

Shareholder Agreements: Update 2022

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Agenda

- Overview of Unanimous Shareholder Agreements (“USAs”)
- Common Provisions, Rights and Obligations
- Private Client Planning Considerations with USAs
- USAs and Relationships under the *Income Tax Act* (Canada)
- Planned and Unplanned Departures



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- Founded in 1988
- Proudly independent and local
- Full-service law firm (*e.g.*, corporate, estates, family, employment, tax, litigation, etc.)
- Entrepreneurial spirit
- Our focus is small to mid-market businesses and growth industries



What is a USA?

- A USA is a specific type of shareholder agreement that is signed by all shareholders at the time it is first signed, binds all subsequent shareholders, regulates the business, and can regulate (or restrict) the powers of the directors.
- A USA should contain provisions to clarify which provisions are binding upon (or give entitlements to) new shareholders
- Provisions to determine when and how shareholders exit
- USAs are in generally in place until:
 - Amended unanimously
 - There is one remaining shareholder; or
 - By order of the Court



Common USA Provisions

- Restrictions on the transfer or disposition of shares subject to the agreement, including rights to sell, mortgage or pledge shares (including limitations on who can be a shareholder)
- Provisions concerning directors and officers of the corporation
- Defining key control issues
- Optional and compulsory buy/sell provisions (including “shotgun clauses”)
- Use of Insurance on key personnel or shareholders
- Requirement to sell shares in certain events:
 - (eg: disagreement in the conduct of the corporation’s affairs, incapacity, death)
- Arbitration provisions
- Confidentiality provisions



Common Buy-Sell Provisions

- Mandatory Buy-Sell (“Shotgun”)
- Puts and Calls
- Right of First Offer (“ROFO”) and Right of First Refusal (“ROFR”)
- Pre-emptive rights
- Tag-Along and Drag-Along Rights



The “Shotgun” Clause

- Used when shareholders are unable to resolve a dispute between each other or just want to exit the business
- Triggering Shareholder A will provide Shareholder B the mandatory requirement to either purchase all of Shareholder A’s shares or to sell all of Shareholder B’s shares at a specified price within a set period
- Shareholders can always agree to buy/sell without the shotgun, so this is often a provision of last resort
- Can pose problems when:
 - Provisions are unclear
 - There is too much time (or not enough time) to activate the clause
 - Shareholder being ousted provides a key asset or service
 - More than two shareholders are involved



Puts and Calls

- Call – shareholders or corporation has option to purchase (and affected shareholder has obligation to sell) shares for a specified time
 - Can be used to:
 - Remove undesirable shareholders
 - Terminate shareholder employees
 - Maintain liquidity as shareholders less likely to leave if share value is lower than call price
- Put – affected shareholder has option to sell (and other shareholders or corporation has obligation to purchase) shares for a specified time
 - Can be used to:
 - Exit business under certain circumstances (e.g., death/disability of key employees)
 - Protects value of shareholdings by establishing floor price



Right of First Offer (“ROFO”) and Right of First Refusal (“ROFR”)

- ROFO – shareholder offers to sell shares to other shareholders before offering them to third parties
 - Offer to third party must be no more favourable than offer to shareholders
 - Less risk to other shareholders – no guarantee of third-party offer
 - Could push shareholders to buy at premium to prevent purchase by undesirable party
- ROFR – shareholder offers to sell shares to other shareholders after receiving offer from third party
 - Offer to shareholders must be on same terms as third party
 - Other shareholders will know identity of third party and have more confidence in the offer price
 - Third parties may be unwilling to negotiate if sale to other shareholders is likely



Pre-Emptive Rights

- Allows shareholders to purchase pro rata share of future share issuances and prevent dilution
- Assumes that all shareholders have liquidity to fully utilize rights
 - can lead to shareholder concentration if not all shareholders can purchase pro rata amount available to them
- Can scare off new investors looking for controlling interest



Tag-Along/Drag-Along Rights

- Tag-along (aka piggy-back) – if controlling shareholder is selling shares, minority shareholders have right to participate in same sale
 - Gives minority shareholders a liquidity source
 - Can scare off purchasers as they must purchase unknown number of additional shares subject to tag along
- Drag-along – if controlling shareholder is selling shares, that shareholder can force minority shareholders to sell shares in same sale
 - Can be used to deal with uncooperative minority shareholders
 - Can attract buyers looking for 100% control



USAs and Estate Planning

- Rather than attempt to govern corporate assets at death through Wills and Enduring Powers of Attorney, USAs allow for clear instructions and requirements on the death or incapacity of shareholders, directors, officers and use of insurance funds that enter an estate
- Owner-Managed businesses often see “overreach” of Wills of their shareholders by directing corporate assets and decisions as a “USA” alternative
- USAs can also provide certainty in transitioning shares and allow for spouses to access the spousal rollover and do an orderly redemption of shares



