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Shareholder's Agreement Important for Private Companies

One of the most commonly neglected parts of establishing a new business is reaching agreement with your partner about the big "what ifs" – what if one of you dies or gets sick, or if you can't agree on some fundamental business decision? The thrill of setting up your own business often overshadows any serious discussion of these issues. Yet failure to have a proper agreement in place to address the "what ifs" is as potentially disastrous as not having fire insurance. Contrary to popular belief, BC's *Business Corporations Act* doesn't effectively deal with these issues.

What you need is a shareholders' agreement setting out the rights and duties of each shareholder. This is particularly important where minority shareholders are involved, and is the only way to ensure that their interests are adequately protected.

Consider the case of a minority shareholder who dies without having entered into a shareholders' agreement.

His family will normally want to cash out his interest in the company. But it's usually very difficult to find an outside buyer for a minority interest in a private company, largely because of concerns about liquidity and lack of control. Typically, the only plausible buyer is the surviving shareholder, but he may have no interest in paying out a large sum of money to the estate, since he already controls the company. Alternatively, he may place an unrealistically low value on the deceased's interest.

From the surviving shareholder's perspective, he may be faced with family members of the deceased whom he would prefer not get involved in the business. Also, he may want to recruit a new investor to participate, but will have difficulty doing so as long as the estate remains involved.

These problems can easily be addressed in a shareholders' agreement by requiring the estate of a deceased shareholder to sell, and the company to buy, all of the deceased's shares at fair market value. The agreement can specify how that value is to be determined, such as by a multiple of past earnings or by a formal business valuation. The agreement can also require the company to maintain key man life insurance on the lives of each of the shareholders to fund the purchase price.

A shareholders' agreement also typically addresses what happens if there's a fundamental breakdown in the relationship between the shareholders. One approach often used is a "shot-gun" clause, under which one shareholder can require the other shareholder to choose whether he wants to sell his own shares or buy the other shareholder's shares, for a specified price per share.

A shareholders' agreement can also deal with other matters of importance to the shareholders, such as how additional capital is to be raised; how much time each of the shareholders is expected to spend in the business; compensation; restrictions on the transfer of shares; whether certain business decisions require unanimous approval of all shareholders; and so on.

With proper legal advice, a customized shareholder's agreement can be put in place so that all the "what ifs" don't keep you awake at night.

This article was written by Janice Mucalov, LL.B. with contribution by James MacLean of MILNE SELKIRK. A version of this was previously published in the Langley Times. ***Copyright by Janice Mucalov. "You and the Law" is a registered trade-mark.*** ***Please call James MacLean (604-882-5015) if you have any questions or for legal advice.***