

## SHAREHOLDERS' AGREEMENT – DRAFTING

### INTRODUCTION

This checklist should be used in conjunction with the *Shareholders' Agreement – Procedure* checklist (CC-6). The checklist is designed to assist in the drafting of a shareholders' agreement. The checklist attempts to show the common elements that should be dealt with, or at the very least considered, in a shareholders' agreement. However, in the preparation of all agreements, there is a balance between the complexity and depth of the agreement and the costs of preparing the agreement. There will be occasions when a client may request a shorter form agreement, which undoubtedly will not cover all of the areas referred to in the checklist. Often, such decisions should be made by the client; however, it is important that the client be well informed as to the consequences of not including all of the sections referred to in the checklist.

Although the checklist covers the major areas that one may wish to include in the shareholders' agreement, all agreements must be prepared to deal with the specific fact situation efficiently and effectively. Checklists can be given to a client prior to drafting the agreement to help prepare the client for the type of information that will be required.

### LIST OF AUTHORITIES

Aird & Berlis (Eds.), *O'Brien's Encyclopedia of Forms, Eleventh Edition, Corporations, Division II*, (Aurora, Ont.: Canada Law Book Inc., 2005).

Bennett, Casuccio, Lundell & Ort (Eds.), *Canada Corporations Law Reporter* (North York, ON: CCH Canada Limited, 1995).

*The Business Corporations Act (Saskatchewan)*

Davies, Ward & Beck, *Canadian Corporation Precedents*, Volume 4 (3rd Edition), (Toronto: Carswell, 1987).

Harris & LeBreux, *Annotated Business Agreements*, (Toronto: Carswell, 1993).

Law Society of Alberta, *Loss Prevention Handbook* (under which the material found in this checklist, in respect of shareholders' agreements, has been modeled, with necessary revisions).

Law Society of British Columbia, *Practice Checklists Manual*, "Shareholders' Agreement Procedure" (under which the material found in this checklist has been modelled, with necessary revisions).

Rossiter, *Business Legal Advisor; Canada Corporation Manual*, Volume A, (Toronto: Thomson Professional Publishers, 2000).

Saskatchewan Bar Admission Course, *Corporate and Commercial Checklist: Shareholders' Agreements*.

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## **CHECKLIST**

### **A. DATE**

1. Date of agreement.

### **B. IDENTIFICATION OF PARTIES**

1. Individual shareholders (all shareholders must be parties, including non-voting shareholders).
2. Company.
3. Where the shareholder is a company, consider adding its shareholders as parties to a covenant regarding control of the shareholder company.

### **C. RECITALS**

1. General statement of legal relationship among parties.
2. Company particulars, which provide background information needed to understand terms of the shareholders' agreement, such as:
  - 2.1 Business that will be carried on.
  - 2.2 Authorized capital, including list of shares issued to each shareholder.
  - 2.3 Reasons for entering into agreement.

### **D. INTERPRETATION AND GENERAL CONTRACT PROVISIONS**

1. Definitions – define all terms as needed.
2. Term of agreement.
3. Arbitration clause.
4. Notice procedure.
5. Additional documents.
6. Counterparts.
7. Time is of essence.
8. Entire agreement.

Notes:

9. Enurement.
  10. Currency.
  11. Headings for convenience only.
  12. Governing law.
  13. Gender.
  14. Calculation of time.
  15. Legislation references.
  16. Extended meaning of shares.
  17. Severability.
  18. Termination of prior agreements.
  19. Assignability.
  20. Facsimile clause.
  21. Schedules, such as:
    - 21.1 Certificate of Incorporation.
    - 21.2 Articles of Incorporation.
    - 21.3 Bylaws.
    - 21.4 Life insurance policies.
    - 21.5 Pro forma budget.
- E. SCOPE AND NATURE OF SHAREHOLDERS' RELATIONSHIP**
1. Agreement governs dealings.
  2. No shareholder has the power to bind any others except as expressly permitted.
- F. CONDUCT OF AFFAIRS OF COMPANY**
1. Statement that, except as provided in the agreement, conduct of the company's business shall be governed by articles and *The Business Corporations Act*.
  2. Directors:
    - 2.1 Number.
    - 2.2 Appointment (e.g., each shareholder to appoint one or more nominees, all shareholders to agree on appointment of nominee to break any deadlocks).

