THE UPDATE

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The Use of the Put Option in a Shareholder Agreement for a Family Business

Thinking of going into business with a family member? While many family businesses do flourish and succeed, statistics suggest that less than one-third of such businesses survive the transition to the second generation. The same array of issues confronts both the family business enterprise and the non-family business enterprise. As a result of the special relationship between its members, however, a family business has a unique dynamic and an additional set of challenges. Since family problems can easily spill over into the business realm, a family business is particularly vulnerable. Generational differences can also lead to differing perspectives on a range of issues — from business strategy to the use of technology, for example — and can be a source of tremendous conflict.

The high failure rate of family businesses can in part be attributed to the lack of planning with respect to how disputes and disagreements will be handled. The tendency is often to believe that less planning is required in the context of a family enterprise. Family members assume that they will see eye to eye on business matters and that conflicts can be resolved without resort to formal guidelines and structures. Moreover, there is often a belief that serious disputes simply will not arise. Unfortunately, these are dangerous assumptions that can lead to the downfall of a business and the destruction of family relationships.

Most disputes will ultimately be resolved amicably. However, there will be times when a dispute in respect of a material issue cannot be resolved informally and the continued existence of the family business may be threatened. It may be difficult for family members to discuss planning issues related to the breakdown of the business, but it must be remembered that it is this very unwillingness to confront issues that presents the greatest risk. Family members must plan a clear strategy for conflict resolution. The most useful tool is a well-prepared shareholders agreement. By forcing family members to address issues before going into business, the actual process of preparing a shareholders agreement can help to prevent future conflict. To foster effective communication and collaboration, family members may even choose to involve a mediator at this stage.

Once drafted, a shareholders agreement provides a plan for resolving conflicts after they emerge. If there is an irreconcilable deadlock, a shareholders agreement will often mandate some form of alternative dispute resolution. This type of dispute resolution, whether mediation or arbitration, is particularly suited to the family context because its goal is to facilitate a mutually agreeable settlement and preserve the ongoing relationship among the family members. While potentially of great benefit, however, this approach to dispute resolution is also very costly and may not be useful to a shareholder who feels that the relationship with other family members has broken down to such a degree that the shareholder cannot continue to participate in the family enterprise.

If a shareholder feels that he or she can no longer be part of the business, what are the options? How can the shareholder liquidate his or her position in the business while also preserving the underlying family relationship? While the sale of shares to a third party is theoretically an option, in reality there is no market for shares in privately held family businesses and nevertheless, even if such a market did exist, restrictions on share transfer would likely prevent a disposition to third parties.

A shareholders agreement can provide a variety of tools in these circumstances. First, the agreement can contain a buy-sell or "shotgun" provision. This provision provides a mechanism whereby a shareholder can attempt to sell her or his shares or acquire the shares of any other shareholder, at the option of the other shareholder. The problem, however, is that it can work unfairly against a shareholder with insufficient financial capacity to exercise a purchase under the shotgun and be forced to sell at a discount. If a minority shareholder wanted out of a family business, for example, the shareholder would likely be unable to take advantage of a shotgun provision.

The second, and most useful tool for dealing with irreconcilable differences is a put option. A put option entitles a shareholder who wants out to send a notice in writing to other shareholders requiring them to purchase all of the shares of the business beneficially owned by such shareholder. The shareholders agreement would set forth the formula for determining the purchase price of the shares, as well as the time period in which the put option could be exercised. In order to give the business enough time to adjust to initial growing pains, for example, the shareholders agreement might state that the put option could not be exercised until a period of two years had elapsed. Unlike the shotgun clause, a minority shareholder of limited means could use a put option.

The danger with a put option is that the remaining shareholders may have difficulty raising the funds to buy out the shareholder exercising the put or may only be able to do so by liquidating business assets. This potential problem can be averted, however, by providing that payments will be made over time, in instalments. The relevant shares can be held in escrow pending payment of the final instalment.

Thus, by enabling a shareholder to sell shares to the other shareholders at a fair price, a put option has the ability to protect both the shareholder who desires to leave the family business and those shareholders who remain. In those situations where a family business relationship has become unworkable, a carefully drafted put option allows a shareholder to effectively liquidate shares without expensive and ineffectual mediation or arbitration, thereby giving the business and the family the best chance for continued success.

We invite you to contact the following Goodmans' lawyers should you wish to discuss a shareholder agreement for your family business.

Toronto

William V. Alcamo 416.597.4100
wvalcamo@goodmans.ca

John Alton 416.597.4101
jalton@goodmans.ca

Stephen Bloom 416.597.4179
sbloom@goodmans.ca

Susan A. Garvie 416.597.4141
sgarvie@goodmans.ca

Daniel Gormley 416.597.4111
dgormley@goodmans.ca

Celia Rhea 416.597.4178
crhea@goodmans.ca

Patricia A. Robinson 416.597.4144
probinson@goodmans.ca

Joel S. Schachter 416.597.4152
jschachter@goodmans.ca

Norman Schipper 416.597.4154
nschipper@goodmans.ca

Charles J. Schwartz 416.597.4157
cschwartz@goodmans.ca

Mark A. Surchin 416.597.4165
msurchin@goodmans.ca

Vancouver

Paul Goldman 604.608.4550
pgoldman@goodmans.ca

Bruce Wright 604.608.4551
bwright@goodmans.ca

Hong Kong

Leo Seewald 852.2522.1061
lseewald@goodmans.ca