The Client Advisor

Shareholder's Agreements

What, Why and When

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Shareholders' agreements can play a pivotal role in running a successful business, resolving conflict and ensuring seamless succession. However, because these agreements are often time-consuming to negotiate and result in the discussion of many "difficult" issues, many business owners choose to go without them. This article answers the basic questions of (a) ***what*** is a shareholders' agreement?, (b) ***why*** are they beneficial? and (c) ***when*** should they be entered into?

WHAT?

A shareholders' agreement is an agreement between the shareholders of a corporation, which deals with the governance of the corporation and the relationship between its shareholders. The contents of a shareholders' agreement can generally be broken down into three main categories: (1) exit mechanisms, (2) financing - being contributions by, and distributions to, shareholders and (3) ongoing governance.

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The exit mechanisms are likely the most important area of the agreement. They attempt to solve a fundamental issue for private corporations with multiple shareholders – that the shares owned by one shareholder are typically unsaleable unless sold to the other shareholders or sold together with all of the other shares. The exit mechanisms in the agreement are used as a last resort to allow shareholders not getting along to go their separate ways, with a shareholder leaving the business still receiving value for his or her shares. The exit mechanisms also restrict share transfers to third parties to ensure that existing shareholders do not end up with unwanted partners. Finally, they deal with the purchase of the shares of a shareholder who has died or become disabled and is no longer able to participate in the business. There are numerous purchase options that can be used to fit the circumstances of the particular business.

The financing section of the agreement typically deals with how much each shareholder will be required to contribute to the business, and when, as well as the plan for addressing other capital needs. As importantly, this section addresses how and when funds are distributed by the corporation to the shareholders, including the payment of salaries, bonuses and dividends, and the repayment of loans.

Finally, the agreement sets out procedures for the ongoing management of the business and usually includes terms on how the business will be managed and who will participate in day-to-day and major decisions. Addressing this in an agreement can resolve many issues down the road.

WHY?

The main purpose of a shareholders' agreement is to minimize and resolve conflict. By allowing the shareholders of a business to set out in advance how a business is run and how they may exit from the business, the potential for conflict when changes arise in the future is greatly reduced.

This conflict reduction is assisted by the fact that a shareholders' agreement allows a corporation to tailor its governance to the wishes of the shareholders involved and to override to the extent possible the default statutory law.

Finally, an often overlooked but very significant advantage to a shareholders' agreement is that it can act as a tool for succession planning. The transition of a business from one generation to another can often be a time of great conflict and jockeying for position. A shareholders' agreement put in place by the generation then running the business can help ensure that an orderly transition from one generation to the next takes place.

WHEN?

The best time to enter into a shareholders' agreement is at the same time the corporation is formed, as this is generally the time when the shareholders are getting along the best. However, this does not mean that an established corporation should not enter into one. As long as you can obtain the agreement of the applicable shareholders, it is never too late to enter into a shareholders' agreement. A properly drafted document, which is supported by all parties, can help a corporation withstand the inevitable changes which time will bring.