Shareholders' Agreement

An important business succession planning tool

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

When two (or more) individuals go into business together they will usually have a common understanding as to how the business will operate and what type of decisions will be made under various circumstances. The purpose of the shareholders' agreement is to document these understandings so that the parties can rely on the written document should a disagreement arise.

Without a shareholders' agreement the relationship between the shareholders could deteriorate because they each want a different response to one or more of the following scenarios:

- One shareholder wants to sell some of his/her shares of the business to a family member
- One shareholder wants to hire his/her spouse
- One shareholder suffers a long term disability or premature death and needs to liquidate his/her interest in the business.

Under each of these events the shareholders could be on opposite sides of the issue based on their own personal perspectives and biases. A shareholders' agreement would document, in writing, how each of these scenarios would be addressed thereby avoiding future disagreements over how an event should be handled.

Shareholders' agreements will cover a wide variety of issues in respect of the business such as management, decision making, financing, share transfers/subscriptions and the buying and selling of shares. Addressing when shares can be bought and sold is very important because it ensures that the parties agree as to who could be future shareholders and under what events the shareholders will buy/sell shares between themselves.

Some common provisions in shareholders agreements with respect to share transfers include:

Restriction on transfer

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

Right of first refusal

If one shareholder wants to sell his/her shares to a third party, this provision requires him/her to first offer the shares for sale to the current group of shareholders. This is important in controlling if new shareholders can enter the business while also allowing a shareholder the opportunity to sell his/her shares.

Buy-sell events

After the occurrence of certain events, shareholders should have the right to buy the shares from the other shareholder in order to protect the financial viability of the business. The other shareholder will want to be able to sell his/her shares under these same events because they represent a change that requires the liquidation of his/her investment in the business. Some or all of the following events could be included as a triggering event:

- Premature Death of a Shareholder
- Permanent Disability of a Shareholder
- Retirement of a Shareholder
- Bankruptcy/Insolvency of a Shareholder

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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 such details as 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 or not 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 will also trigger the insurance funding.

The life insurance can be owned directly by the shareholders on each other, or it could be owned by the company. 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 can be important policies because they can provide the funding necessary for the 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 of the shareholders are in agreement. The document will lay the ground rules on issues that are important to the shareholders and important to the company to limit any disruptions to the ongoing operation of the business.

This article is intended to be very general in nature. 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.

For more information, speak with your BMO financial professional.

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