SHOTGUN CLAUSES AND OWNER MANAGERS: LIMITATIONS AND ALTERNATIVES

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While everyone has heard of "shot-gun" clauses, many people do not know what they are. Fewer yet have seriously considered their limitations. Like many things in life, a tool that should produce fairness in human relations can easily have the opposite result when put into practise. In addition, many people have not sufficiently considered the alternatives. This article is a brief introduction to these issues, from the owner-manager's perspective.

Shotgun Clauses In Theory: Fair, Efficient, No-Fault Corporate Divorce

Shotgun clauses are found in shareholder or buy-sell agreements. They come under different names, usually referenced by the terms "buy-sell" or "shotgun". They are meant to provide a fair, speedy, efficient and no-fault corporate divorce.

The clause usually works like this:

- If one of the shareholders in the business wants a "divorce" from the other shareholders, he or she triggers the shotgun.
- There may be some time restrictions set out in the clause. For example, shareholder agreements often prevent the use of the shotgun clause too soon after the relationship is formed so that shareholders do not jump to divorce the first time they have a disagreement. But generally there are very few if any restrictions on when it is used.
- In most cases no fault, default, deadlock or breakdown is required for the shotgun to be used. It is usually set up as a "no-fault" divorce mechanism.
- The shotgun requires the person making the offer to offer to buy the shares of the other shareholders, or sell their shares to the other shareholders, at the same price per share whether they are buying or selling.
- The clause will often deal with other more administrative provisions, but the essence is that the person making the offer sets the price and terms, and the person receiving the offer gets to choose whether to sell or buy at that price and on those terms.

That is where the "fairness" should come in. Because the person triggering the shotgun process does not know if they will be buying or selling, they need to be careful about how they set the price and payment terms:

- If they set the price too high and the payment terms are too restrictive, they will pay too much to the other shareholders and unduly restrict themselves if they are buyers.

- If they set the price too low and the payment terms are too liberal, they will not receive as much as they should for their shares and may leave the purchase price too much at risk if they are sellers.

The result should be a "just right" price and terms formula that balances the interests of buyers and sellers no matter who they are.

In theory, this is a great method of no-fault corporate divorce.

In practise, however, it can turn out to be a very unfair mechanism. If often leads to bitter and expensive litigation as one party tries to take advantage of the clause at a time and in circumstances which favours them, while the other party seeks to avoid what they believe to be an unfair use of the clause.

Shotgun Clauses In Reality: Often Not Fair At All

I have not seen any statistical studies on shotgun clauses and litigation, but based on my years in practise I have concluded that shotgun clauses are only resorted to by a party who thinks they can get an advantage out of it, and the shotgun recipient usually turns to the courts or arbitration to avoid or minimize the impact of the shotgun clause on their business affairs.

This results from many things, including:

- A poorly designed shotgun clause.
- Attempting to use the clause in a way that was not intended.
- A set of circumstances that were not imagined or anticipated at the time the shotgun clause was agreed to.
- Inserting a shotgun clause in a shareholder situation where it should never have been inserted in the first place.

Here are some of the practical limitations on shotgun clauses, in no particular order:

- ***The 50/50 problem.*** Shotgun clauses work best when you have two shareholders, or two defined groups of shareholders, each with 50% of the company. In a 90/10 scenario, for example, the 10% shareholder has to come up with nine times as much money as the 90% shareholder if they want to be the buyer under the shotgun scenario. This is often impossible in owner-managed companies, where the 10% shareholder is most likely to be a shareholder with very limited financial resources. The impact is just as harsh if the 10% shareholder wants to leave the company, as they must offer to buyout 90% of a company they may not want to own.
- ***Multiple shareholders.*** For the same reason, a shotgun clause can be unfair in practise in multiple shareholder situations. If there are five equal shareholders, and four of them can use the shotgun clause to "force out" one shareholder, the 20% shareholder may not have a realistic opportunity to buy because he or she has to come up with four times as much money. Also, if all or most shareholders are active in the company, the 20% shareholder may also have to raise financing for or run a company that has just lost most of its management team. Again, the impact can be just as harsh if the 20% shareholder wants to leave the company, as they must offer to buy-out 80% of the company that they may not want to own.

