IBA Guide on Shareholders' Agreements

Canada

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A corporation can be incorporated under the federal statute or the statutes of one of Canada's ten provinces or three territories, and the corporate laws in each may differ. This article focuses on the federal statute and the statutes of British Columbia, Alberta, Ontario and Québec (these four provinces account for more than 85% of Canada's GDP). It is worth noting that Canadian and provincial legal systems are common-law based, except for Québec, which has a distinct civil law system. Generally, stock exchange rules discourage or do not permit broadly based shareholders' agreements affecting listed shares. Our comments will be confined to unlisted shares.

1. Are shareholders' agreements frequent in Canada?

Shareholders' agreements are common in Canada in closely held corporations, particularly where larger equity investments are involved, whether by individual, institutional, or private equity investors. Shareholders' agreements are usually recommended, but less common, in family-owned corporations and in small corporations set up by a few individuals, as a means of resolving disputes and succession issues.

There are no restrictions on the number of shareholders that may be party to a shareholders' agreement, but the larger the group the more difficult they are to negotiate.

2. What formalities must shareholders' agreements comply with in Canada?

Normally, a shareholders' agreement is a private written contract between some or all of the shareholders of a corporation and as such is governed by the law of contracts. However, in certain situations, corporate legislation in Canada may set specific formalities with respect to shareholders' agreements. There are two principal types of shareholders' agreement that are dealt with in corporate legislation: vote pooling agreements ("VPA") and unanimous shareholder agreements ("USA").

The corporation does not need to be, but often is, a party to the agreement. Sometimes third parties are also parties to the agreement in order to be entitled to exercise certain rights thereunder.

A VPA is not subject to any formalities under corporate legislation but the legislation normally recognises that if two or more shareholders agree on the voting of their shares then those covenants will be enforceable as provided in the VPA.

A USA must be signed by all the shareholders of the corporation and they can have the effect of overriding the corporate legislation under which the corporation was incorporated and amending its incorporating documents. USAs are also recognized under corporate law because of the fact that their effect may be to fetter the discretion of the directors, which would otherwise be unenforceable in Canada. As a result, it is common practice in USAs to state explicitly that the agreement is intended to constitute a USA under the applicable corporate statute.

Shareholders' agreements that are not USAs or VPAs are also used to provide for matters not covered by those agreements and, provided that they do not deal with the matters allocated to USAs, do not need to comply with the formalities of a USA.

Recent changes to legislation in Québec compel corporations to disclose on a public registry of enterprises either the existence or termination of a USA and - if applicable - the removal of all powers from the board of directors. In such a case, the corporation must also disclose publicly the names and addresses of those who have assumed such powers. Presumably this provision aims to indicate to third parties the identity of the persons who actually exercise power on behalf of the corporation.

The British Columbia legislation does not provide for USAs, but it does provide that a corporation's articles may transfer, in whole or in part, the directors' power to manage or supervise the management of the business and affairs of the corporation to one or more other persons, which could include other corporations. This is similar to a USA in that the persons to whom the powers are transferred have all the rights, powers, duties and liabilities of the directors, and the directors are released of their corresponding rights, powers, duties and liabilities.

3. Can shareholders' agreements be brought to bear against third parties such as purchasers of shares or successors?

Generally, shareholders' agreements are only enforceable against the contracting parties.

As noted above, however, USAs are different. In Ontario and Quebec, a purchaser of shares subject to a USA is bound by the terms of the USA whether or not the purchaser had knowledge of the existence of the USA. However, if the purchaser had no notice of the existence of the USA and the certificate representing the purchased shares did not refer to a USA, then the purchaser may be entitled to rescind its purchase or require the seller to pay to the purchaser the fair market value of the shares.

In Alberta, if a USA is in effect at the time a share is issued by a corporation to a person, other than an existing shareholder, that person will be bound by the terms of the USA whether or not the purchaser had knowledge of its existence when the share certificate was issued. However, if the purchaser is a *bona fide* purchaser without actual knowledge of the unanimous shareholder agreement, that person may rescind the contract under which the shares were acquired by giving a notice to that effect to the corporation within a reasonable time after the person receives actual knowledge of the unanimous shareholder agreement. In the case of shares acquired by a person otherwise than by their issue by the corporation and a unanimous shareholder agreement is in effect at the time of purchase, then whether or not the purchaser had knowledge of the existence of the USA, that person will be bound by its terms. However, if the purchaser gives value, does not have notice of the USA, and obtains control of the shares, the purchaser is entitled to be paid by the corporation (subject to certain financial tests) the fair value of the shares, determined as of the close of business on the day on which the person became a shareholder and also has the right to recover from the transferor by action the amount by which the value of the consideration paid for the transferee's shares exceeds the fair value of those shares.

