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 practice. 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 practice, 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 practice I have concluded that shotgun clauses are only resorted to by a party who thinks they can get an