USAs and Family Property Planning

- USAs may provide an opportunity to limit the recourse or rights that a person may have to a share held by a spouse in the event of a marriage breakdown
- Restriction of the issuance and transfer of shares without the approval of a significant number of shareholders or percentage of shareholders can protect shares from being transferred to a spouse, including in order to satisfy an equalization payment or pursuant to the terms of a separation or divorce agreement
- A USA is not a substitute for a cohabitation, pre-nuptial, or marriage agreement, but is a useful for business continuity and family businesses



USAs and Family Trusts

- Many families employ family trusts to multiply lifetime capital gains exemption claims, and provide for control and continuity of businesses
- While a trust can govern individual families, a USA can be particularly effective in determining a change of control, and identifying the “principal” of a trust for buyout or transition purposes
- USAs may have particular use in estate freezes
E.g., parents will exchange common shares for preferred shares to pass future growth on to children
Common shares then issued to family trust with children as beneficiaries, with the USA used to ensure survival (or orderly dissolution) of family business, transfer of control to children, and transfer of wealth to parents for retirement
- Consider the interplay of a USA and Trust for tax filing purposes



Seek Tax Advice for USAs

- Adverse consequences without tax advice
- Do not assume precedents or prior advice is applicable to your situation
 - There may be nuances that were key to the prior advice or precedent that are not applicable on your current file
 - Rules change and new case law is released every day
- Understand the objectives of the USA and each shareholder's circumstance



Types of Relationships under the *Income Tax Act*

- Related persons – section 251
- Association – section 256
- Affiliated – section 251.1



Control

- Generally, control is the trigger for each type of relationship
- Two types of control: (1) *de jure*; and (2) *de facto*
- *De jure* control:
 - Generally, the “right of control that rests in ownership of such number of shares as carries with it the right to a majority of votes in the election of the board of directors”
 - Restrictions in a USA are relevant if they limit the ability of a majority shareholder to elect the board of directors, or the ability of the board of directors to manage the affairs of the corporation (*Duha Printers* [1998] 1 SCR 795)



Control

- *De facto* control:
 - “Controlled, directly or indirectly in any matter whatever”
 - Focuses on a taxpayer's ability to influence the decision making within a corporation and is not limited to the right to effect a change in the board of directors or its powers: s. 256(5.1) to (5.11)
 - A broad range of factors that influence control of the corporation:
 - family relationships
 - commercial relationships
 - economic dependence
 - operational decision-making authority



Impact of Different Relationships

Related	Affiliated	Associated
Deemed to not deal at arm's length, which can cause the FMV consideration rule	Stop-loss rules apply to transfers between affiliated persons	Share the annual \$500,000 small business deduction (" SBD ") limit amongst associated corporations
Acquisitions of control by related parties deemed not to be an acquisition of control	Income tax attribute multiplier rule in subsection 69(11) is only excluded for transactions between affiliated persons	Taxable capital calculation includes all associated corporations for SBD erosion
Acquisitions of control by a non-related group trigger loss-streaming rules, deemed year-end, etc.		Reduction of the SBD limit for investment income >\$50,000 for all associated corporations
Type of control: <i>De jure</i>	Type of control: <i>De facto</i>	Type of control: <i>De facto</i>



Deemed Ownership and Deemed Control

- In addition to *de jure* and *de facto* control, control can be “deemed” to occur
- Deeming rules in para. 251(5)(b) and s. 256(1.4) must be considered when drafting a USA
 - A taxpayer is deemed to own shares that it has a contingent right to acquire (251(b)(i) & 256(1.4)(a))
 - A taxpayer who has a right to cause a corporation to redeem, acquire or cancel any of its shares is deemed to be in the same position in relation to its control of the corporation as if the shares had been redeemed, acquired or cancelled (251)(b)(ii) & 256(1.4)(b))
 - **Exceptions:** exercisable only on the death, bankruptcy or permanent disability of an individual



Deeming Rules in Context of USA Provisions

Application of Deeming Rules

- Non-defaulting shareholder has right to acquire shares of defaulting shareholder
- Non-voting shareholder has right to convert to voting shares on the occurrence of specified events
- Mandatory share redemption when shareholder-employee ceases to be employed by the corporation and other shareholder can fire the shareholder-employee



Deeming Rules in Context of USA Provisions

Non-Application of Deeming Rules

- Shot-gun clauses
- Right of first refusal
- Tag-along or drag-along
- Automatic redemptions on a “triggering event”
 - Unless a person has the ability to force the corporation to redeem



