Shareholder Agreements: An Overview

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There is no legal requirement for shareholders to enter into a shareholder agreement, and it is possible for a corporation to be governed only by the applicable corporation statute, together with its articles of incorporation and by-laws. However, most shareholders find that this "default" scenario is not satisfactory. For example, minority shareholders may not be willing to subject themselves entirely to the will of the majority when important corporate decisions are made. On the other hand, majority shareholders may wish to have the right to compel minority shareholders to sell their shares to a third party who wishes to acquire all of the corporation's outstanding shares. In general, a shareholder agreement can be used to ensure that each shareholder's investment in the corporation will be dealt with fairly and in accordance with the rules set out and agreed to by the parties.

In the case of a technology startup that intends to seek external investment, it is often debated whether founders should enter into a shareholder agreement prior to receiving outside investment. As the outside investor will typically require significant changes to an existing shareholder agreement, some argue that negotiating and entering into a shareholder agreement before external investment is received is an unnecessary expenditure of time and money. Nevertheless, many founders find that a basic form of shareholder agreement is desirable even before outside investment is obtained. Care should be taken, however, to avoid provisions that require unanimous consent for actions such as the amendment of the corporation's articles or the shareholder agreement itself, as a difficult shareholder can use these provisions to block an investment or a potential exit.

Key Provisions of a Shareholder Agreement

A typical shareholder agreement will deal with a number of complex issues, each of which must be tailored to the circumstances and the parties involved. For example, the founding shareholders of a corporation that has no plans to issue additional shares will have a different perspective on what should be included in a shareholder agreement than an investor who has invested significant funds in a corporation, but whose shareholdings do not give it control over the direction of the corporation's business.

This article describes some of the key provisions that are usually found in a shareholder agreement for a startup technology company that has received funding from venture capital investors. The applicability of these provisions to a particular group of shareholders will depend on the circumstances of the shareholders and it is strongly recommended that the assistance of experienced legal counsel be sought to ensure that the interests and intentions of all of the shareholders are properly considered.

Unanimous Shareholder Agreement

Where a startup company has a small group of shareholders, it is common to require all of the shareholders to be become parties to the shareholder agreement (commonly referred to as a unanimous shareholder agreement). A unanimous shareholder agreement has special legal status in that it can be used to restrict the powers of the directors (under the common law, directors cannot rely on a non-unanimous shareholders agreement to delegate or reduce their discretion).

When the shareholder group becomes larger and more disparate, however, a unanimous shareholder agreement can be unwieldy. If a non-unanimous shareholder agreement is used, minority shareholders who are not a party to the principal shareholder agreement should be required to enter into a separate agreement with the corporation (often referred to as a share restriction agreement). Share restriction agreements typically contain restrictions on transfer, a right of first refusal in favour of the company, a drag-along and confidentiality provisions, and sometimes provide for a company repurchase right.

Management of the Corporation

One of the key issues to be addressed in a shareholder agreement is the management of the corporation. In particular, the following items should be considered:

Board of Directors

Where investors are to receive representation on the corporation's board of directors, the shareholder agreement should set out the size of the board and the manner in which board members will be elected. One common method of selecting members for the board is to permit particular shareholders, or groups of shareholders, to nominate persons to serve as directors.

In order to ensure that each of the respective party's nominees is elected to the board, the shareholder agreement should provide that each shareholder shall vote its shares to elect the directors nominated in accordance with the agreement.

When nominating directors, it is important to consider the Canadian residency requirements for directors under the applicable corporation statute as well as any effect that the board composition may have on the corporation's status as a Canadian-controlled private corporation (if applicable).

Procedural Matters

A shareholder agreement will often include provisions dealing with the frequency of board meetings, the manner in which a meeting may be called, what constitutes a quorum for a board meeting, and other related matters. In drafting these provisions, the corporation's by-laws should be reviewed to ensure there are no inconsistencies between the by-laws and the shareholder agreement.

Observer Rights

Investors who are not represented on the board of directors may seek to have observer rights who is a person entitled to be present at board meetings and to receive materials and information provided to board members, but is not entitled to vote on matters before the board. Observer rights are usually only granted to investors who have made a significant investment in the corporation. The shareholder agreement should provide for a mechanism to remove an observer when the appointing shareholder's shareholdings in the corporation fall below a designated threshold.

Covenants of the Corporation

Investors will often require the corporation to agree to certain obligations with respect to the information provided to investors and the operation of the corporation. For example, the shareholder agreement might provide that the corporation must prepare and deliver to the investors unaudited quarterly and audited annual financial statements within prescribed timeframes. The shareholder agreement may also include obligations regarding the acquisition and maintenance of directors and officers liability insurance.