In addition, some jurisdictions in Canada permit creditors of the corporation to examine the USA of such corporation.

Corporations are not entitled to assert the failure to comply with the provisions of a USA governing the corporation against any person, unless that person had knowledge of the non-compliance.

4. Can a shareholders' agreement regulate non-corporation contents?

There is no prohibition against including subjects that are not related to the relationship of the shareholders or the management of the corporation, but it is not a common practice to do so.

5. Are there limits on the term of shareholders' agreements under the law of Canada?

No. Typically, a shareholders' agreement provides for termination if the parties consent in writing to the termination, if the corporation becomes insolvent or bankrupt, or upon the closing of an initial public offering of the securities of the corporation.

In Québec, the law provides for the automatic termination of the shareholders' agreement upon implementation of a long form amalgamation unless the amalgamation agreement provides otherwise.

6. Are shareholders' agreements related to actions by directors valid in Canada?

Yes. As explained in response to Question 2, it is possible to either remove or limit certain powers from the board of directors and grant those powers to shareholders or to third parties through a USA. It is also possible to require a majority of greater than 51% for certain decisions taken by directors.

7. Does the law of Canada permit restrictions on transfer of shares?

Yes. Corporate legislation specifically contemplates restrictions on the transfer of shares or the requirement of the approval of the board of directors or shareholders to transfer shares either in the incorporating documents or in a shareholders' agreement, including in a USA. Shareholders' agreements typically include many other forms of transfer restrictions to maintain the ownership and control of a corporation in the hands of persons acceptable to the other shareholders.

Canada's securities legislation in fact requires a "private issuer" to include restrictions on the transfer of shares either in the articles of incorporation or in an agreement amongst security holders to take advantage of certain trading exemptions.

8. What mechanisms does the law of Canada permit for regulating share transfers?

Canadian corporate law permits mechanisms for regulating share issuance and transfers of shares, both through restrictions contained in the incorporating documents, and through shareholders' agreements as noted in questions 2 and 7.

Trading in shares, including both issuance by the corporation and transfers by shareholders, is regulated by securities laws. The corporation must file a prospectus with the securities regulators to issue shares, through a registered securities dealer. That said, the law also provides for many exemptions from such requirements. As a result, closely held corporations rarely feel the burden of compliance with securities legislation on share transfers, other than the occasional representation that enables reliance on a particular exemption.

If the shares of a closely held corporation were issued under a prospectus exemption, the shareholder may not resell those shares unless he has filed a prospectus for the trade in those shares or is also able to make the trade under a prospectus exemption.

Outside of these provisions, there is a high level of flexibility for the parties to contractually agree on the mechanisms appropriate to each corporation.

9. In Canada do bylaws tend to be tailor-drafted, or do they tend to use standard formats?

Canada does not have a single, standardised set of bylaws. However, many law firms and corporations providing corporate services adopt their own standard bylaws that contain many of the same provisions.

Typically, bylaws cover administrative topics such as the schedule for calling meetings, voting procedures, disclosure of conflicts of interests and directors' indemnification. Any specific or unique rules addressing administrative topics are often provided for within the shareholders' agreement itself. One of the reasons for this is that a shareholders' agreement is a private document while, in some Canadian jurisdictions, a corporation's by-laws are public. Parties often want to specify that the shareholders' agreement has precedence over the by-laws and that, in the event of a conflict, the by-laws will be amended so that they are consistent with the shareholders' agreement.

10. What are the motives in Canada for executing shareholders' agreements?

Parties often wish to be more specific on the decision-making process within the corporation than is prescribed by Canadian law. They may want to determine who makes decisions and how important decisions are made. In addition, minority shareholders may seek to be granted a voice in certain decisions they consider to be important, and that they would otherwise not be entitled to by virtue of their shareholdings.

Maintaining control over share ownership is a common motive for executing a shareholders' agreement. In the absence of contractual restrictions in a shareholders' agreement, and subject to a restriction requiring the approval of the corporate directors, a shareholder can usually transfer any shares owned in the corporation to any third party. Unless conditions for transfer are set out in the incorporating documents, the directors have only limited discretion to refuse a share transfer. Consequently, without additional barriers, the shareholders of a corporation can easily change. The parties could find themselves associated with persons they did not initially choose as business associates. In closely held corporations, the identity of shareholders is often a significant factor. Often shareholders wish to restrict the ability of a departing shareholder to leave them with a new shareholder whom they may not know.

