Russian Roulette Anyone?
Shotgun Clauses in Shareholders' Agreements

By Scott T. Johnston

In my last article, I provided a rudimentary overview of the legal documents known as "shareholders' agreements" for corporations in British Columbia. A corporation is a form of business organization that is wholly owned by individuals (or corporations or other entities) known as "shareholders". The shareholders subscribe for the bundle of legal rights known as "shares" in the authorized share structure of the corporation and are provided share certificates to provide a tactile representation of their proprietary rights in the capital.

Shareholders agreements attempt to clarify the relationship among the shareholders of a British Columbia corporation and to define in advance their respective responsibilities and obligations, both to each other and to the business itself. Just as even the same types of businesses differ in their actual operations, shareholders' agreements are not "cookie cutter" documents and vary considerably in their terms and conditions. That being said, shareholders' agreements often set out what happens to the venture in the event of a dispute among the shareholders. Sadly, sometimes all that glitters is not gold and shareholders require a coherent exit strategy.

Provisions contained in shareholders' agreements that deal with disputes among shareholders fall into a general category described as "compulsory buy-out" mechanisms. The lion's share of British Columbia corporations consists of private small businesses, in that the shares are not publicly traded on any of stock exchanges like the TSX Venture Exchange. As such, a shareholder in a private corporation cannot freely trade his or her shares in an active market of outside vendors and purchasers, where liquidity and valuation of the shares is independently established. If shareholders of a corporation listed on a stock exchange have a falling out with the others, it usually only takes a phone call to a stockbroker to wash their hands of the situation.

Compulsory buy-out mechanisms in shareholders' agreements commonly attempt to resolve the lack of an active market by providing for the compulsory buy-out of shares by the corporation itself or other shareholders upon the trigger of certain events, including a dispute. Arguably the most drastic of compulsory buy-out mechanisms is known as a "shotgun" clause whereby a shareholder may be effectively forced out of the corporation in a process somewhat akin to a round of Russian Roulette.

A "shotgun" clause provides that a shareholder who wishes for an exit strategy (likely due to some egregious squabble with the others), may give written notice requiring the other shareholders to elect to either: (a) sell all of their shares in a corporation to him or her at a set price; or (b) buy all of his or her shares in the corporation at the same price. Under the written "shotgun" notice the terms and conditions of the options of purchase or sale are identical. The instigator sending the notice has therefore loaded the shotgun by setting the value of the investment and effectively pointed the firearm at the other shareholders to see if they will fire back.

Where all of the shareholders of the corporation are of comparatively equal financial means and resources, a "shotgun" clause is a simple and effective way to determine who will end up owning the business. However, if the angry shareholder initiating the "shotgun" mechanism is very wealthy and the other shareholders are not, then this process may work in a relatively unfair manner. In other words, if you know that the other shareholders do not have enough money to buy you out of the business at the price you set, then providing them with that option is a somewhat contrived gesture. In reality, the "shotgun" clause may prove to be more of a Machiavellian device for the affluent shareholder to gain control of all of the shares of the corporation.

By way of illustration, in previous articles I have described the misguided wholesale "pre-owned" discount barbeque sales and repair business incorporated under the name "420 Holdings Ltd." by Ricky and Julian as a British Columbia corporation. Ricky and Julian each own an equal amount of shares and enter into a shareholders' agreement for 420 Holdings Ltd. that includes a "shotgun" clause. Due to a heated disagreement over the correct preparation of frozen chicken fingers, Julian decides that he no longer wants to be involved with Ricky in the venture. As there is no active market on a stock exchange for his shares, Julian employs the "shotgun" mechanism set out in the shareholders' agreement and sends a written notice to Ricky requiring him to either fish or cut bait. However, Ricky has no money and cannot afford to purchase Julian's shares in 420 Holdings Ltd. Accordingly, Ricky elects to sell his shares to Julian for the price set out in the "shotgun" notice and Julian must now pay Ricky for his interest in the enterprise. By operation of the "shotgun" clause and after payment of the purchase price, Julian will now hold all of the shares of the corporation and be able to carry on the barbeque redistribution business on his own terms.

Scott T. Johnston is a business lawyer with Campbell, Burton & McMullan LLP, http://www.cbmlawyers.com/our-lawyers/scott-t-johnston, practising corporate/commercial and commercial real estate law. *The general information contained in this article should not be treated by readers as legal advice or opinion and ought not to be relied upon without detailed legal counsel being sought.*