Fondation du Barreau du Québec

your RIGHTS your Business

NUMBER 3 OF 6

Your Shareholders' Agreement

You are a 50% shareholder in *Dream Image Inc.* with George. You were shocked to learn of his death yesterday and now you're wondering what will happen to his shares.

In the absence of a shareholders' agreement, the heirs or legatees of the estate of the deceased shareholder generally become shareholders of the corporation automatically. You have therefore just learned that his parents have become 50% shareholders in the corporation with you. You should have signed a shareholders agreement as George was insisting you do!

In the following pages, the *Quebec Bar Foundation* describes what a shareholders' agreement is and what it is used for. You will also learn about the importance of entering into a shareholders' agreement in order to better protect your rights and interests.

There are some nuances to a shareholders' agreement depending on whether your corporation is incorporated provincially or federally. To find out more about corporations, see Issue 1 *"The Legal Form of Your Business"*.

You're wondering how decisions are made in a corporation. What's the relationship between the directors and the shareholders?

These are excellent questions, and the answers to them will allow you to better understand the importance and usefulness of entering into a shareholders' agreement. If the classic structure for sharing power described in the following pages does not suit you, you can change the rules under certain conditions by entering into a shareholders' agreement or a unanimous shareholders' agreement.

The distinctions between these two types of agreements will be explained below but first, it is important to understand certain internal rules regarding the operation of a corporation, which is made up of two decision-making bodies: the Board of Directors and all the shareholders.

Don't get CAUGHT offguard

1. The Board of Directors

The role of the Board of Directors is to manage the corporation's business. As a general rule, many decisions to be made within the corporation are directly up to the Board of Directors: enter into contracts with customers, hire employees, purchase goods, rent premises, declare and pay dividends, etc.

The corporation's directors sit on the Board of Directors, after being elected to their position by the shareholders. In theory, all decisions are made by the simple majority (50% +1) and each director has one vote. It is interesting to note that the law does not require a director to hold shares in the corporation. For example, Ben would like to devote a few hours of his time on the Board of Directors of *Choco Inc.* Even though he is not a shareholder, he can be a director provided the shareholders of *Choco Inc.* elect him and the corporation's articles allow it.

The law attaches great importance to who is a director because the directors are at the very heart of many of the corporation's decisions. If Geoff expects to be absent from a meeting of a Board he is on, he cannot have someone else attend for him because his right to vote is not transferable. In other words, voting by proxy is not allowed on a Board of Directors.

2. Shareholders' meetings

There are two types of shareholders' meetings: the annual general meeting and the special meetings.

The annual general meeting

In theory, only shareholders with voting shares may attend and vote at meetings. To be a shareholder, a person must hold shares which have been issued by a corporation. For example, by purchasing one thousand "common" shares of *Laugh-Out-Loud Inc.*, for $5 each, Nancy became a shareholder of that corporation. She also could have become a shareholder following a transfer of shares

(purchase, donation, exchange) from another shareholder or following the transmission of shares from a deceased shareholder.

The rule is one share, one vote. However, the right to vote can be removed from one class of shares and the number of votes per share can also be increased. In the case of *Laugh-Out-Loud Inc.*, each "common" share acquired by Nancy gives her one vote, contrary to a "preferred" share, which would have given her ten votes per share.

The shareholders are informed of the corporation's management at the annual general meeting. They adopt the financial statements at it, appoint an auditor for the financial statements and, if necessary, elect the members of the Board of Directors. This is also a good time for the shareholders to ask questions and obtain information about the corporation's operations. At the annual general meeting, many decisions are made by a simple majority vote (50% +1).

Contrary to a director, a shareholder can find someone to replace him if he is unable to attend a meeting. The replacement can act on behalf of the absent person if he has been given a proxy, i.e. a document authorizing him to act as such.

Special meetings

A special meeting must be held in all other situations which require the consent of the shareholders. For example, if the directors of *Choco Inc.* want to change the name of the corporation to *Yum! Chocolate Inc.*, the shareholders will have a say in it because this is not a day-to-day management decision.

Most decisions made at a special meeting are made by a two-thirds majority (66 2/3%).

Decision-making formalities

The decisions made by a Board of Directors or at a shareholders' meeting are set out in writing. This writing can be in the form of "minutes" of the meeting which are signed by the President or Secretary of the corporation, or a resolution signed by all the members.