Dealing with Shares in the Corporation

A shareholder agreement should clearly set out any restrictions or obligations related to the shares of the corporation. The following are some examples of such restrictions and obligations:

Restriction on Transfer of Shares

A shareholder agreement will typically include a prohibition on transferring shares, or any rights or obligations under the shareholder agreement, except as specifically permitted in the shareholder agreement or as consented to by the shareholders (or a defined group of shareholders, such as a percentage of the shareholders of a particular class of shares in the corporation).

Permitted Transfers

A shareholder agreement should provide for sufficient flexibility so that shareholders can deal with the shares in an efficient manner for tax planning purposes. For example, for shareholders that are investment funds, the shareholder agreement may provide that such investors can, upon notice to the corporation, transfer all or any part of their shareholdings to an affiliate of the investor, a fund under common management or control with the investor, as part of a distribution of assets to the shareholders, limited partners, the investor's own investors or members, or in the sale of all or substantially all of the assets of the investor. Where the shareholder is an individual (e.g., a founder), such shareholder should ensure that the shareholder agreement permits him to transfer his shares to a corporation wholly-owned by the shareholder or his family members, a custodian, trustee (including RRSP, RIF, IRA or similar retirement or investment fund) or other fiduciary for the shareholder and/or his family members, or any other person if such transfer is effected pursuant to the shareholder's will or, where there is no will, applicable laws dealing with the succession of property upon death.

In case of a permitted transfer, the shareholder agreement should state that any transfer is conditional upon the transferee agreeing to be bound by and becoming a party to the shareholder agreement.

Right to Repurchase

In addition to the general restrictions on transfer, it may be desirable to include a right for the corporation to repurchase shares owned by a founder on the death, disability or insolvency of the founder, or on the involvement of the founder in a division of net family property as a result of marital breakdown. Such a

repurchase right may instead be included in a separate founder share repurchase agreement. These provisions usually contain a valuation mechanism for the repurchase of the shares and contemplate life insurance coverages.

Pre-Emptive Rights

In order to prevent their ownership interest from being diluted by future issuances of shares, investors will typically require that they be given the right to participate in any subsequent offering of shares, options, warrants or other securities. In granting such rights, one should consider the following:

- if the right extends to a founder or an employee, extinguishing the right if the founder leaves employment of the company;
- including a minimum ownership threshold, below which the shareholder loses its pre-emptive right;
- whether shareholders will have the right to subscribe for more than their pro rata share of securities if not all of the shareholders elect to exercise their pre-emptive rights; and
- issuances of securities that should not trigger pre-emptive rights such as up to a certain percentage or a certain class of shares.

Right of First Refusal

A right of first refusal affords shareholders the opportunity to purchase the shares of another shareholder who wishes to sell his shares to a third party. Prior to selling his shares, a shareholder who is subject to a right of first refusal must first offer his shares to those shareholders who hold a right of refusal.

In addition to determining whether the obligation of a right of first refusal applies to all shareholders or a subset of all shareholders (e.g., founders), one of the most important considerations in negotiating a right of first refusal provision is whether the selling shareholder must first obtain a bona fide offer from a third party before offering the other shareholders the first right of refusal. The alternative is that the shareholder who wishes to sell his shares makes an offer to the other shareholders and, if such offer is not accepted, may make the same offer to a third party within a prescribed time-frame.

Co-sale or Piggy-Back Rights

A co-sale right entitles the applicable shareholder(s), on a pro rata basis, to participate in any third party offer made to purchase the shares held by one or more shareholders.

Drag-Along Rights

Drag-along rights permit the holders of such rights to compel the other shareholders to sell their shares (or approve other transactions related to a sale of the business, such as a sale of assets) to a third party who has made such an offer. In order to trigger a drag-along, the approval of the holders of a specified percentage of shares (or class of shares) is typically required. In addition, a drag-along right should include conditions to the drag-along, such as a limitation on the type of representations and warranties that the shareholders who are forced to sell their shares must give to the buyer, a minimum purchase price, and restrictions on the type of consideration that may be used to acquire the shares (e.g., illiquid securities).

The above list is by no means an exhaustive list of key items to be considered when negotiating a shareholder agreement. The above is intended to illustrate the potentially complex issues and interests that should be addressed when documenting the rights and obligations of shareholders.

The above information is meant to be informational and does not constitute binding legal advice. Special legal advice should be sought for your particular circumstances.

CONTACT
David J. Wilson
djwilson@beardwinter.com
416.306.1796