

WOOD GUNDY

SHAREHOLDERS' AGREEMENT

When starting a business, entrepreneurs are filled with excitement and the anticipation of future prosperity. Taking steps to protect your business from unforeseen circumstances can help pave the way for a smooth road ahead. A Shareholders' Agreement can set out a course of action for certain events, relieving the possible conflicts and potential disruptions that could hinder the future of your business. Since a Shareholders' Agreement is a legal document, you should consult with a lawyer if you are thinking of drafting one; however, this report will give you an overview of details that can be included.

Shareholders' Agreement

A Shareholders' Agreement is an arrangement created specifically for your business, usually defining the operation of the corporation and the privileges, protection and obligations of its shareholders. In general, a Shareholders' Agreement must be unanimously agreed to by all shareholders in order to be effective. It can be used to establish the ongoing rights and responsibilities of shareholders and provide instructions regarding the roles and responsibilities of business partners and involved family members during certain events.

Shareholders' Agreements are tailored to the needs of your corporation, and can include a course of action regarding events such as death, disability, critical illness or divorce of a shareholder, bankruptcy, termination of key people, or disagreements. They can outline a defined course of action for "what if" scenarios, including the terms and procedures for the sale of the business. As a crucial step in the business planning process for small businesses, Shareholders' Agreements are intended to act as a mechanism for protection in the event of a disagreement between shareholders.

Reasons to establish a Shareholders' Agreement

A Shareholders' Agreement can protect individual shareholder's interests. Shareholders may be at risk if they are in a disagreement with one another and there is no clearly defined document to guide them. This can lead to lengthy arbitration and negotiation, and affect the general well being of the business, since shareholders often act as directors or officers in many small businesses. If there is a dispute or uncertainty on how to proceed with a particular situation, the shareholders can refer to this document for guidance. A well-drafted Shareholders' Agreement can help protect the business and give a degree of comfort to shareholders as their respective duties, obligations, rights and benefits are clearly defined.

Possible issues addressed by a Shareholders' Agreement

Not all Shareholders' Agreements are alike and the clauses included in each agreement are unique to the corporation they are drafted for. The following are examples of issues that can be addressed by a well-drafted shareholders' agreement.

Operation of the business: The Shareholders' Agreement can spell out responsibilities and requirements regarding the operation of the business. It may also contain a list of any key decisions that require unanimous agreement by all shareholders (e.g., the sale of part of the business).

Conflict resolution: If deadlock on a decision or conflict with shareholders arises, a trusted third party or mediator outlined in the Shareholders' Agreement could become involved.

Death of a shareholder: An agreement may outline the steps the company should take if a major shareholder passes away. This is usually done with a Buy/Sell Agreement using insurance. For more information on Buy/Sell Agreements, please see our Special Report, *Business Solutions: Buy/Sell Agreements*.

Disability of a shareholder: The Shareholders' Agreement can specifically define what constitutes a disability, and may include a provision for the disabled to draw income from the business.

Bankruptcy of a shareholder: A provision for a mandatory buyout when a shareholder becomes personally insolvent or bankrupt can be included, as this may force the shareholder to sell off his or her shares in the corporation.

Retirement of key persons or shareholders: The agreement may include how pension plans are administered and/or how other benefits are defined and distributed.

Marriage breakdown of shareholder: In a divorce situation, privately held corporate shares may be included in the distribution of assets. Without a provision for this scenario, shareholders may find themselves dealing with an extra shareholder they did not anticipate.

Business valuation: The fair market value of the business can be determined either by a formula in the agreement, or by hiring a business valuator. With both options, a re-evaluation should occur every few years to take into account changes in the business. This is a crucial step should the business ever need to be liquidated.

Buy-Sell Issues: A buy-sell provision known as a "shotgun clause" provides for one of the partners to make an offer to the other partner for his share of the business. It is most applicable when there is a shareholder dispute and an amicable buyout cannot be reached. The partner receiving the offer has the option of either accepting the offer, or buying out the partner who proposed the offer on the same terms. It is a "last resort" option to solve the dispute, and to ensure a fair price for the shares is tendered.

Failure to execute a Shareholders' Agreement

When starting a new business, partners often share a vision and hold similar opinions on many key decisions. As time goes on, however, views may deviate, and situations may occur that shareholders never contemplated. For example, if the corporation requires additional capital, there may be disagreements as to where it should come from. If there is a difference of opinion, and there is no written Shareholders' Agreement, it may be extremely difficult and expensive to resolve any disputes between shareholders. Without a shareholders' agreement, the success of the business may be in jeopardy when disagreements or unexpected events occur and cannot be resolved.

When consulting a lawyer to develop a shareholders' agreement, the ultimate goal is to ensure fair treatment of all shareholders, and the protection of their rights. Outlining legitimate pricing of shares, what outside parties may become future shareholders and implementing safeguards for minority positions can all be included as part of the shareholders' agreement. Developing a decision making process for crucial events is a smart way to protect the operation of your business.

**For more information on protecting your business, speak to your
CIBC Wood Gundy Investment Advisor.**