Each of these documents must be included in the corporation's minute book in the appropriate register: the register of shareholders' minutes or the register of directors' minutes.

Avoid arriving at a lawyer's office with a blank minute book when your corporation has been in operation for several years and many decisions have already been made but not recorded. Keep track of your minutes or resolutions carefully—this will save you a lot of trouble. Penalties, in the form of fines, can be incurred if you fail to comply with any of these formalities.

A shareholders' agreement is a written or verbal agreement pursuant to which a corporation's shareholders agree to be subject to certain rules they have chosen and determined in advance, in order to govern their relationship. A shareholders' agreement is an agreement which provides solutions to or ways of dealing with certain problems or situations which could occur during the life of a corporation: the death of a shareholder, the arrival of a new shareholder, etc.

The law does not require that you sign a shareholders' agreement. However, such an agreement is almost indispensable when a corporation has more than one shareholder. It may be a good investment for all shareholders to the extent that an agreement nips in the bud conflicts which could degenerate or lead to multiple and costly visits to a lawyer's office.

A SHAREHOLDERS' agreement... putting *it* down *in* writing

Why do I need a shareholders' agreement?

There are many situations in which a shareholders' agreement can get you out of trouble or provide for a solution other than that prescribed by law.
Here are a few:

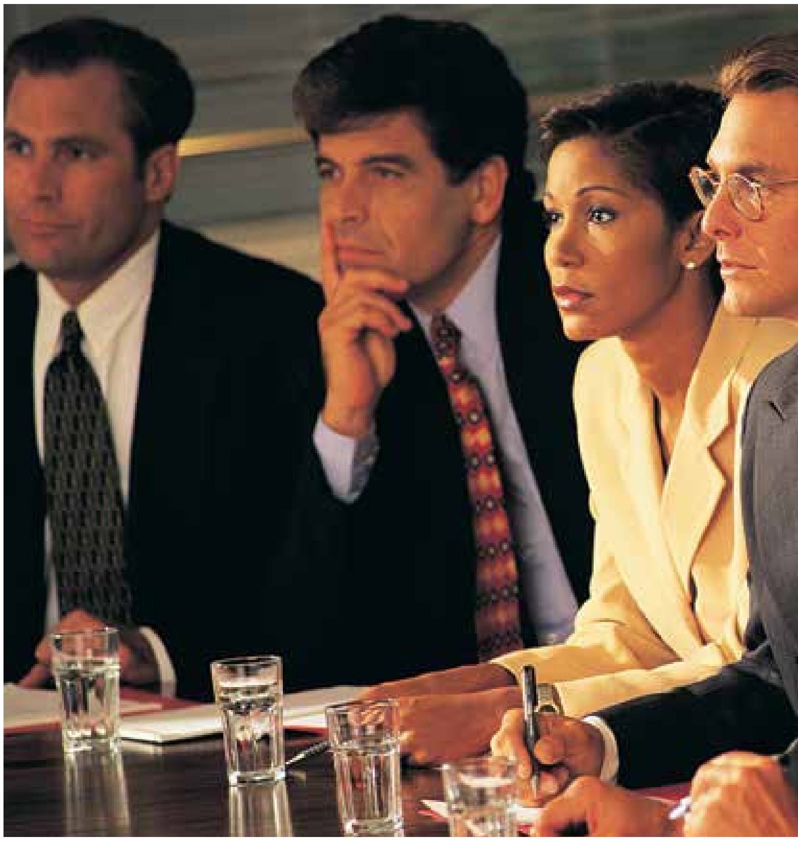
- when an unfortunate event occurs, such as a conflict with one of the shareholders, disability, the bankruptcy or death of a shareholder, etc.;
- when the shareholders want to maintain equal shareholding among them throughout the corporation's existence;
- when the shareholders want to participate in certain decisions, such as the introduction of new partners into the corporation;
- when it has been decided that certain specific situations require an increase in the number of votes required with respect to shareholder voting.

Even if your corporation has just three shareholders, for example, you have every interest in signing a shareholders' agreement. A departure or a disagreement between a few people can often take on dramatic proportions.

