

# Shareholder Agreements in Private Equity Transactions

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# Overview of Topics to Discuss

- Overview of Shareholder Agreements
  - General shareholder agreements
  - Unanimous shareholder agreements
- The Nature of Private Equity Investors
  - Active/passive investors
  - Objectives that drive the structure of shareholder agreements
- The role of Shareholder Agreements in the Private Equity context
  - Governance
  - Liquidity/Exit strategies

# Shareholder Agreements

- In general, directors have the power to manage the corporation
- A shareholder agreement can transfer all or a portion of such powers from the directors to the shareholders
  - it is important to provide for how shareholders are to nominate and elect the directors
- General entitlement to board representation may change as circumstances change (i.e., a reduction of share ownership or on default)
- All directors are required to adhere to certain standards set out in the corporate statute even if they are nominated by a particular shareholder

# Shareholder Agreements

- In some cases governance mechanics will result in deadlock and consideration should be given to how to resolve that deadlock
  - Exercise of a liquidity right
  - Mediation or arbitration
  - Dissolution
- Where one shareholder has a majority, consider a list of material decisions for which a super-majority vote will be required
- Set out quorum and other requirements in respect of meetings
- Set out corporate officers and individuals to serve as officers
- Consider other governance clauses relating to annual budgets, financial plans, financial statements, reporting obligations and dividend and distribution policy

# Unanimous Shareholder Agreements

- A unanimous shareholders agreement (“USA”) is a written agreement among all shareholders that restricts the powers of the directors in whole or in part
- A USA is a constating document of the corporation and binds transferees of shares
- Shareholders who assume the rights and duties of the directors become subject to the liabilities applicable to those directors

# Private Equity

- Investment in equity securities that are not publicly tradable
- Typically entered into through a negotiated process
- Transfers are strictly regulated, returns flow from:
  - merger or sale of the company
  - public offerings
  - recapitalization
- In North America private equity investments tend to take one of the following forms:
  - common shares
  - convertible preferred shares
  - convertible subordinated debt
  - subordinated debt
  - warrants