Notes:

- 2.3 Resignation.
- 2.4 Filling vacancies.
- 2.5 Removal (e.g., cause for removal, procedure, replacement).
- 2.6 Right of director to appoint alternate.
3. Quorum for transaction of business:
  - 3.1 Number constituting a quorum, and whether the nominee for each shareholder is required to be present.
  - 3.2 What happens when there is not a quorum (e.g., adjournment, with whoever attends adjourned meeting constituting a quorum).
  - 3.3 Procedure for breaking a deadlock.
4. Directors' meetings:
  - 4.1 Place and time.
  - 4.2 Calling a meeting, including notice requirements.
5. Shareholders' meetings:
  - 5.1 Place and time.
  - 5.2 Calling a meeting, including notice requirements.
  - 5.3 Quorum and voting.
6. Officers and employees:
  - 6.1 Positions.
  - 6.2 Duties.
  - 6.3 Appointment (e.g., shareholder nominees to be appointed).
7. Major decisions requiring unanimous approval or special approval of directors or shareholders, such as:
  - 7.1 Sale, lease, transfer, mortgage, pledge or other disposition of undertaking of company or subsidiary: see *The Business Corporations Act*, s. 183.
  - 7.2 Increase or reduction in capital of company; issue of additional shares in capital of the company.
  - 7.3 Consolidation, merger or amalgamation of the company with any other legal entity.
  - 7.4 Capital expenditures or commitments exceeding specified amount.

Notes:

- 7.5 Leases of company property having capital value exceeding a specified amount.
- 7.6 Borrowing by the company or subsidiary that would result in aggregate indebtedness, exceeding specified amount: see *The Business Corporations Act*, s. 183(1).
- 7.7 Loans by the company or subsidiary to a shareholder or affiliate.
- 7.8 Contracts between the company and a shareholder or affiliate.
- 7.9 Any transaction out of the ordinary course of business of the company, including establishment of new business ventures.
- 7.10 Any change in authorized signing officers in respect of legal documents or any financial institution.
- 7.11 Amendments to articles, bylaws and other fundamental changes such as amalgamations: see *The Business Corporations Act*, ss. 98 and 167.
- 7.12 Payment of dividends and profits of company.
- 7.13 Adoption or amendment of budget.
- 7.14 Any agreement by the company restricting or permitting any other party to accelerate or demand payment of company indebtedness upon sale, transfer, or other disposition by shareholder of their shares or loan.
- 7.15 Any amendment to any employment contract made between the company and one of the other parties to agreement, or representatives of one of those other (corporate) parties.
- 7.16 Employment by the company of any relatives of a shareholder or, if a corporate shareholder, its representative.
- 7.17 Waiver or appointment of auditor.
- 7.18 Other decisions of particular importance having regard to the nature of the company business.
- 7.19 Compensation of directors, officers and key employees: see *The Business Corporations Act*, s. 120.
- 7.20 Issue, redemption, hypothecation or purchase of shares.
- 7.21 Declaration of dividends and dividend policy.

Notes:

8. Where shareholders will be running the business, consider:
    - 8.1 Including shareholders' employment provisions in the shareholders' agreement.
    - 8.2 Having separate employment or management contracts tied to the shareholders' agreement so that default by shareholders, under their employment contract, would trigger a default under the shareholders' agreement.
    - 8.3 Restricting the ability of directors to manage the business of the company.
  9. Shareholders' duties to the company:
    - 9.1 Duty not to compete, during time as a shareholder and reasonable time thereafter, within reasonable geographic area.
    - 9.2 Methods for authorizing exceptions to duty not to compete.
    - 9.3 Duty of confidentiality.
  10. Statement that each shareholder acknowledges that, by reason of their unique knowledge of association with the business of the company, the covenants set out in paragraph F. 9 are reasonable and commensurate with protection of legitimate interests of the company, and that it is agreed that covenants shall be several and subsist even if the rest of the agreement is terminated.
  11. Bank and accounts.
  12. Signing officers.
  13. Auditor/accountant.
  14. Books of account, financial statements and accounting principles.
  15. Indemnification of shareholders and directors:
    - 15.1 Who will become liable for obligations of company?
    - 15.2 Who will incur personal liability in connection with company?
  16. Pro forma budget (consider attachment as a schedule and inclusion of the statement of intent).
- G. FINANCING**
1. Initial financial contribution required from each shareholder, distinguishing between subscribed capital (equity) and shareholder loans.