Finally, shareholders often enter in to shareholders' agreements to ensure their business objectives are met. This is especially true of institutional investors who are concerned with ensuring that they will be able to exit their investment in the manner, and at the time, desired.

11. What contents tend to be included in shareholders' agreements in Canada?

Shareholders' agreements that are not USAs typically contain provisions aimed at creating certain rights and obligations among the shareholders of the corporation, such as:

- nomination and election of directors (this would constitute a VPA)
- capital contribution obligations
- provisions relating to payment of dividends
- mechanisms for dealing with a third-party offer to purchase the corporation
- rights as among shareholders for the purchase and sale of issued shares as described in question 13
- the departure of a shareholder from the corporation in circumstances such as death, termination of employment, or fraud committed against the corporation
- non-competition, non-solicitation and confidentiality undertakings
- mechanisms for dealing with disputes.

As noted in question 2, a shareholders' agreement that is a USA (or a shareholders' agreement in British Columbia) can provide for other matters affecting the management of the corporation, including:

- restrictions on board decisions or special voting majorities on certain issues
- restrictions on the issuance and transfer of shares by the corporation
- the appointment of officers.

12. What determines the content included in shareholders' agreements in Canada?

The most influential elements to consider are the identity of the parties who hold securities in the corporation, the projected length of their investment in the corporation, and the percentage of voting rights held by the shareholders who actually manage the corporation. For instance, institutional investors typically wish to be consulted on fundamental decisions taken by the corporation's board. They also normally want a provision to sell their shares to the corporation or to other shareholders after a period of time or on the occurrence of a stated event.

Individual investors who are close to the founders are usually less interested in controlling managerial decisions. Typically they agree to align their exit strategy to that of the founders of the corporation.

Strategic investors who are active in the same domain are generally more interested in taking the operational decisions along with the founders. Since their investment is usually long term, they do not require an exit strategy.

Because corporate statutes require that certain important decisions be approved by not less than two-thirds (66 2/3%) of shareholder votes to be implemented, shareholders who hold less than one-third (33 1/3%) of the voting rights in the corporation sometimes ask for “veto rights.” This enables them to block the implementation of certain decisions by the board of directors or the shareholders.

13. What are the most common types of clauses in shareholders’ agreements in Canada?

- *Nomination of directors*: Securityholders often want to fix the number of directors of the corporation. Typically, they also want to deviate from the general rule of proportional representation by directing which shareholders are entitled to nominate which directors to the board. This would require a USA if it was intended to apply to all present and future shareholders and not just a voting majority.

- *Veto rights*: This concept takes the form of a list of decisions that must be taken at a higher percentage of votes at the board of directors or at a meeting of shareholders than a simple majority, require the consent of a specific shareholder or a third party, or are withdrawn from the board and are transferred to the shareholders or a third party. This would require a USA.

- *Preemptive rights*: Any new offering of shares or convertible securities of the corporation are offered initially to current shareholders of the corporation so that they have the opportunity to maintain their pro rata participation in the corporation before allowing a third party to subscribe for shares and become a party to the agreement. This would require a USA and the corporation would have to be a party.

- *Transfer of shares*: A general prohibition on transferring any shares of the corporation or granting a security interest therein other than with the consent of all the other shareholders or as provided for in the shareholders’ agreement. This would require a USA.

- *Right of first offer*: This concept provides a process by which a shareholder wishing to sell shares must first offer such shares to the corporation and/or the remaining shareholders for an identified price. If the corporation and/or the remaining shareholders decline, the offering shareholder may then sell the shares to a third party at a price equal to or greater than the proposed price. This does not require a USA.

- *Right of first refusal*: This concept provides a mechanism by which a shareholder who has received a written third-party offer for shares must first offer to other shareholders the right to purchase the shares upon the same terms and conditions as those set forth in the third-party offer. This does not require a USA.

- *Tag along*: Immediately after the implementation of a right of first refusal, if the sale to the third party proceeds, shareholders can sell to the third-party offeror the same proportion of shares that the departing shareholder sells to the same third party at the same price. This does not require a USA.

- *Drag along*: A group of shareholders who have accepted a third-party offer can compel the other shareholders also to sell their shares to the third-party offeror on the same terms and conditions. Often these provisions also force shareholders to vote in favor of a sale of the corporation through a different transaction structure such as a sale of assets or an amalgamation. This does not require a USA.