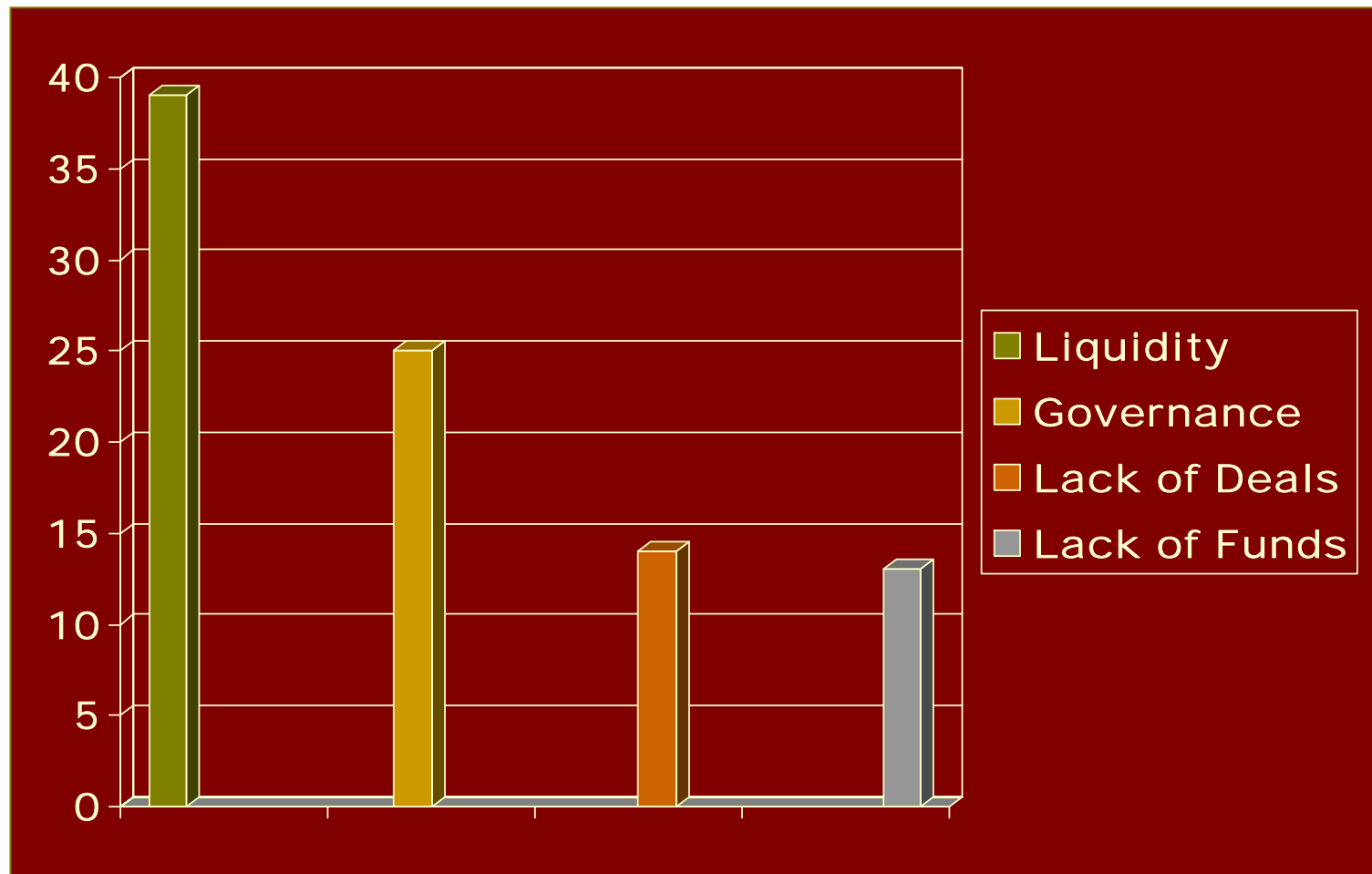
# Categories of Private Equity

- Venture Capital
  - The “business of building businesses”
  - Focus on businesses at an early stage of development
- Buyout
  - Buyout funds seek to acquire a significant percentage of a company’s equity
  - Target mature companies
  - Can take an active or a passive role in managing the company
- Mezzanine
  - Investment is often in the form of subordinated debt
  - Debt captures equity appreciation through conversion features
- Special Situations
  - A broad range of situations including distressed debt, project financing, leasing

# Private Equity Investors

- **Passive Private Equity Investors**
  - Characterized by faith in the expertise of the company's management
  - Do not seek day to day involvement in management decisions
  - Some passive investors will define milestones in the shareholder agreement
  - If milestones are not met, the passive private equity investor may become much more active
- **Active Private Equity Investors**
  - Investment motivated by the belief company can be run more efficiently
  - May seek an active voice in improving management and operations

# Problems Facing Private Equity Investors



Source: Deloitte & Touche "Canadian VC Confidence Survey" 5<sup>th</sup> annual Canadian Private Equity Markets Summit, 2003

# Shareholder Agreements And Private Equity Transactions

- Many business agreements are oriented towards the present
- Shareholder agreements, in contrast, are focused primarily on anticipating future circumstances
- Existing shareholder agreements are unlikely to be suitable to deal with new private equity investors
- Private equity investors must negotiate appropriate control and liquidity provisions into the shareholder agreement, especially in light of the fact that most private equity investors do not intend to remain invested in the company for the long term

# Governance - Board Representation

- Board Appointment Rights
  - It is common for private equity investors to negotiate the right to appoint one or more members of the board of directors
  - In some cases the general entitlement to board representation will change as circumstances change, such as in connection with a reduction of share ownership or on default
  - It is important to specify how a withdrawing director will be replaced
  - Although directors may be nominated by a particular shareholder, they retain a fiduciary duty to the corporation
    - Note the potential for conflict of interest between the nominating shareholder and the corporation
    - This conflict may limit the effectiveness of board representation as a control mechanism
- Observer Status
  - Observer status requires representatives get notice, can provide input at board meetings but do not vote
  - It may be possible for observers to be named in suit against directors, depending on their level of involvement