The law does not offer a solution for every conflict that may arise. Setting out your own solutions in a shareholders' agreement can be a very smart thing to do.

In certain respects, the agreement can seem like a marriage contract, which is more often than not used to determine, before a conflict arises between the spouses, how the couple's property will be divided up in the case of separation or divorce. A shareholders' agreement provides substantially the same thing with respect to the corporation's shares and the sharing of power among the shareholders.

To have a shareholders' agreement which meets your needs, it is advisable to consult a lawyer who will determine with you what clauses should be included in the agreement and suggest solutions tailored to your situation and that of the other shareholders. Expect to pay a few hundred dollars for the preparation of a shareholders' agreement.



Clauses you may wish to include in your agreement

Type of Clause	Purposes of the Clause	Effects of the Clause
First refusal	❖ Ensure that shareholders have some say over the sale of a shareholder's shares to a person who is not already a shareholder of the corporation.	❖ This clause gives the shareholders a say when a shareholder decides to dispose of his shares.
Mandatory offer due to death	❖ Provide what will happen upon the death of a shareholder.	❖ This clause may require a deceased shareholder's estate to sell his shares to the other shareholders. ❖ Depending on the case, it may also provide that the corporation or the shareholders have to purchase the deceased shareholder's shares using the proceeds of a life insurance policy, at a price determined in advance.
Mandatory offer due to withdrawal from business	❖ Provide for situations or events which could lead to the withdrawal of a shareholder from the corporation's business, such as bankruptcy, a change of career, illness, etc.	❖ This clause can provide a mechanism requiring the shareholder to sell his shares. ❖ It can also help the parties determine the value of the shares at the time of the shareholder's departure as well as any terms of payment.
Pre-emptive right	❖ Safeguard the rights and interests of the shareholders among them, in order to circumvent the provisions of the law saying that all new shares must be issued by the Board of Directors, without consulting the shareholders.	❖ This clause requires, in different ways, that equality be maintained between the principal shareholders with respect to the shareholding. ❖ As is often the case for corporations with a limited number of shareholders, the equal holding of voting and participating shares is vital. ❖ If the corporation's directors decide to issue new shares to only one shareholder, the equality will be jeopardized.
Shot-gun clause	❖ Provide for the consequences of a disagreement between the shareholders.	❖ This clause provides for the mandatory purchase in the event of a disagreement between the shareholders. ❖ This clause can be a useful way to break a deadlock.
Working conditions	❖ Set out the working conditions for shareholders who work for the corporation.	❖ This clause allows the shareholders to agree, for example, on the type of benefits or amount of vacation.
Voting	❖ Require shareholders to elect each other as directors.	❖ This clause prevents one shareholder from being excluded from the Board of Directors.

When is the right time?

Ideally, your shareholders' agreement should be entered into before the corporation's activities begin. The more you wait before signing an agreement, the more difficult it will be to obtain the signatures or consent required of the other shareholders. Over time, the number of shareholders may have increased. Consent may also be more difficult to obtain because there is tension between the shareholders or because a conflict has arisen between them.

For example, Caroline, Jock and Louis are all equal shareholders (33 1/3%) of *Hair And There Ltd.* They did not sign a shareholders' agreement. For almost nine months, Louis has been absent from the corporation a lot, causing more work for Caroline and Jock. Louis has a serious drinking problem and no longer agrees with anyone. Caroline and Jock want to purchase Louis' shares, but they can't afford the outrageous price he's asking. By signing a shareholders' agreement, they could have avoided such a situation.

What should the agreement contain?

A shareholders' agreement may be verbal. However, it is always preferable to set it out in writing to avoid any difficulty proving it before the court in the case of a dispute.

All the shareholders or only some of them may sign the shareholders' agreement. Generally, the shareholders holding voting shares are the ones who want a shareholders' agreement.

The content of a shareholders' agreement may vary considerably. The agreement may have three pages or over one hundred. Take the time to talk to the other shareholders about the most important points in the agreement to be signed. You will come out ahead! Your discussions will contribute positively to the business relationship between the shareholders.