Notes:

2. Mechanisms by which a company may raise additional funds for working capital:
  - 2.1 Borrowing from an institutional lender:
    - 2.1.1 Whether the company is required to try to obtain funds in this manner before turning to shareholders.
    - 2.1.2 Whether shareholders are required to enter into guarantees of indebtedness of company (consider provision that liabilities for guarantees shall be shared pro rata and each shareholder will indemnify others for their share of amount guaranteed).
  - 2.2 Borrowing from shareholders:
    - 2.2.1 Circumstances in which company may do this, how division is made and whether there is a maximum amount that may be demanded.
    - 2.2.2 Contribution and repayment to be pro rata.
    - 2.2.3 Notice requirements.
    - 2.2.4 Shareholders' obligation (or option) to advance funds.
    - 2.2.5 Where the shareholder is obliged to advance funds, sanctions for failure to do so (may take the form of dilution in shareholding if shareholder refuses to provide requested financing).
  - 2.3 Whether shareholder loans bear interest.
  - 2.4 Provisions regarding repayment of shareholder loans, including whether there is right to demand repayment.
  - 2.5 Distribution of net profit:
    - 2.5.1 Statement that distribution will occur except as prohibited by terms of debt financing, and to extent permitted by law, after board has provided (by resolution) for such reserves as are necessary.
    - 2.5.2 Frequency of distribution.
    - 2.5.3 Priorities (e.g., repayment of loans, dividends).

Notes:

**H. RESTRICTIONS ON TRANSFER/RIGHT OF FIRST REFUSAL**

1. Right of first refusal to be offered to the company or other shareholders, setting forth investment offered for sale.
  - 1.1 Purchase price, which must be within the guidelines set out in agreement.
  - 1.2 Terms and conditions of sale, including method of payment, whether price may be paid over time and, if so, provisions regarding interest on unpaid balance, security on unpaid balance (e.g., in form of escrow agreement annexed as schedule), and whether prepayment can be made without penalty.
  - 1.3 Prospective purchase (where there is an offer from a third party). Consider whether it should be a pre-condition that the third party offer has been obtained.
  - 1.4 Whether offer may be accepted in part, or must be accepted in its entirety or not at all.
  - 1.5 Length of time an offer is open for acceptance (as set out in agreement).
  - 1.6 If an offer has not been wholly accepted within a specified time period, offeror has the right, for a specified period of time, to dispose of investment to a third party (specify whether this may be to any third party, upon no better terms and conditions than were set out in offer, or to a particular third party, where terms and conditions offered have first been offered to other shareholders and have not been taken up), provided that third party has entered into an agreement with the company and shareholders by which the third party is bound by agreement.
  - 1.7 Provisions regarding completion of sale (including where, when and how).
  - 1.8 Consider including set-off where the vendor is indebted to the company.
2. Whether disposition to affiliate is authorized and, if so, under what conditions (e.g., that affiliate will remain an affiliate so long as it holds investment and, prior to ceasing to be an affiliate, will transfer investment back to shareholder; that the affiliate is bound by agreement).
3. Defaulting shareholders are not entitled to dispose of their investment pursuant to the above provisions, unless prior to or concurrently with transfer they ceases to be a defaulting shareholder.

Notes:

4. Except as provided in agreement, no shareholder shall dispose of his or her investment without meeting requirements set out in agreement (e.g., prior written consent of other shareholders, or of any other party where such consent is required by agreement between company and that party).
5. Shareholders shall not encumber their investment, except as provided in the agreement.
6. Upon execution of the agreement, shareholders shall surrender to the company each share certificate, which shall be endorsed to indicate that the transfer is subject to the agreement. Consider whether shares should be placed in escrow to be dealt with in accordance with agreement.

**I. COMPULSORY BUY-OUT (SHOTGUN CLAUSE)**

1. Shareholder may make a compulsory offer to other shareholders either to sell all of their investment or to buy all of the other shareholders' investment at a price and on terms and conditions set out in an offer.
2. Notice requirements and limitation periods are as set out in agreement.
3. Shareholders to whom offer is made have the option of buying (pro rata) or selling, but failure to give notice of election within a specified time period shall be deemed to be acceptance of the offer to sell.
4. Provisions for handling a situation in which some shareholders elect to sell and some to buy.
5. Provisions regarding completion of sale (including where, when and how).
6. Consider including set-off where the vendor is indebted to the company.