# Board Representation - Sample Clause

Until the right of Party A to do so shall terminate in accordance with the terms hereof, each of Party B, Party C and permitted Party C transferees shall take all action within its power, including but not limited to, the voting of Capital Stock of the Company (to the extent that any such person holds Capital Stock of the Company entitled to vote thereon), and CS equity and each Permitted CS Equity Transferee (if any) shall vote its respective Capital Stock (to the extent that such person holds capital stock of the company entitled to vote thereon), at each annual or special meeting of the stockholders of the Company at which the election of directors is held or pursuant to any written consent of the stockholders required to cause the board of directors to include as a director two individuals designated by the Party A and Director B.

# Replacing Directors - Sample Clause

Replacement of Designated Directors: In the event that any director designated in the manner set forth in sections 2.2 or 2.3 hereof is unable serve or, once having commenced to serve, is removed or withdraws from the Board of Directors (a “Withdrawing Director”), such Withdrawing Director’s replacement (the “Substitute Director”) on the Board of Directors (and, if applicable, any executive or similar committee thereof) shall be designated in accordance with Sections 2.2 or 2.3, as applicable. The company, each of the Party A, Party B, Permitted Party B Transferees (if any), Party C, and Permitted Party C Transferees (if any) agrees to take all action within its or his power, including, but not limited to, (i) the voting of capital stock of the company (to the extent that any such person holds capital stock of the Company entitled to vote thereon) to cause the election of such Substitute Director as soon as practicable following his or her designation and (ii) the instruction of any director it had previously designated to serve as member of the Board of Directors, as the first order of business at the first meeting thereof after such Substitute Director has been so designated, to vote to seat such designated Substitute Director as a director in place of the Withdrawing Director.

# Governance - Veto Rights

- It is common for private equity investors to negotiate an ability to veto key decisions, including:
  - amending the articles of incorporation
  - changing the nature of the business
  - amalgamating with another entity
  - issuing securities
  - engaging in non-arm's length transactions
  - replacing CEO
  - incurring debt
  - approving budget
- An effective veto can be established by
  - requiring shareholder approval for certain actions
  - requiring that those actions be approved by a super-majority of board.
- There may also be a process established to amend and adopt business plans.

# Governance - Information and Preferences

- Private equity investors will frequently want preference rights on future issues on a pro rata basis
- Where an investment is made in contemplation of active participation in business operations, it will frequently be desirable to negotiate broad rights to information
- Exactly what information is required will vary with the nature of the business, but may include:
  - right to visit company
  - examination of records
  - discussion with the company about its affairs, finances, accounts etc.
- Where shareholder agreements confer the right to information, it is important that they also cover confidentiality
- Some private equity investors will contribute proprietary information to a company, agreement may need to deal with IP issues

# Information Requirements – Sample Clause

## Periodic Reports

Within five Business Days after the end of each calendar month, the chief financial officer of the Corporation shall send to each director and Shareholder a sales report prepared on a profit centre basis disclosing:

- unit sales on a cumulative, monthly basis compared to corresponding periods in the previous Fiscal Year;
- monthly dollar sales on a cumulative monthly basis compared to corresponding periods in the previous Fiscal Year and compared to the Budget; and
- cumulative year to date statistics.

Within ten Business Days after the end of each calendar month, the chief financial officer of the Corporation shall send to each director and Shareholder a profitability report disclosing:

- net profit on a cumulative, monthly basis and compared to the Budget;
- bank collateral calculations compared to operating line borrowings as of the last day of the relevant month;
- cash position as of the last day of the relevant month and compared to the Budget;
- capital expenditures during the month in excess of \$●; and
- a brief statement prepared by the chief operating officer analyzing the material results for the month, reasons for any material deviations from the Budget and any material changes in the operations or affairs of the Corporation or its subsidiaries.

