

# Protecting your business with a shareholders' agreement

A shareholders' agreement sets out the rights and obligations of the shareholders of a private business.

When two or more people go into business together, they usually have a common understanding of the way the business will operate and what decisions will be made as circumstances change. The purpose of a shareholders' agreement is to record these understandings so there is a documented reference that can be used if a dispute arises.

There are also partnership agreements; the difference between shareholder and partnership agreements relates to the legal structure as partnerships share business ownership based on the interests of each partner, while shareholders hold ownership based on the number of shares held by each person and the percentage of the business' value represented by those shares. While this article is general in nature and focuses particularly on shareholders' agreements, there are similarities to partnership agreements.

Without a shareholders' agreement, the relationship between the shareholders could deteriorate if they disagree about the response to events that affect the business. Some scenarios that may cause disputes between shareholders:

- A shareholder wants to sell some of their shares of the business to a family member
- A shareholder wants to hire their spouse
- A shareholder suffers a long-term disability or premature death and their interest in the business needs to be liquidated

In each of these scenarios, shareholders could be on opposite sides of the issue based on their own personal perspectives and biases. A shareholders' agreement should address how each of these scenarios would be handled, thereby avoiding future disagreements over such events.

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### Having a say, sharing the profits and transferring ownership

Typically, each shareholder will have voting rights that allow them to make decisions that are important to the business.

These decisions are most often made by a majority vote, but there may be instances when a critical decision should demand a certain percentage of the vote. Most often, the shareholders' agreement will list the types of corporate actions that require a vote and specify when a significant majority is required for the most crucial of decisions. Examples of such crucial decisions include the sale of assets or shares of the company, changes to shareholder rights, or large capital expenditures.

The shareholders' agreement should also include a distribution policy that specifies when and how corporate

profits will be distributed to the shareholders. The agreement should allow for some flexibility to allow the company to scale back on distributions when the company needs additional cash flow or to increase cash distributions when there are excess funds that do not need to be reinvested in the business.

The shareholders' agreement should also stipulate who can become a shareholder of the company. Frequently, provisions are set in the agreement that prohibit shareholders from transferring their shares to anyone without the other shareholders' consent.





## Common provisions in shareholders' agreements

Shareholders' agreements usually cover a wide variety of issues in respect of the business, such as the way it is managed, decision making, financing, share transfers/subscriptions and the buying and selling of shares. Addressing how shares are bought and sold is very important because it ensures that the parties agree who could be future shareholders and under what circumstances the shareholders will buy or sell shares among themselves.

There are a number of provisions with respect to share transfers that are commonly included in shareholders' agreements.

### Restriction on transfer

This provision prohibits shareholders from transferring their shares to any other person without the unanimous consent of all the shareholders. This ensures that one shareholder cannot admit a new shareholder without the consent of the other shareholders.

### Right of first refusal

If one shareholder wants to sell their shares to a third party, this provision requires that they are first offered to the current group of shareholders. This controls the way new shareholders can enter the business while also allowing a shareholder the opportunity to sell their shares.

### Buy-sell events

Certain events can be defined as triggers that determine when shareholders should have the right to buy shares from another shareholder to protect the financial viability of the business. These events normally represent a change in a shareholder's circumstances such that they want to be able to sell their shares to liquidate their investment in the business:

- Premature death
- Permanent disability
- Divorce
- Retirement
- Bankruptcy/insolvency

The provisions with respect to the buy-sell events should clearly define a closing date and the terms of the buy-sell arrangement. The terms would include the amount of payment due at the closing date, the period over which the outstanding balance is paid, the security for the outstanding balance and whether the outstanding balance attracts interest.

### Using insurance to fund a buy-sell arrangement

Insurance is one of the most efficient funding vehicles for completing a buy-sell arrangement between shareholders triggered by a premature death or a long-term disability. The event that triggers a buy-sell event between the shareholders would also trigger the insurance payout.

The life insurance policy covering each other can be held personally by the shareholders, or it could be held by the business. Since the exact structure of the insurance ownership and beneficiary designation will depend on the facts of the situation and objectives of the shareholders, professional advice is required.

Insurance policies are also available that pay a lump sum amount, after a waiting period, following the permanent disability of a shareholder. These policies can provide the funding necessary for a buy-sell arrangement. Since the insurance company will already have an adjudication process in place, these policies can be used to confirm the permanent disability as well as provide the funding necessary for the buy-sell arrangement.

### Conclusion

The best time to complete a shareholders' agreement is when all the shareholders are in agreement. The document will lay out the ground rules for issues that are important to the shareholders and the business to limit any disruptions to the ongoing operation of the business.

It is important to consult with professional advisors when drafting a shareholders' agreement. If you are considering a shareholders' agreement for your company, your BMO financial professional can refer you to the appropriate professionals.



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