

## **How can the shareholders agreement focus everyone on value? V2**

### **What is the purpose of this article?**

This article discusses how a shareholders agreement in a private company could help focus everyone on value creation and extraction.

I am not providing legal advice. Please consult a lawyer if you need legal advice on creating, reviewing, or updating a shareholders agreement or other legal governance documents.

### **What are two types of shareholders agreements**

#### **#1 USA (Unanimous Shareholder Agreement)**

"The written agreement among all of the shareholders of the corporation can wholly or partly restrict the powers of the directors to manage, or supervise the management of the business and the affairs of the corporation"<sup>1</sup>

#### **#2 Voting trust or pooling agreement**

"Some shareholders of a corporation may choose to enter into voting arrangements such as voting trusts, pooling agreements or shareholder agreements under which they agree to vote their shares in a consistent manner. Voting arrangement of this sort....do not have the effect of reducing the powers and liabilities of directors"<sup>1</sup>

### **What are some potential shareholder expectations regarding their investment?**

- 1) limiting some decisions to only the shareholders e.g. hiring, termination, and compensation of the CEO; sale or wind down of the company; terms and conditions of future financing.
  - 2) requiring shareholder approval of various documents: e.g. Board of directors mandate, board committee mandates, company policies, strategic plan, budget.
  - 3) defining the process used by the shareholders to make the above decisions and approvals.
  - 4) defining what information needs to be reported to shareholders at what time and in what format.
  - 5) constraining the business e.g. limit geographical operations, which products and services may or may not be provided, pricing.
  - 6) defining the process and constraints for shareholders to sell their equity.
  - 7) defining the dispute resolution process. This process could result in a forced sale of shareholder equity.
  - 8) describing the ways specific shareholders extract value from the company e.g. dividends; products and services; future sale of shareholder equity.
  - 9) describing how shareholders will support the company e.g. introductions; financing guarantees.
- The shareholders may have other expectations as well e.g. the purpose of the company

Some or all of the above expectations might be included in the USA.

### **How might the USA impact on value creation and value extraction?**

I assume the company has a value creation plan and the shareholders have a value extraction plan. The plans can be directed and constrained by shareholder expectations which are in the USA.

### **What are the risks of not documenting the shareholder expectations?**

The short-term risk is a series of immediate disputes, which could harm both value creation and extraction. For example, what if the shareholders don't understand and agree that some shareholder will extract value through low-priced products and services while other shareholders extract value through dividends arising from high priced services to customers. How will management create and execute strategies when they are attempting to limit profits and grow profits at the exact same time?

The long-term risk is that shareholder expectations could change, especially when shareholders are companies. The companies' strategies for their investment could change and new executives representing the companies could have different expectations.

### **What are your next steps?**

- 1) Shareholders should discuss and document their expectations regarding value creation and value extraction. Agreement and consensus are not always required.
- 2) The challenge is to figure out how to reconcile conflicting expectations. (e.g. one founding shareholder might want to stay with the company for the rest of her life. Another founding shareholder might want to exit and sell her equity in 5 years for maximum value). This expectation setting process is carried out without lawyers and there is no legal document as an outcome.

- 3) Then lawyers review the shareholder expectations document. The lawyers point out potential issues and risks, which may result in further shareholder negotiations regarding expectations. The shareholders decide among the legal options.
- 4) I assume that the USA will be one of the selected options. The lawyers must craft this. The process of creating the legal USA may well result in more issues, requiring a negotiated update to the shareholder expectations document.
- 5) The lawyers will have to craft a dispute resolution process into the USA which is able to deal with future changes of shareholder expectations. Potential outcomes of dispute resolutions include: sale of the company, existing shareholders buying out some other shareholders.
- 6) The shareholder expectations document needs to be reviewed on a regular basis and must be reviewed every time there is a potential new shareholder or change to an existing shareholder.

#### **Footnotes**

<sup>1</sup> Barry Reiter, Bennett Jones LLP, Directors Duties in Canada, 5<sup>th</sup> edition, Page 95

#### **Further reading**

How can founders and investors create a shareholders agreement?

<http://koorandassociates.org/corporate-governance/how-can-founders-and-investors-create-a-shareholders-agreement/>