BREAKING THE DEADLOCK: HOW SHAREHOLDERS' AGREEMENTS AND "SHOTGUN" CLAUSES HELP RESOLVE DISPUTES

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A shareholders' agreement is a crucial document that outlines the rights, responsibilities, and obligations of shareholders in a company. Disputes may arise among shareholders for various reasons, and without proper mechanisms in place, these conflicts can threaten the stability and profitability of a company. This bulletin explores the importance of shareholders' agreements in preventing and managing disputes, with a particular focus on the role of shotgun clauses in providing a resolution in certain scenarios.

Shareholders' Agreements and Disputes between Shareholders

Shareholders' agreements are legally binding contracts between a company and its shareholders that govern the relationship among the shareholders and the company. Provisions in a shareholders' agreement often relate to the conduct and management of corporate affairs; financing of the business; shareholder contributions; restrictions on share transfers; rights of first refusal; drag-along and tag-along rights; transfers of shares upon death; default of a shareholder; and dispute resolution mechanisms. While the specific provisions included in a shareholders' agreement should be tailored to suit the unique needs and circumstances of the business, they should be flexible enough to evolve as the business grows and the needs of the shareholders change over time.

A well-crafted shareholders' agreement is also an effective way to manage, prevent, and minimize conflicts between shareholders. By outlining the rights and responsibilities of each party, a carefully constructed shareholders' agreement ensures that all parties understand their roles and the processes to follow in case of disagreement. Dispute resolution provisions in shareholders' agreements should clearly specify how conflicts will be resolved and set out a clear timeline and procedure for resolving disputes.

Some conflicts may be better resolved through mediation, which offers a collaborative and confidential process to deal with disagreements; however, mediation does not always result in enforceable outcomes. Alternatively, arbitration could be a more favorable option as it provides a binding resolution without having to go to court, but it can be more costly and less flexible than mediation. Parties can pursue litigation, although the court

process can be time-consuming and expensive, and private companies may not want to disclose private details of their business on the public record. Regardless of which conflict resolution tool is used, setting out a structured approach to address shareholder disputes can avoid unnecessary delays and protect the long-term interests of the business.

Compulsory Buy-Out Clauses or "Shotgun" Clauses

In many cases, shareholders' agreements include a compulsory buy-out clause (also known as a "shotgun" clause) to avoid deadlock in the event the shareholders cannot come to a resolution. A shotgun clause provides a mechanism by which one or more shareholders can buy out the shares of one or more other shareholders to resolve conflicts that cannot be settled through other means. Shotgun clauses are typically triggered by specific events or conditions outlined in the shareholders' agreement, such as shareholder disputes, deadlock situations, or material defaults by a shareholder.

While shotgun clauses can offer a practical solution to business disputes, they carry significant risks, particularly the potential for reversal. The shareholder receiving the offer to sell their shares may either accept the offer and sell their shares, or, alternatively, may choose to purchase all of the offeror's shares on the same terms. This creates an inherent risk for the offeror, as they may find themselves being forced to sell their shares instead. Accordingly, it is crucial for the offeror to carefully evaluate the financial situation of the offeree before making a shotgun offer.

For a shotgun offer to be legally enforceable, both the offeror and the offeree must strictly adhere to the procedures for the buy-sell process as outlined in the shareholders' agreement. To prevent any uncertainty or confusion, the shotgun clause must be drafted with precision and clarity. If the clause is vague or ambiguous, it could be deemed unenforceable.

Since shotgun clauses result in a forced sale of shares, they are often viewed as a last resort. They are typically invoked only after other methods of conflict resolution have failed to resolve the dispute. The intention behind the shotgun clause is to provide a final, decisive way of ending a deadlock or dispute, but its use can be disruptive to shareholder relationships and the business as a whole.

A Case Study: *Jeana Ventures Ltd. v Garrow*

The 2023 case of *Jeana Ventures Ltd. v Garrow* provides valuable insights into the application of shotgun clauses and the approach taken by courts in British Columbia when considering such clauses.[1] This case involved two individuals, Sallay and Garrow, who, through their respective closely-held companies, jointly invested in the development of 1103 Gilston Road and 1449 Sandhurst Place in West Vancouver, each of which was affiliated with a holding company. Sallay's company was Jeana Ventures Ltd. ("**Jeana**"), and Garrow's

companies were ADC Projects Ltd. ("**ADC Projects**") and ADC Holdings Ltd. ("**ADC Holdings**").