Sample clauses might give you some food for thought and are presented in the table *"Clauses you may wish to include in your agreement"* in this booklet. ■

REMINDER

If there is more than one shareholder in your corporation, a shareholders' agreement is a good idea when you wish to:

- ✔ control the arrival of new shareholders in your corporation;
- ✔ prevent your partner's estate from becoming involved in your corporation in the event of his death;
- ✔ provide a mechanism which will allow the voluntary withdrawal or expulsion of a shareholder in the event of a conflict with one of your partners, or an unfortunate situation such as the bankruptcy or disability of a shareholder;
- ✔ maintain an equal shareholding with your partners throughout your corporation's existence;
- ✔ change the decision-making rules for certain issues within the corporation.

IF YOU NEED HELP

NEED A LAWYER?
Referral service
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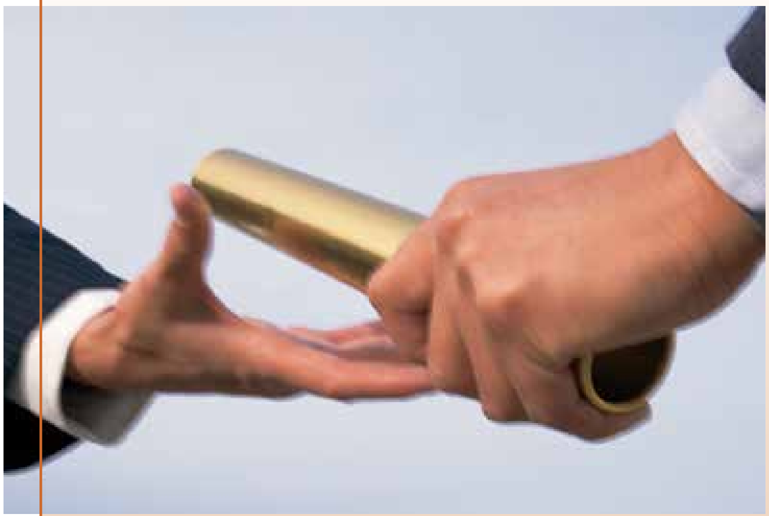
Unanimous SHAREHOLDERS' agreements



There is one type of shareholders' agreement which is called a "unanimous shareholders' agreement". This agreement is different from a simple shareholders' agreement because it is not used for the same purposes and does not necessarily follow the same rules.

What is it for?

The purpose of a unanimous shareholders' agreement is to limit the powers of the directors and increase that of the shareholders in managing the corporation. This is the only mechanism the law allows for this purpose.

A unanimous shareholders' agreement can be useful in different situations. For example, Eric, Stephanie, Meredith, Joanne and Don are equal shareholders in *Rapid Glass Inc.* If Eric acts as the sole director and is the only one on the corporation's Board of Directors, he is the only one who can issue shares to a new shareholder. In such a case, Stephanie, Meredith, Joanne and Don would have every interest in signing a unanimous shareholders' agreement. This way, they would be able to take back some of Eric's power and decide how and when shares are issued.

The role of the directors and shareholders: what's the difference?

The directors make day-to-day decisions and do what has to be done to run the corporation, such as declaring dividends, entering into contracts with suppliers, hiring employees and issuing shares. They must act in the interests of the corporation.

The shareholders own shares of the corporation. They participate in certain important decisions affecting the corporation, such as its merger with another corporation and the change of its name. They act in their personal interest and have a role which is more similar to that of an investor.

What powers are affected?

Through a unanimous shareholders' agreement, the shareholders can take certain powers which are generally given to the directors. Here are a few:

- declare dividends;
- set the remuneration of the directors and officers;
- purchase assets for the corporation;
- issue shares.

Is there anything else I should know?

In general, any new shareholder of the corporation is automatically bound by the unanimous shareholders' agreement.

A unanimous shareholders' agreement must be in the form of a written document. A copy of it must be inserted in the books and records of the corporation. Any shareholder can obtain a copy of it free of charge from the corporate secretary.

Also, all the shareholders holding voting and non-voting shares must sign it.

As unanimous shareholders' agreements are not governed by the same rules as a regular shareholders' agreement, it is recommended that you make it a separate document. The unanimous shareholders' agreement and the shareholders' agreement are documents which can complement each other. One does not exclude the other!

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The information found in this booklet is general and does not constitute a legal opinion. If you have specific questions or a legal problem, don't hesitate to consult a lawyer.

In this text, the masculine form is used to refer to both men and women.

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