**J. OBLIGATION TO JOIN IN SALE**

1. Shareholder may require other shareholders to join in sale of whole of business to an outsider, by notifying them of an offer or alternatively, compelling other shareholders to sell their shares to it. This is commonly known as a "call" provision and is usually used to give majority shareholders the right to remove minority shareholders in specific circumstances.
2. Notice requirements and limitation periods are as set out in the agreement.

Notes:

3. Alternatively, shareholders to whom an offer is made have the option of buying the investment of the shareholder who gave notice (pro rata) at an offered price, or of joining in the sale of all investments to a third party. This is commonly known as a "piggy back" provision and ensures protection of minority shareholders.
4. Provisions for handling situation in which some shareholders elect to sell and some to buy.
5. Provisions regarding the completion of sale (including where, when and how).
6. Consider including set-off where the vendor is indebted to the company.

**K. OBLIGATION TO PURCHASE**

1. Shareholders may require a company or other shareholders to purchase their investment in circumstances set out in agreement (e.g., retirement from work force or from active involvement in the company's business). This provision creates liquidity for minority shareholders and is commonly known as a "put" provision.
2. Price, terms and conditions and procedure are as set out in the agreement.

**L. INDEMNIFICATION AND DISCHARGE OF  
GUARANTEES**

1. Obligation of the shareholders and company, where the shareholders have disposed of all of their investment in compliance with the agreement, to use their best efforts to have any guarantee or pledge issued or granted by the shareholders discharged or canceled, and to indemnify departing shareholders for liabilities arising with respect to such a guarantee or pledge subsequent to their departure.

**M. INSURANCE POLICIES**

1. Obligation of the company to own and maintain life insurance policies of specified value on all shareholders and representatives of corporate shareholders (such as policies to be listed in schedule to agreement). (Or, alternatively, obligation of shareholders and representatives to own and maintain criss-cross life insurance policies).
2. Obligation of shareholders to cooperate (e.g., by attending physical examinations).

Notes:

3. Rights of the company with respect to policies, such as:
  - 3.1 To apply any policy dividends to payment of premiums.
  - 3.2 To collect death benefits.
  - 3.3 No right to modify or impair any rights or values of policies, or exercise any rights of ownership, except as provided in the agreement or with prior written consent of shareholders.
4. Rights of the shareholders with respect to policies, such as:
  - 4.1 To obtain information from insurer regarding status of policy on their life.
  - 4.2 To pay premiums where the company fails to do so, and to be reimbursed.
  - 4.3 To purchase a policy on their life, at a price set out in the agreement (e.g., cash surrender value), on happening of specified events (e.g., termination of agreement during lifetime of shareholder).
  - 4.4 Apply any dividends received on policy to premiums.
5. Uninsurability provisions.

#### **N. SALE ON DEATH**

*Caveat:* This section of the checklist is very involved with tax legislation, which changes regularly. It may be appropriate to consult a tax expert before drafting these clauses.

1. Where shareholder who is an individual dies, his or her personal representatives shall sell, and the company or remaining shareholders shall purchase, from estate the investments held by the deceased at death.
2. Where representative of a corporate shareholder dies, shareholder shall sell, and the company or remaining shareholders shall purchase from the corporate shareholder the investment held by it at date of the representative's death.
3. Purchase price and terms and conditions of payment are as set out in the agreement.
4. Where purchase is required to be made by a company, and surplus and capital dividend accounts are insufficient to authorize purchase, parties to the agreement agree to take such steps as are necessary to increase the accounts to amount sufficient to authorize purchase.
5. Where purchase is required to be made by the remaining shareholders, it shall be on a pro rata basis.