Exception: Death, Bankruptcy or Permanent Disability

Death

- Ordinary meaning
- Must be death of an individual

Bankruptcy

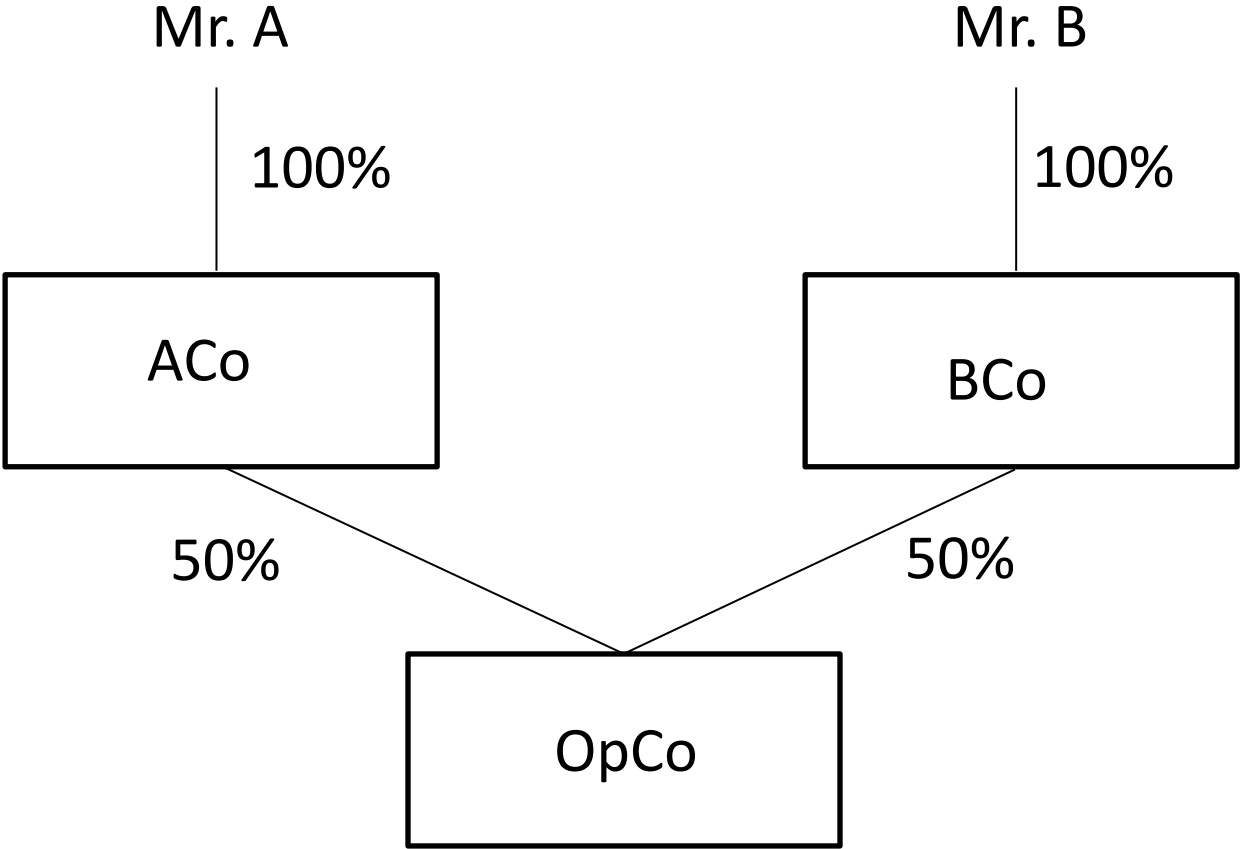
- Insolvency not sufficient to satisfy exception
- Must be bankruptcy of an individual

Permanent Disability

- No statutory definition of permanent disability
- “Lifelong”, “prolonged” and the “antithesis of temporary”



Deeming Rule Example



- A and B are not related and deal at arm's length
- Without more, ACo, BCo and OpCo should not be associated
- However, if USA of OpCo provides ACo and BCo with right to acquire the other's OpCo shares in the event of a default under the USA that does not meet the exceptions, ACo, BCo and OpCo can all be associated with each other.



Select potential results: sharing SBD limit and reduction of SBD limit for investment income of ACo and/or BCo

Planned and Unplanned Departure Planning

- Planning for business owners should always involve a consideration of planned and unplanned exits even when the business is new and families are young:
 - Planned exits – e.g. sale of business to a third party, retirement, family succession
 - Unplanned exits – e.g. exit from the business as a result of death, incapacity, personal issues, shareholder disputes
- Planning for the owner-managed business does not always need to be overly complex, but should be able to grow with the life cycle of the business and consider both planned and unplanned exits



Structuring Departure and Succession Planning

- A proper plan tends to consist of proper corporate structures for the business (such as corporations, trusts and partnership structures), proper governance structures (like USAs), as well as personal documentation (Will, Enduring Power of Attorney, Personal Directive)
- Proper planning can result in tax savings (including probate savings) and may involve planning for the payment of taxes arising in the event of an unplanned exit (i.e. on death or incapacity)
- Proper planning can also address business continuity, succession, and prevent reasonably foreseeable litigation and administrative delays



Thank You

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