ACCOUNTING

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Friendly Shareholder Agreements

How do you stop a simple transaction from devolving into a nasty shareholder dispute? Draft a good buy/sell clause

George Cope (BCE)
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PHOTO: REUTERS

WHEN A COMPANY has multiple shareholders with large voting and equity stakes, the importance of a precisely worded buy/sell clause within the shareholders' agreement cannot be overstated. Take the case of Maple Leaf Sports & Entertainment. Last year, the Ontario Teachers' Pension Plan announced that it would be divesting its 66.1-per-cent controlling interest in the sports company, which owns a number of properties including the Toronto Maple Leafs, the Toronto Raptors, the Toronto FC soccer team and the Air Canada Centre, as well as a number of TV stations.

The other two shareholders, Lawrence Tanenbaum (with 20.5 per cent) and the Toronto-Dominion Bank (with 13.5 per cent), each had a right of first refusal (in direct proportion to the shares they owned) on any proposed sale of the Teachers' shareholding. If either of the minority shareholders decided not to purchase any Teachers shares, then the other would have to purchase the entire stake or nothing at all.

In addition to the right of first refusal, the agreement stipulated that Tanenbaum and TD, as the two remaining shareholders of MLSE, would be required to approve any transfer of the company's broadcast and Internet assets.

One can only imagine the turmoil that would have ensued without such a carefully constructed buy/sell covenant. With the MLSE's majority stake in play, the interest could have been sold to outsiders – at a dilutive price, perhaps – whose strategy might have diverged significantly from that of the current shareholders. Lawsuits would have been a real possibility.

That didn't happen, however, thanks to a shareholder agreement that contained explicit buy/sell provisions. The purpose of these, broadly, are to offer a predictable "liquidity event" for departing shareholders. Assume a shareholder wants to sell his or her stake in the company. The buy/sell clause sets the terms under which a sale can be conducted and often stipulates "triggering events" that allow current shareholders, or the corporation itself, to purchase shares on favourable terms.

The clause is also meant to achieve a number of other objectives. In the case of death, the buy/sell clause sets out how the shares of the deceased will be dealt with. The provisions are designed to ensure fairness and to permit management to continue without interference from outside parties. And they take a variety of possible events into account when determining the selling price and terms of payment.

That being said, there are a number of important considerations that are often overlooked by lawyers.

> DEFINING VALUE One of the more common problems with buy/sell clauses that are prepared by lawyers is that they do not clearly define value. Terms such as "book value," "fair market value," "market value," "fair value," or just plain "value" are often adopted (the implications of which are rarely given much thought). However, each of these terms can lead to materially different valuation conclusions.

> FORMULA APPROACH Some shareholder agreements make use of formulas, such as a multiple of the average earnings for the past five years or a multiple of book value. The problem with this approach is that a formula often fails to take into account the business's future prospects or potential. Furthermore, the parties may wish to have different values or different payment terms, depending upon the specified event. Formulas, while simple, can be rigid and inflexible, producing inequitable results.

> SHOTGUN ARRANGEMENT With this approach, a shareholder wishing to acquire another stakeholder's shares will stipulate an offering price. The offeree will then have the option to either sell at that price or turn around and, instead, buy the offeror's shares. To use an analogy, it's as if one of the parties were asked to cut a pie in two, and the other got to pick the slice.

As for Maple Leaf Sports & Entertainment, Rogers Communications and Bell Canada, which already own TV channels, jointly acquired a 75-per-cent stake for $1.32 billion. Tanenbaum has the remaining 25 per cent. (See "Big Deals," pg. 30.)

Such a clear path to transfer of ownership could not have existed without a strong buy/sell agreement, but drafting one often requires a business valuator. A little help at the start can go a long way to avoiding problems down the road when the inevitable "triggering event" occurs.

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