Notes:

6. Company shall, upon the death of shareholder or representative, claim and collect proceeds of a life insurance policy. The proceeds shall be applied as set out in the agreement (e.g., to pay any indebtedness of company to the deceased, to pay purchase price, to pay remaining shareholders who make purchase). Consider appropriate disposition of excess insurance proceeds.
7. Provisions regarding completion of sale (including where and when).
8. At closing, the following shall occur in order set out in the agreement:
  - 8.1 Purchasers shall pay purchase price, or a specified percentage of it, to the vendor, and deliver any documents that may be required (e.g., promissory notes, escrow agreements).
  - 8.2 Unpaid balance, if any, shall be paid and secured as set out in the agreement.
  - 8.3 Vendor, on receipt of purchase price or portion payable pursuant to paragraph N. 3, shall give to the purchasers all share certificates, instruments, conveyances, assignments and releases as may be reasonably required to complete the sale and to transfer all of the investment.
  - 8.4 Where purchasers are remaining shareholders, company shall pay to them a capital dividend equal to the lesser of the purchase price or the proceeds of the life insurance policy (and, in the latter case, the company shall elect to have dividends payable out of its life insurance capital dividend account pursuant to provisions of the *Income Tax Act*).
9. Provision for purchase price adjustment to take into account value of investment as determined by Revenue Canada.
10. Provision that the agreement shall have no application upon the death of the final shareholder or representative of a corporate shareholder, notwithstanding any other term of agreement.

**O. VALUATION OF SHARES**

1. Valuation formula must be practical, reasonable and certain. The following are examples of different methods of valuation:
  - 1.1 Directors determine value with third party valuation, should directors fail to do so or should departing shareholder object to the valuation.

Notes:

- 1.2 Purchase price fixed to a certain date after which purchase price is set by an agent or failing an agent, by a third party valuator.
- 1.3 Share price set by the agreement and, failing agreement, by a third party valuator. If that valuation is objected to, second third party valuation is obtained and if that is objected to, average of the two is taken.
- 1.4 Valuation based on earning power of the company.
- 1.5 Fixed value to a certain date, followed by a value set by the agreement of parties and, failing that agreement, set by a Board of Arbitration consisting of three parties.
- 1.6 Third party valuation by an accountant and, should parties object, valuation to be determined by a panel selected by parties.

**P. WILLS**

1. As an alternative to sections M and N, where shareholders are all natural persons, consider provision that each shareholder shall make and maintain a will, providing that others will inherit their shares. (Note: if the will is later changed, it is not likely that it will be set aside on basis of the agreement).

**Q. DEFAULT**

1. Circumstances that constitute default, such as:
  - 1.1 Failure to carry out obligations under the agreement after other shareholders have made a written demand that failure be cured.
  - 1.2 Failure to defend a proceeding affecting possession or management of shareholder's investment after other shareholders have made written demand that failure be cured.
  - 1.3 Bankruptcy, commission of act of bankruptcy, appointment of receiver or receiver-manager with respect to a shareholder's assets, or assignment for benefit of creditors or otherwise.
  - 1.4 Change in control of a corporate shareholder.
  - 1.5 Termination of employment of a shareholder, or representative of a corporate shareholder, who was employed by company.

Notes:

- 1.6 Incapacity (as defined in the agreement).
- 1.7 Retirement.
2. Consequences of default (indicate if consequences differ for different types of default; indicate alternatives), such as:
  - 2.1 Winding-up of company under articles.
  - 2.2 Other parties may waive specific default.
  - 2.3 Other parties may pursue any remedy available in law or in equity.
  - 2.4 Other parties may take such actions as may reasonably be required to cure default, in which case expenses shall be recoverable as provided in the agreement.
  - 2.5 Implementation of a buy-sell procedure, whereby:
    - 2.5.1 Defaulting shareholder is deemed to offer to sell all or part of investment to the company or other shareholders.
    - 2.5.2 Purchase price is determined as set out in the agreement (e.g., discounted value for specified types of default).
    - 2.5.3 Terms, conditions and procedure are as set out in the agreement.
  - 2.6 Where default consists of failure to make loan to company as required under agreement, additional remedies may be provided to non-defaulting shareholders, such as:
    - 2.6.1 Recovery of loans made to company.
    - 2.6.2 Right to elect not to make loan without being held to be in default.
    - 2.6.3 Right to make loan on behalf of the defaulting shareholder and to be entitled to reimbursement from defaulting shareholder and from the company out of any funds owing to defaulting shareholder; this may bring defaulting shareholder out of default, if requirements set out in the agreement are met.
    - 2.6.4 Right to force defaulting shareholder to sell some or all of its shares.

Notes:

Notes: