The Advisor – Spring 2011

Shareholder Agreements

In a scenario where an owner has sold a portion of the business to a third party, a key component of the sale would be the negotiation and signing of a unanimous shareholders' agreement between the Owner and the Investor. This newsletter discusses some of the items the Owner should expect to see in a shareholders' agreement.

An institutional investor in a company will usually make its investment in the form of a separate class of shares to what is in existence at the time of the investment. Assuming only common shares are in existence, the Investor will be granted preferred shares. The preferred shares granted to the Investor will have different rights than the existing common shares. For example:

1. **Dividends**. These are normally cumulative on the preferred shares and will range from 6% to 8% of the initial investment.

2. **Conversion Rights.** The Investor will be able to convert its shares into common shares at its sole option and automatically upon a liquidation event such as an initial public offering or sale to another investor.

3. **Voting Rights.** The percentage of voting rights is calculated on the assumption that all shares are of the same class.

4. **Board Representation.** This is based on the percentage of voting rights held. For example, if the investor has 35% of the outstanding shares (based on the assumption that all shares are of the same class), it would be entitled to elect one member of a three member board or two members of a five member board.

5. **Reporting Covenants.** This provides the Investor with rights to financial statements and other financial and management reports on an agreed upon basis.

6. **Board vs. Shareholder Rights.** Certain actions of management would require board and (in some cases) shareholder approval. Examples include:

    a) Amendments to bylaws or articles of incorporation
    b) Issuance of new securities or the assumption of new debt
    c) Approval of annual budgets and financial statements
    d) Capital expenditures
    e) Related party transactions
    f) Management compensation
    g) Declaration of dividends; and
    h) The sale of the business.

7. **Right of First Offer.** If the common shareholders decide to sell their shares, they must first offer them to the Investor. If the Investor decides not to accept the offer, the common shareholders can then sell their shares to a third party at the same price.

8. **Drag Along Rights.** If the Investor decides to sell its shares to a third party, it can force the common shareholders to sell their shares at the same price to the third party.

9. **Co-Sale Rights.** If the common shareholders receive an offer to sell their shares from a third party, the Investor has the right to "tag-along" and sell some or all of its shares to the third party.

10. **Shotgun Rights.** After a certain period of time (usually five to seven years), the Investor can instigate a liquidation event and force the common shareholders to either (a) buy the Investor's shares or (b) sell their shares to the Investor or to a third party.

The above list is by no means exhaustive. The length and complexity of the shareholders' agreement is dependent on the number of shareholders and the nuances of the transaction. It is imperative that the owner obtain advice from a knowledgeable Mergers and Acquisitions Advisor as well as a lawyer experienced in the drafting and negotiating of these agreements.

Aries Advisory Group can help you with the sale of your business and in the drafting of a shareholders' agreement. Given our experience, we can assist you in negotiations with the Investor and can recommend the necessary changes to ensure your rights are protected. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.