareholder Agreements

- ◆ Not all shareholder agreements are limited to the “usual matters” discussed previously such as management and control, share transfers and exit. Certain other contractual arrangements between shareholders, or between a corporation and certain of its shareholders, also raise interesting issues. Three such special cases will be discussed here:
 - * Special Case #1 – Companies with a large shareholder base
 - * Special Case #2 – Agreements involving public companies
 - * Special Case #3 – Pooling/voting agreements

Special Case #1 - Companies With a Large Shareholder Base

- ◆ Private corporations with large numbers of shareholders (e.g., due to issuance of shares to employees, customers or suppliers, or as a result of several acquisitions from companies with multiple shareholders) can pose special challenges where they have shareholder agreements.
- ◆ Shareholders will naturally tend to form groups according to commonality of interest, for example:
 - * Management shareholders;
 - * Employees;
 - * Venture capital providers; and
 - * Institutional shareholders (certain institutions, such as pension funds, may be non-taxable and thus have different interests from taxable shareholders in respect of distributions).
- ◆ Each of these groups will want to maximize its leverage over the governance of the corporation. Formalizing these groups through a shareholder agreement (i) may help prevent smaller, more easily organized groups which naturally have better communication (such as management) from exerting a disproportionate influence as shareholders over the corporation's affairs, and (ii) provides recognition and structure to the various competing interests.
- ◆ Features sometimes encountered include:
 - Multiple classes of shares with each group holding shares of a particular class, so that corporate action requiring a class vote can be vetoed by any group.
 - Directors nominated by each shareholder group, plus a number of "independent" directors nominated by a majority of the other directors. The nomination procedures within each group may need to be specified.
 - Actions that cannot be taken without approval by certain groups acting individually or in combination.
 - For administrative purposes, the groups may wish to appoint "shareholder representatives" in the shareholder agreement to represent their interests.
 - Mini-pooling arrangements between members of a group to vote all of the shares held by group members in accordance with the group majority.
 - No restrictions on transfer between members of a shareholder group.
 - To preserve the group's shares in the hands of its members, in the event of exit by a shareholder, the other members of the group could be given a right of first refusal to acquire any of the exiting member's shares.
 - Many of the other features of shareholder agreements previously discussed, such as those relating to governance and dispute resolution, can be replicated at the group level.

Special Case #2 – Agreements Involving Public Companies

While shareholder agreements involving public companies are less common than for privately-held companies, certain unique issues can arise, including the following:

◆ Standstill Agreements

- May be seen where (i) a party makes a substantial investment in treasury securities of a public company, or (ii) a public company makes an acquisition for share consideration, with the result that the vendor of the acquired business/assets obtains a significant ownership position in the public company. As a condition of either transaction, the corporation may require the new substantial shareholder to agree not to acquire any additional shares of the public company.
- May be seen in conjunction with pre-emptive rights so that if the public company issues additional shares (under a financing, another acquisition or otherwise), the substantial shareholder can maintain its percentage ownership interest.
- Where the public company is otherwise widely held, this can serve as a limited form of take-over bid protection without adopting a more general deterrent such as a shareholder rights plan. Additional take-over bid protection can be obtained if the holder of the large block of shares agrees not to sell into a take-over bid or other business combination which is not recommended by the corporation's board of directors.

◆ Information Sharing

- Consider a scenario where a publicly-held company ("subsidiary") has a controlling or substantial shareholder ("parent") which is also a public company.⁹ Under such circumstances, it is likely that parent will have one or more nominee directors on the board of subsidiary.
- Parent may require information from subsidiary for purposes of preparing parent's financial statements and other filings with securities regulatory authorities, which information may be more extensive than what is publicly disclosed by subsidiary in its own filings. Parent may also require non-public information regarding subsidiary's business plans, earnings forecasts, etc. in order to act prudently in connection with its substantial investment in subsidiary.
- Absent an agreement providing for such information to be furnished to it by subsidiary, in general, parent has no right at law to demand any information above and beyond what is required to be disclosed by subsidiary to all its shareholders under securities laws. Accordingly, prior to acquiring its interest in subsidiary, parent may seek to enter into an agreement with subsidiary which gives it the right to demand such information, on terms which provide subsidiary with appropriate safeguards as to parent's use of such information.

⁹ Examples include (i) Falconbridge Limited, which is 59% owned by Noranda Inc., (ii) Hollinger International Inc., which is controlled by Hollinger Inc., and (iii) Kraft Foods Inc., whose common shares are 85.4% owned by Altria Group, Inc. In each case, the parent and subsidiary have agreements or other arrangements in place regarding information sharing and/or business opportunities.

