Don Sihota Business Succession

When Shareholders Can't Get Along - Part 1

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Many privately owned businesses have more than one owner. This can be beneficial to a business, but it also poses its own problems. Sometimes one or more of the parties realizes that the partnership is not working which leads to dissention and conflict. What options are there for individuals facing this scenario?

If the partners had entered into a shareholder agreement, that agreement would likely contain a provision specifically designed for partnership disputes. This provision is commonly called the "shotgun clause". The legal term for this provision is "compulsory buy out" and it is intended as a means of separating shareholders who are not getting along. The shotgun clause can be an effective way of avoiding litigation and providing a clean split between the warring parties.

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How does the shotgun clause work? Generally speaking, it provides that one shareholder may make an offer to buy the other shareholder's interest at a price set by the shareholder making the offer. However, the interesting twist is that having made the offer to buy, that shareholder is also deemed to have offered to sell his interest at the same price and on the same terms as the offer to buy. So it is left up to the shareholder receiving the offer to determine whether or not he wants to sell his interest or whether he wants to purchase the interest of the other shareholder. This has the effect of making the offering shareholder think carefully about his price. If he makes a lowball offer, he may end up being bought out at that low price!

Normally, the shotgun clause will provide for time frames and procedures for completing the transaction. Naturally, the details will all depend on the wording of the shareholder agreement. In addition, if there are more than two shareholders, the shareholder agreement will normally state that only one shotgun may be fired at a time. In other words, the other shareholders have to sit on the sidelines to see who wins the duel.

There are a couple of things that you should keep in mind when considering a shotgun clause. If the ownership is not 50/50, a shotgun clause may not be appropriate. This is because whatever the price, the minority will have to come up with a lot more money to buy out the majority than the majority will have to come up with to buy out the minority.

Furthermore, if one party has more financial wherewithal than the other, that can create inequalities in power. The shareholder with more money may bid low if he thinks the other shareholder cannot raise the funds to buy.

Finally, if there is more than one shareholder, the shotgun clause should include a "piggy back" right, which will prevent the winner of the duel from diluting the interests of the shareholders that are sitting on the sidelines. For example, absent a piggy back right, if there were three shareholders the winner of the duel would end up with 2/3 interest. The piggy back right would have allowed the shareholder watching the duel to get his pro-rata percentage of the spoils, thereby leaving two shareholders with 50% each. You should check your shareholder agreement to see if it covers these points.

What if there is no shareholder agreement and no shotgun clause? Sometimes it is possible to implement a "non-binding" shotgun procedure. In effect, the shareholder wishing to separate makes a shotgun offer, but acknowledges that it is not binding. The same thought process would be carried out in determining what the price should be, given that it is both an offer to buy and an offer to sell.

If you are going to fire the shotgun, you need to think carefully about how to do it. In my next report, I will discuss what interesting things actually can happen when the shotgun is fired.

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