

SHAREHOLDERS AGREEMENTS:

What Every Shareholder Needs to Know

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The following memorandum summarizes the main provisions of a typical shareholders agreement. The memorandum has been broken down into three main areas, namely, management, share ownership and financial matters.

1. Management

(a) Board

The shareholders agreement would specify the size of the board and the entitlement of the shareholders to nominate the individual board members. The entitlement to nominate the individual board members is usually proportionate to the share ownership. In addition, the quorum requirements, requiring representation from the principal shareholders at meetings is usually set out.

(b) Unanimous Decisions

The board of directors is usually responsible for the general policy decisions affecting the corporation. It is possible for the shareholders to limit the authority of the directors and appropriate these responsibilities for themselves. In this instance, a list of unanimous decisions is often included in the shareholders agreement and no action may be taken with respect to these matters without the agreement of all of the shareholders. These decisions would typically include amendments to the articles, issuance of additional shares, capital expenditures and non-arm's length transactions and payments.

(c) Budgets

In situations where the shareholders are not actively involved in the day to day business operations, the shareholders agreement may provide for an annual business plan and corresponding budget. Once the business plan and budget have been approved by the shareholders, then the directors have the authority to implement the plan and make the expenditures contemplated in the budget without further approval. This procedure is effective to transfer management responsibility while establishing financial controls.

2. Share Ownership

(a) General Prohibition

It is fundamental to the operation of the shareholders agreement to provide that the shares may not be dealt with except in accordance with the terms of the agreement. As a result, most agreements contain a general prohibition on transferring, pledging or otherwise dealing with the shares.

(b) ***Non-Arm's Length Transfer***

If one of the shareholders is an individual, then the shareholders agreement usually permits that individual to transfer his shares to a corporation which is controlled by him or to a trust of which his family members are the sole beneficiaries. These transfers are frequently made as a result of personal tax planning. Where there is a corporate shareholder, then restrictions are typically imposed upon the transfer of shares of the corporate shareholder so that the individual may not indirectly transfer his interest in the corporation by transferring the shares of the corporate shareholder.

(c) ***Pre-emptive Right***

If the corporation contains a minority shareholder and no general restriction on the issuance of new shares, then the shareholders agreement would typically contain a pre-emptive right. This provisions allows the existing shareholders to acquire new shares issued from treasury pro rata in the ratio of their existing shareholdings. This prevents an existing shareholder from being diluted.

(d) ***Lack of Market***

The primary problem in share ownership of a private corporation is the lack of a market for the shares. There are a number of contractual rights which are given to the parties so that if any one of them desires to terminate the relationship, then he is able to realize on the value of his share investment. These contractual rights are summarized below and include a right of first refusal, buy/sell, put/call, and third party offer.

(e) ***Right of First Refusal***

The right of first refusal permits a shareholder to sell his shares in the corporation to a third party, provided he has first offered them to the other shareholders pro rata. The right of first refusal usually requires that the shareholder has received a third party offer which the remaining shareholders are then obliged to match. As an alternative, the shareholder may offer his shares to the remaining shareholders at a stipulated price and if the offer is not accepted then he can sell them to a third party on terms and at a price no worse than what the shares were offered to the remaining shareholders.

(f) ***Buy/Sell***

The most common means of establishing a market for the shares is the buy/sell or shotgun. The party who wishes to terminate the relationship must select a price per share at which he is equally prepared to buy the shares of the other party or sell his shares. The buy/sell mechanism provides an advantage to an individual with strong financial resources and to an individual who is most greatly involved in the day to day business of the corporation. While most shareholders agreements contain a buy/sell or comparable provision, they are seldomly used. Instead these provisions act as an inducement to a negotiated settlement. The buy/sell mechanism works best where there are only two shareholders.

(g) ***Put/Call***

A put/call mechanism is often used as an alternative to the buy/sell. The put/call mechanism is used where there is a dominant shareholder or a founding shareholder who depends upon the corporation for his livelihood and does not want to sell his shares under any circumstances. This mechanism would also be used in a family situation where the confrontational nature of the buy/sell is to be avoided, key employees who are not members of the founding group, or if there are more than two shareholders. In effect the corporation and not the other shareholders makes the market for the shares. The party wishing to buy or sell his shares delivers a notice to the other. The sale price is determined by a formula or appraisal and the purchase price generally paid in instalments with a substantial down payment.

(h) ***Third Party Offers***

In many instances, a purchaser is only interested in acquiring 100% of the shares of the corporation. If a third party offer is received on this basis and is acceptable to a defined majority, say 65% of the shareholders, then the remaining shareholders are obliged either to purchase the shares of the shareholders who wish to sell or to sell their shares to the third party purchaser on the same terms and conditions.

(i) ***Death/Disability***

The shareholders agreement could contain a provision whereby if a key employee/shareholder dies or becomes disabled, then the corporation has the right or obligation to purchase his shares. This is really a variation on the put/call described above.

3. Financial

(a) ***Distribution Policy***

It is usual for a private corporation to have a distribution policy. This policy would require distributions of a specified percentage of the after tax earnings of the corporation each year unless otherwise agreed. Without the distribution policy it would be possible for a majority shareholder who controlled the board of directors to deny any distributions to the minority shareholders and thereby emasculating their investment other than through a sale.

(b) ***Guarantees***

If guarantees of the corporate indebtedness are required then all of the shareholders should be obliged to provide the guarantees proportionately or if only one shareholder provides the guarantee then he should be paid a fee at market rates. If one shareholder is called upon his guarantee and not the other, then the second shareholder should agree to indemnify the paying shareholder pro rata according to their shareholdings.

(c) ***Capital Contributions***

In most instances, the parties agree to make a capital contribution at the outset and any other funding requirements are to be sourced from third party lenders. However, the shareholders

agreement could go on and provide that if funds were required for corporate purposes then the shareholders would contribute the same pro rata. The shareholders would be paid interest on their loans and would be entitled to repayment of the loans in priority to other distributions. Furthermore, if a shareholder neglected or failed to make a contribution then the other shareholders would have a right, but not the obligation, to do so and would receive a premium rate of interest.