# Liquidity Issues

- A Private Equity investor intends to exit the investment within a defined time period
- If a company is to be a private issuer under securities law, it must restrict the transfer of its shares
  - This may significantly affect the liquidity of the investment
- Consequently, it is imperative that the shareholder agreement is drafted to contain mechanisms that provide the private equity investor with sufficient liquidity

# Liquidity Mechanisms

- Right of first refusal
  - this mechanism requires that a shareholder presents a written offer from a bona fide third party purchaser
  - other shareholders must purchase on the same terms and conditions or the offeree shareholder is entitled to sell to the third party
  - have been given a broad interpretation by courts, can be very restrictive.
- Right of first offer
  - no hard third party offer must be presented
  - a shareholder can specify a set of terms, if the other shareholders do not accept the terms then the shares can be sold to a third party so long as the terms given the third party are not more favorable than those offered other shareholders.
- Shotgun Buy/Sell provision
  - the initiating shareholder states the terms and the responding shareholder decides whether to be a buyer or seller
  - work best where there are two shareholders with similar resources

# Liquidity Mechanisms (Cont'd)

- Drag along
  - majority of shareholders, or a specific percentage, can accept a bona fide third party offer
  - the accepting shareholders then have the right to require that other shareholders sell their shares to the third party
- Puts and calls
  - a put allows a particular shareholder to require the corporation or another shareholder to buy its shares
  - a call allows the corporation or a shareholder to buy a particular shareholder's shares
  - typically used in connection with
    - departing employees with a small number of shares
    - on insolvency or default if a shareholder
    - on the death or disability of a shareholder
- Divestiture Committees
- Dissolution

# Share Transfers-Sample Shotgun Clause

## Buy-Sell Notice

- a) Either Group (the “**Offeror**”) shall have the right at any time to give written notice (the “**Buy-Sell Notice**”) to the other Group (the “**Offeree**”) and the Secretary of the Corporation, which Buy-Sell Notice shall contain the following:
- b) an offer (an “**Offer to Purchase**”) by the Offeror to purchase all of the Shares beneficially owned by the Offeree;
- c) an offer (an “**Offer to Sell**”) by the Offeror to sell all of the Shares beneficially owned by the Offeror to the Offeree; and the price (the “**Purchase Price**”) to be paid for each Share pursuant to the Offer to Purchase and the Offer to Sell, which price shall be payable in cash on closing and shall be the same for both the Offer to Purchase and the Offer to Sell and shall be accompanied by a certified cheque or bank draft payable to the Offeree in the amount of 15% of the total purchase price for all the Offeree’s Shares based on the Purchase Price (the “**Deposit**”). Neither the Offer to Sell nor the Offer to Purchase shall subject the Offeree to any term or condition not otherwise contemplated by this agreement. If the transaction contemplated by the Offer to Purchase is not completed by reason of a default of the Offeror, the Deposit shall thereupon be forfeited to, become the property of and be retained by the Offeree as liquidated damages for the Offeror’s default.

# Share Transfers-sample ROFR and Drag-Along Provision

- If a Group (the “**Offered Group**”) receives a Third Party Offer which it wishes to accept, then before it accepts the Third Party Offer:
- a) the Offered Group shall promptly give notice to the other Group (the “**Notified Group**”) stating its desire to sell the Shares owned by the Offered Group in accordance with the Third Party Offer, a true copy of which shall accompany the notice;
  - b) the Notified Group may elect to either:
    - purchase all the Shares owned by the Offered Group for cash at a price per share equal to the price provided in the Third Party Offer on terms no more favourable to the Notified Group than those set out in the Third Party Offer; or
    - sell all of the Shares owned by it on the terms set out in the Third Party Offer.

# The Exit Strategy

## Public Offerings

- registration rights are common in shareholder agreements made by private equity investors, such rights allow a shareholder to force the company to facilitate the public trading of its shares
- if a company is closely held, registration rights can give a shareholder the right to force the company complete a public offering
- common share IPO rarely allows for 100% exit since investors and underwriters will be hesitant to allow the majority of IPO proceeds to buy out an exiting shareholder, rather than help the company
- Income trusts
  - more suitable for 100% exit
  - trust sells units of itself and uses the proceeds to purchase a business or asset, recapitalizes the asset and the trust holds the debt
  - this leads to significant tax savings

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