- *Withdrawal rights*: Although less common, the corporation or shareholders can purchase the shares of a "retiring shareholder." The definitions of a "retiring shareholder" vary greatly but normally include cases where a shareholder commits fraud towards the corporation, refuses to comply with the shareholders' agreement, leaves employment with the corporation earlier than expected, or other events such as the death or disability of a shareholder who is critical in the operation of the corporation or who holds a significant portion of the shares. In some Canadian jurisdictions, this would require a USA to which the corporation is a party if the corporation is required to repurchase or redeem shares and will be subject to the corporation meeting a liquidity and solvency test.

- *"Shotgun" provisions*: These provisions enable a shareholder, usually after a specified period of time, to offer to purchase the shares of one or more other shareholders at a specified price. The other shareholders then have the right to either accept the offer and sell to the triggering shareholder, or to purchase the shares of the triggering shareholder at the specified price. Because of the complexity of the provisions, shotgun clauses are usually only found in companies with a small number of shareholders. This does not require a USA.

14. What mechanisms does the law of Canada permit to ensure participation of minorities on the board of directors and its control?

There are no provisions in Canada at either the federal or provincial/territorial level that prescribe the nomination of representatives of minority shareholders on the board of directors of closely held corporations.

15. Is it possible in Canada to ensure minority shareholder control by means of a shareholders' agreement?

Directors of Canadian or provincial corporations are elected by the shareholders holding voting shares by an ordinary resolution. As a result, shareholders holding more than 51% of the votes cast at a shareholders meeting generally exercise these votes to control the board of directors.

Minority shareholders who want to control the business of the corporation could do so through a USA that gives them the right to nominate a certain number of directors or provides them with “veto rights” on certain decisions they consider important.

16. What are the usual valuation mechanisms in connection with rights of first refusal or share transfer regulations?

Normally a valuation mechanism is not used in the case of a right of first offer or a right of first refusal.

In shareholders’ agreements that contain sale provisions among the shareholders other than through a right of first refusal or right of first offer, the mechanism for determining the value of shares to be sold will be negotiated at the time the shareholders’ agreement is entered into and will vary depending on the nature of the business the corporation is engaged in and the amount of equity invested.

In simpler cases, it is often based on the determination of an independent party, such as the corporation’s auditor or a business valuator using the corporation’s financial statements.

In more complex cases, the mechanism may require the valuator to take into account other factors. For example, in the case of an asset-based business, the valuation may be made using the financial statements and a resource or property valuation. In cases of industrial-based businesses, normal business valuation methods will be used that take into account future earnings, or break up value, or fair market value. These arrangements often also include a mechanism for appealing the valuator’s determination.

Retaining a business valuator can be expensive. To eliminate such costs, some corporations establish a value for each class of shares of the corporation every year. This requires a significant level of discipline on the part of management and shareholders.

The initial subscriptions of institutional investors are often driven by a valuation formula such as a multiple of EBITDA. As a result, it is common to see a valuation mechanism for the exercise of the right to sell the shares upon expiry of the contemplated term of the investment based on the same formula. These can be simple or quite sophisticated as parties attempt to forecast events in the future and evaluate whether or not the same formula applies to any set of circumstances. Valuation formulas vary greatly from one industry to the other.

17. Is it admissible for a shareholders’ agreement clause to refer dispute resolution to the courts other than those of Canada and/or under a law other than that of Canada?

Parties to a contract normally have great flexibility in choosing a foreign governing law provided the application of such law would not lead to inconsistencies with public order. But some issues that are often included in shareholders’ agreement must remain governed by Canadian or provincial legislation. For example, the status and capacity of a corporation is governed by the law of its incorporation, as is the validity of the issuance of a share or of a security interest granted on a share and its publication. Because a USA is the creation of the incorporating legislation, we suspect that a foreign court decision may not be binding in the incorporating jurisdiction.

The parties can designate a foreign court as a competent forum in a shareholders' agreement, subject to our comments above. The fact that at least some aspects of the relationship may require the proof of Canadian or provincial law in a foreign court renders this alternative either impractical or costly. Accordingly, this approach is almost never used.

18. Is it admissible for a shareholders' agreement to include an arbitration clause with a seat outside Canada and/or under a law other than that of Canada?

Recourse to arbitration as a dispute resolution mechanism is more common than the designation of a foreign court in shareholders' agreement. The arbitration agreement must be in writing. The rules applicable to procedure are governed by the law of the seat of arbitration which can be located outside of Canada.

The analysis set forth in Question 17 on the law governing the contract is also applicable to arbitration. It is uncommon to apply the law of a foreign jurisdiction to the shareholders' agreement of a Canadian or provincial corporation.