November 2014

STARTUPSOURCE

Brought to you by Aird & Berlis LLP

STARTUPSOURCE.ca

Foundations for Startup Success:

The Shareholders' Agreement

By Rebecca Kacaba, Mathew Goldstein and Andreea Andrei*

Startup founders frequently set their course for the stars. With sweeping vision, high spirits and grand plans, what could go wrong? Unfortunately, plenty. Building a successful company requires a solid foundation and advance planning to navigate key challenges. A properly drafted shareholders' agreement can be a roadmap through the foreseeable and unforeseeable twists and turns associated with growing a new business (e.g. bringing on new investors, selling shares, and even unlikely scenarios such as the sudden death or disability of a founder or key shareholder).

Snapchat's large and very public co-founder dispute illustrates the point. Snapchat's co-founders were sued by a former colleague claiming an ownership interest in the billion dollar company. While the dispute has apparently been settled, ambiguity over ownership is undesirable for an emerging company seeking to raise capital and grow.

Accordingly, although it may not be the most romantic way to set out on a business venture, founders should make sure they have a professionally-drafted shareholders' agreement in place as early as possible. Here are a few common scenarios that demonstrate why:

1. Our business is starting to gain traction and our valuation is increasing. Now my co-founder wants to sell out to an investor, and I don't.

Shareholders' agreements can restrict shareholders from selling equity to a third party. By including a first right of refusal, one party must give the other shareholders in the business the opportunity to buy out the person who wishes to sell.

2. I've changed my mind and decided that I would like to sell the company after all. I found a reasonable buyer, but some of the other shareholders do not want to sell. The buyer is only interested in the company if they can have 100% control.

Shareholders' agreements can prevent such stalemates by including a drag-along clause. As its name suggests, a drag-along clause will allow major shareholders to force minor shareholders to sell their shares in specific circumstances where the major shareholders are in agreement (i.e. "drag them" along). This clause typically requires that all shareholders receive an equal purchase price and a valuation method for the shares in case of dispute, so that all the shareholders receive equal and fair value for their shares.

3. I've come up with a realistic business plan and found potential investors, but they will only invest if they can sit on the board of directors. I need the investment, but I don't want to lose control over my own company.

Clauses can be drafted so that certain important decisions, such as issuing shares, require unanimous shareholder approval and certain other day-to-day decisions, such as a threshold of capital expenditures, require majority shareholder approval. That way, investors can sit on the board and participate in corporate governance, without necessarily taking control.

4. My partner decides that he/she no longer wants to be a part of the company. What happens if he/she leaves?

Unless an agreement provides otherwise, a partner who leaves will retain his/her shares and enjoy the fruits of ownership whether or not he/she adds value to the company. Frequently, the shareholders will agree that a departing shareholder should not be able to keep the full value of his/her shares if they are no longer contributing to the company. A shareholders' agreement can be drafted to include provisions that induce or restrict a shareholder from transferring his/her shares without other shareholder approval. It can also create a first right of refusal for existing shareholders and provide for inactive shareholders.

5. My co-founder and I had a disagreement. He/she left the company but has intimate knowledge of the product and/or operations of the company and I'm afraid he/she may set up a company in direct competition.

A shareholders' agreement can include non-competition, non-solicitation and confidentiality clauses that prevent an individual from setting up a competing business within a set time period in a set area, restrict a former founder from poaching staff and customers and restrict the publication or transfer of confidential company information.

Make no mistake – it is easy to undervalue the benefit of an appropriate and responsible process when you are starting your business. In many cases, not doing so at the outset can land you in an expensive or possibly unredeemable imbroglio later down the road.

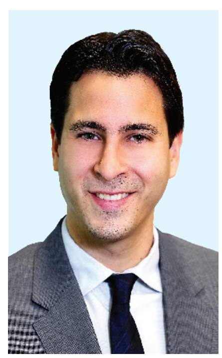
** Andreea Andrei was a summer student with Aird & Berlis LLP*

Rebecca Kacaba
Partner, Startup Team Leader

Rebecca Kacaba is a member of the Aird & Berlis LLP Corporate Finance and Mergers & Acquisitions Groups and is Team Leader of the Startup Group.

Rebecca has experience in corporate finance, securities law and mergers and acquisitions. She has assisted a wide range of clients ranging from start-up private businesses to large multinationals. She regularly advises both domestic and international clients, including those listed on the Toronto Stock Exchange and the TSX Venture Exchange, on mergers and acquisitions (cross-border and domestic), public and private offerings (both initial and secondary), private placement financings (including debt and equity offerings), corporate reorganizations and corporate governance matters.

E rkacaba@airdberlis.com | T 416.865.7707



Mathew Goldstein
Associate

Mat is a member of the firm's Financial Services Group. Prior to joining A&B, Mat practised at a top-tier New York City law firm.

Mat practices in the areas of corporate/commercial, banking and bankruptcy law, with a focus on financing transactions and restructuring.

Additionally, Mat advises entrepreneurs as well as startups and emerging companies, including those in the media and technology sectors, with respect to corporate structure, governance, financing, technology licensing and commercialization.

Mat is a contributor and editor of startupsource.ca, a blog which features timely commentaries on the latest developments in startup news, events and information on capital raising and planning for future growth.

E mgoldstein@airdberlis.com | T 416.865.4637