Special Case #2 – Agreements Involving Public Companies (cont'd)

- Appropriate safeguards for subsidiary in connection with the disclosure of such information to parent could include (i) undertakings from parent and its directors and officers to keep such information confidential and to use it solely for purposes of compliance with applicable securities and other laws, and (ii) existing obligations of parent under insider trading legislation not to trade in securities of subsidiary with knowledge of material undisclosed information.
- The directors of subsidiary would need to be mindful of their fiduciary duties to the corporation in agreeing to provide such information, and would need to conclude it was in the interests of subsidiary to discriminate between shareholders in this manner (the “interests of subsidiary” could include the maintaining of mutually satisfactory relations with its controlling shareholder). However, if the primary purpose of such an agreement was improper, then such agreement could be open to challenge by minority shareholders.¹⁰
- ◆ Dealing With Corporate Opportunities
 - In circumstances where parent and subsidiary share information and are in similar lines of business, issues may arise as to which of them will be allowed to take advantage of a corporate opportunity which could potentially be exploited by either of them.
 - Directors’ fiduciary duties require them to ensure that neither they, nor others to whom they are related (including other corporations) benefit from corporate opportunities belonging to the corporation of which they are directors or officers.¹¹ For interlocking directors on the boards of both parent and subsidiary, this may prove a source of conflict – they will be bound by their fiduciary duties to their respective corporations to disclose corporate opportunities known to one corporation to the other, but if the other corporation avails itself of any such opportunity to the detriment of the first the director could be exposed to liability for assisting in the diversion of the opportunity.
 - This source of exposure could be mitigated by agreeing in advance how corporate opportunities are to be dealt with (for example, an agreement could provide that they be allocated based on geographic or business lines, the size of the opportunity or other factors). If the “natural” party for a particular opportunity declined to exploit it, the other party could be afforded a right of first refusal over such opportunity.
 - While not affording absolute protection to directors and officers, this kind of allocation arrangement, together with board guidelines requiring that all decisions regarding corporate opportunities be taken by independent directors only, could serve as a defence to a claim brought against such directors and officers based on their alleged participation in the diversion of a corporate opportunity.

¹⁰ See, e.g., *Hogg v. Cramphorn Ltd.*, [1967] Ch. 254; *Teck Corporation v. Millar*, (1973) 33 D.L.R. (3d) 288 (B.C.S.C.).

¹¹ *Regal (Hastings) Ltd. v. Gulliver* [1942] 1 All E.R. 378 (H.L.); *Canadian Aero Service v. O’Malley* (1973) 40 D.L.R. (3d) 371 (S.C.C.).

Special Case #3 – Pooling/Voting Agreements

- ◆ A pooling agreement (or voting agreement) is a form of limited purpose agreement between two or more shareholders to vote their shares together in a particular way. It is most often entered into between shareholders who are already party to a shareholders agreement, where a subset of the shareholders have an interest in ensuring that their collective shares are voted together. This may be important if, collectively, such shares have an effective veto over shareholder action because they exceed a certain percentage ownership or because they comprise a separate class of shares. Alternatively, a pooling agreement could be used to negate a veto power held by certain shareholders for certain corporate action which arises because tax considerations dictated the use of multiple share classes.
- ◆ Pooling agreements are contemplated in CBCA s. 145.1.
- ◆ The corporation is not typically a party to such an agreement.
- ◆ One simple mechanism by which common voting can be achieved would be the granting by one shareholder to another of a power of attorney to vote the granting party's shares.
- ◆ A more complex mechanism, which may be appropriate where there is a large number of shareholders, is for all shares subject to the pooling arrangement to be registered in the name of a nominee (such as a trust company) which is instructed to vote all the shares in accordance with the decision of the majority of the parties to the agreement.
 - Shareholders may be issued voting certificates representing their interests. The transfer of voting certificates could be made subject to restrictions similar to the restrictions on share transfers described above.
 - The nominee would be instructed to pay to the beneficial holders any dividends or other distributions received by it, but would have the sole ability to vote the shares in accordance with the pooling agreement.
- ◆ In lieu of a pooling arrangement, a similar result could be achieved by transferring all the pooled shareholders' shares to a holding company in exchange for holding company shares issued in proportion to their shares of the subject corporation. The pooled shareholders would then enter into a shareholder agreement at the holding company level.