- ***Equal ability to operate the company.*** A shotgun clause may also be unfair if all shareholders do not have an equal ability or opportunity to operate the company. If one shareholder is a passive investor, or lacks the skill or ability to operate the company, putting them in a position where they have to choose to sell or buy may not be as "fair" in reality as it looks in theory as buying may not be a realistic option to them.
- ***Equal desire to own and operate the company.*** Also, in many cases, the shareholders do not have an equal desire to own and operate the company on their own. For example, if the shareholder receiving the shotgun is seventy and retired, or in ill health, or wants to do something else with their life or money, being a buyer may be unrealistic if not downright impossible.
- ***Equal desire to give up ownership of the company.*** The reverse can also be true. Since the shotgun clause requires even the initiating shareholder to be willing to be a seller, it requires both shareholders to be willing to give up ownership. This can be very difficult in some situations. For example, one shareholder could be a founding shareholder with their name on the door, or a third generation owner with strong emotional attachments to the business. A shotgun buy-sell mechanism may not be fair in this situation.
- ***Equal financial resources.*** In addition, shotgun clauses are not always fair in practise if the shareholders have significantly different financial resources. The shareholder with the most money can put an offer together that the responding shareholder cannot match financially, making the choice to buy or sell more of a sham than a fair, no-fault divorce.
- ***Equal ability to finance the company.*** The same is true when it comes to financing the company post-closing. Through experience, reputation, track record or hard assets, some owner-managers are better able to finance their business post-closing than others. If one shareholder is at a significant disadvantage in that department, being a buyer just might not be something that they can pull off.
- ***Equivalent shareholdings by class and number.*** A shotgun clause also assumes that each shareholder has the same type and class of share. This is not always the case. Different shares have different attributes. For example, equity ownership may be shared 50/50, but voting control could be 51/49. Valuing the voting shares and dealing with the potential premium for control can make the different positions between the shareholders less than "equal".
- ***Equivalent investment in shareholder loans, options, warrants, etc.*** The same is true for shareholder loan accounts, options, warrants and other security or investment in the company. They all must be dealt with as part of the separation process. Unless they are roughly equivalent, this can be more of a burden or risk to one shareholder than the other.
- ***Equal impact on change in personal employment.*** The personal impact of leaving the company can be significantly different for some shareholders than others. Depending on the age or personal circumstances of the shareholders, being a seller and losing their job may be more severe for one shareholder than the other.
- ***Reasonable impact in terms of restrictive covenants.*** Restrictive covenants are tied into this. Shareholder agreements usually include non-solicitation, non-competition and similar covenants. They could severely restrict or damage the career or financial circumstances of the departing shareholder, especially in circumstances that amount to a "force-out".

- ***Equal access to information.*** For a shotgun clause to work, each shareholder must have equal access to information about the company so they can know whether to make an offer, or respond by being a buyer or a seller. Access to information will also be critical in naming or assessing the price and payment terms, and arranging financing. This can require real in-depth knowledge of the company's affairs. It is far from automatic that all shareholders will have equal access to the kind of information necessary to make a shotgun process as fair as it should be.
- ***Equal support from other stakeholders.*** Finally, no company succeeds without support from a number of third parties, including senior management, employees, customers, suppliers and financiers. Unless all shareholders have equal support from key stakeholders, the opportunity to buy may not be realistic for everyone.

Almost all of these concerns apply as much before the shotgun is initiated as after. If circumstances are such that you would not really be able to be a buyer if you receive a shotgun notice, then your ability to trigger the shotgun to get out of your partnership may be equally unrealistic.

Since a shotgun clause is meant to be a simple, fair, no-fault divorce, it needs to be used in the right situations, it may have to be drafted to limit its application to circumstances which fairly take into account the factors noted above, and may need to be supported by other provisions in the shareholders' agreement such as access to information and reasonable restrictive covenants.

Other Means Of Efficient, No-Fault Corporate Divorce

In our practise, shotgun clauses are rarely inserted into the shareholder agreements we draft for our clients as their true value only applies to a small number of owner-manager partnership situations. Usually there are other forms of no-fault corporate divorce that our clients feel would better suit their situation. Here is a very brief introduction to some alternatives.

- ***Right to Sell with Right of First Refusal.*** A shareholder who wants out is entitled to find a buyer for their shares without any restriction, but subject to a right of first refusal in favour of the existing shareholders. While the market for private company shares is usually very small or even non-existent, in some situations this can actually be a meaningful exit strategy, especially if there are a large number of shareholders and management and success of the company in question is not dependent on one or two key people.
- ***Force Out Call or Put With Appraisal or Formula.*** A shareholder who wants out can insist that the company or the other shareholders buy them out (a "put"), or the other shareholders or the company can force a shareholder they want to leave to sell their shares to the other shareholders or the company (a "call"). While never a perfect solution, a formula or appraisal process applies to set the price if the parties cannot agree, and payment terms and security are normally spelled out in the shareholders agreement, along with acceleration clauses and restrictions on decision-making until the purchase price is paid in full.
- ***Drag-Along/Tag-Along with Right of First Refusal.*** Depending on the circumstances, if a shareholder wants out, or some shareholders want to force out other shareholders, and they cannot agree on price or terms, the whole company can be put up for sale, shares or assets. When an offer comes in which one shareholder wants to accept, the other shareholders have a limited period of time to match the offer for the company or go along with the sale. This works well in real estate investment companies, as the parties have the assurance that the

market has set the price and terms. Of course such clauses usually limit acceptable offers to good faith, third party purchasers. One downside is that these kinds of mechanisms are often drafted such that the shareholders themselves cannot bid on the company.

- ***Auction or bidding process.*** Although not often used in practise, in some situations a shareholders' agreement may contain an auction or bidding process, which can be initiated if the shareholders want to split up but both shareholders want the company or its assets. Naturally the company would go to the highest bidder.
- ***Liquidation and winding up.*** Finally, in some situations, a simple liquidation of the company assets and winding up of the company is a simple, effective and fair no-fault divorce mechanism. This if often true in service companies or sales agencies which rely heavily on the personal goodwill of the individual shareholders and there are limited fixed assets and very little corporate goodwill (if any).

Concluding Thought

The goal should be fair, efficient, no-fault corporate divorce, and there is no single, perfect mechanism that automatically applies in all situations. You may even have to set up multiple strategies for the shareholders to choose from depending on the situation. Taking the time to tailor the mechanism to your particular situation is critical if you are going to achieve your goals and avoid the kind of long-term, expensive, uncertain, emotional and messy litigation that seems to be a common alternative for those who can afford it, or the simple destruction of the company in a "winner take all" contest for those who can not.