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ISBN-10: 1-55093-710-3
ISBN-13: 978-1-55093-710-7

An Update: Rights of First Refusal, Shot-Gun, and Drag-Along Clauses — What Are We Talking About Anyway?

First Presented at: Legal Education Society of Alberta, *Unanimous Shareholder
Agreement Disputes* (Edmonton – April 6, 2016 & Calgary – April 20, 2016).

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Edmonton, Alberta – February 6, 2019

Calgary, Alberta – February 13, 2019



Legal Education
Society of Alberta

AN UPDATE: ROFR, SHOT-GUN, AND DRAG-ALONG CLAUSES— WHAT ARE WE TALKING ABOUT ANYWAY?

Introduction..... 2

1. Rights-of-First-Refusal 2

 A. Introduction 2

 B. Principles of Interpretation 3

 (i) Basic Principles of Contractual Interpretation 3

 (ii) Application 7

 C. Case Law 7

 (i) Applying Sattva and Bhasin to ROFRs..... 7

 (ii) The Whole Agreement 9

 (iii) Schemes to Sidestep ROFRs 9

 (iv) Ensure the ROFR Meets the Intention and Objective of the Client..... 13

 (i) Corporate Reorganization and Package Sale 15

3. Shot-Gun Clauses..... 16

 A. Introduction 16

 B. Principles of Interpretation 17

 (i) Strict Compliance... 17

 (ii) ...but not Perfect Compliance 17

 (iii) No Duty of Good Faith 18

 C. Case Law 19

 (i) Offering Price 19

 (ii) Joint Offers and Sale Items..... 20

 (iii) No Duty to Disclose 21

 (iv) Performing Management Functions..... 22

 (v) Acceptances..... 23

 (vi) Arbitration 25

4. Drag-Along Rights 27

 A. Introduction 27

 B. Principles of Interpretation 27

 C. Case Law 28

 (i) Drag-Along Rights and Appraisal Rights..... 28

 (ii) Offer from an Existing Shareholder 29

Bibliography 31

 Legislation 31

 Jurisprudence 31

 Secondary Materials 32

INTRODUCTION

Shareholder agreements often provide mechanisms by which shareholders can control the disposition of shares ("Buyout Mechanisms"). These mechanisms, well drafted, can effectively protect shareholder interests, prevent legal disputes, and promote the orderly disposition of shares when transfers of shares are in order. As Buyout Mechanisms also create obligations on shareholders that may turn out to be harsh, unanticipated, or otherwise unappealing, they often give rise to disputes and litigation issues, particularly when they are drafted in an ambiguous or open-ended way.

This paper will discuss three common Buyout Mechanisms: Rights-of-First-Refusal, Shot-Gun Clauses, and Drag-Along Rights. Greater focus will be paid on the former two mechanisms as they are far more common. The purpose of this review is to identify litigation issues that have arisen from Buyout Mechanisms and to highlight ways to improve strategies when relying upon, enforcing, and drafting Buyout Mechanisms.

1. RIGHTS-OF-FIRST-REFUSAL

A. Introduction

A right-of-first-refusal ("ROFR") is a right drafted in a shareholders' agreement to allow a shareholder of a company to sell his shares to a third party, but only after he first offers the same terms to the remaining shareholders of the company.¹ Where the remaining shareholders refuse the offer, the offering shareholder may then accept the offer from the third party.² The benefit of including a ROFR in a shareholders' agreement is that it allows shareholders of a company to sell their shares while enabling the other shareholders to have the option of buying out a selling shareholder before an unwanted buyer joins the company.³

The wording used to provide ROFRs will vary across shareholder agreements and will depend on the needs and intentions of the shareholders involved. Some ROFRs will be detailed and drafted with specific limitations. Others will be contained in a few provisions and remain relatively open-ended. Not surprisingly, much litigation regarding ROFRs has arisen from disputes on whether shareholders have appropriately complied with their obligations under ROFR clauses.

¹ RW Ewasiuk, QC "Shareholder Agreements" in Christine Sanderman & Robin Wilms, eds, *Business Law Fundamentals* (Edmonton, Alta: LESA, 2011) 5-1 at 5-8 & 5-9 [Ewasiuk].

² *Ibid.*

³ *Canadian Long Island Petroleums Ltd et al v Irving Industries (Irving Wire Products Division)*, 1974 CarswellAlta 99 at para 10 (SCC) [*Irving*]; *GATX Corp v Hawker Siddeley Canada Inc.*, 1996 CarswellOnt 1434 at para 36 (Ont Ct J) [*GATX*].

B. Principles of Interpretation

(i) Basic Principles of Contractual Interpretation

In order to determine whether a given ROFR clause has been breached or can be enforced, one must determine the scope of the ROFR. This has been done by applying basic principles of contractual interpretation to the ROFR clause.⁴ As in the interpretation of other contractual provisions, interpreting a ROFR clause involves finding an interpretation that promotes or advances the true intentions of the parties at the time they entered into the contract.⁵ The true intentions of the parties are generally found in the language of the ROFR clause and the "cardinal presumption" that they have intended what they have said.⁶ As stated in *Seven Oaks*, "[w]here there is no ambiguity, a written contract must be given its literal meaning, assuming that a plain and ordinary meaning would not result in inconsistency or repugnancy with other parts of the contract, or an absurd result."⁷

Thus, the plain meaning of the express language used has been the point of focus in the interpretation of ROFRs. It is interesting to note, however, that while the Alberta Court of Queen's Bench has held that "[r]ights of first refusal are restrictions on a shareholder's right to deal freely with his property and so are strictly construed,"⁸ the Alberta Court of Appeal in *IFP Technologies (Canada) Inc. v. EnCana-Midstream and Marketing*⁹ has more recently adopted the Supreme Court of Canada approach established in *Creston Moly Corp v Sattva Capital Corp* that contracts must be interpreted as a whole, in a contextual approach, considering the factual matrix of the dealings between the parties.¹⁰ The purpose for this contextual approach is to determine what the parties would objectively have understood from the words of the document read as a whole and from the surrounding circumstances.¹¹ What background facts will the court consider? Examples include:

⁴ *ADESA Auctions of Canada Corp. v Southern Railway of British Columbia*, 2001 BCSC 1421 at para 26 ("The starting place for the analysis of the claims must be the construction of the document creating or granting the right") [*ADESA*].

⁵ *GATX*, *supra* note 3 at para 38 citing *Consolidated-Bathurst Export Ltd. v. Mutual Boiler & Machinery Insurance Co.* (1979), 112 DLR (3d) 49.

⁶ *Seven Oaks Inn Partnership v Directcash Management Inc.* 2013 SKQB 342, *aff'd* 2014 SKCA 106 at para 51 [*Seven Oaks*].

⁷ *Ibid* at para 50.

⁸ *Zust Bachmeier International Air Cargo Inc. v Klapatiuk*, 2006 ABQB 633 [*Zust*]; *ADESA*, *supra* note 4 at para 26; *Trimac Ltd v C-I-L Inc.*, 1989 CarswellAlta 136 at para 83 [*Trimac*].

⁹ *IFP Technologies (Canada) Inc. v. EnCana Midstream and Marketing*, 2017 ABCA 157, leave to appeal to SCC refused.

¹⁰ *Creston Moly Corp v Sattva Capital Corp*, 2014 SCC 53 at para 50 [*Sattva*].

¹¹ *IFP Technologies*, *supra* note 9, at para. 79.