Sallay and Garrow, through their respective companies, entered into two separate shareholders' agreements with each of the two holding companies. The shareholders party to the shareholders' agreement for the Gilston property (the "**Gilston Agreement**") were Jeana and ADC Projects. The shareholders party to the shareholders' agreement for the Sandhurst property (the "**Sandhurst Agreement**") were Jeana and ADC Holdings.

Both agreements contained the same shotgun clause. The shotgun clause permitted a shareholder to terminate the shareholding arrangement by offering, in writing, the other shareholder the option to either buy or sell their shares. Failure to respond within thirty days of receiving the offer deemed the offeree to have elected to buy out the offeror.

Despite the joint nature of the investments and Sallay contributing his share to fund the investments, Garrow had only contributed a fraction of his share. As an attempt to profit off of Sallay's investments, Garrow invoked the shotgun clause under each shareholders' agreement through written letters, each of which was addressed from and signed by ADC Holdings as per Garrow. Given that Garrow's decision to invoke the shotgun clauses was the culmination of months of defrauding Sallay, Jeana initiated legal proceedings against Garrow, and Garrow counterclaimed.

As part of Garrow's counterclaim, the British Columbia Supreme Court (the "**BCSC**") considered whether Sallay breached each of the shotgun clauses by refusing to exercise the buy or sell option as invoked by Garrow. The BCSC ultimately found that Sallay had not breached either clause. In coming to this conclusion, the BCSC highlighted the following aspects of shotgun clauses with reference to past British Columbia Court of Appeal decisions:

- **Doctrine of Privity.** The doctrine of privity, which restricts individuals or entities that are not parties to an agreement from enforcing or benefitting from the agreement's terms, applies to shareholders' agreements and, accordingly, to shotgun clauses. In this case, Garrow attempted to exercise the shotgun clause of the Gilston Agreement through a separate corporate entity distinct from the parties to the shareholders' agreement (ADC Holdings), which violated the doctrine of privity.
- **Fraudulent Actions.** Fraudulent actions may relieve a shareholder from any obligation to comply with an invoked shotgun clause. The BCSC highlighted the importance of equal information and comparable shareholdings for the proper functioning of a shotgun clause. In their absence, a shareholder risks being forced to sell or buy shares on unfair or disadvantageous terms. In this case, Garrow breached the Sandhurst Agreement by intentionally failing to make the required contributions to the joint investment. The BCSC deemed that such failure was a fraudulent action on Garrow's part, thereby relieving Sallay from complying with the shotgun clause.

- **Irrevocable.** Where a true shotgun clause has been exercised, it is irrevocable.[2] The purpose of a shotgun clause is to terminate the shareholder relationship on mutually fair terms and allowing it to be revocable would be inconsistent with this purpose.
- **Strict—Not Perfect—Compliance.** In order to properly invoke a shotgun clause, the parties to the shareholders' agreement must adhere strictly to the pre-conditions of the clause agreed to in the shareholders' agreement.[3] The courts do not look for perfect compliance. Rather, in assessing compliance, the courts will adopt a more practical approach to allow the shareholders' agreement to function and to achieve its commercial purpose.

Key Takeaways

By setting out tools and mechanisms for conflict resolution, shareholders' agreements can help prevent and minimize disagreements among shareholders from escalating and potentially adversely affecting the business. A properly drafted shotgun clause can be an effective way to break the deadlock if shareholders cannot resolve their disputes. Shotgun clauses must be clearly drafted to leave no room for ambiguity or uncertainty that may render them unenforceable. Perfect compliance with the terms of a shotgun clause is not necessary, but courts will look at whether the shareholders have strictly adhered to the terms of the clause.

Overall, a well-crafted shareholders' agreement, particularly one that includes a shotgun clause, can play a vital role in preserving business stability and ensuring that disputes are resolved in an efficient manner. For tailored advice on shareholders' agreements and shotgun clauses, please contact a member of McMillan's Business Law Group.

[1] *Jeana Ventures Ltd. v Garrow*, 2023 BCSC 1831.
[2] *Blackmore Management Inc. v Carmanah Management Corporation*, 2022 BCCA 117 at paras 43, 45, 47.
[3] *Wolverton Pacific Partnership v Triple F Investments Ltd.*, 2022 BCCA 262 at paras 45-46.

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A Cautionary Note