Shareholders' Agreements

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What is a shareholders' agreement?

A shareholders' agreement is an agreement entered into between all or some of the shareholders in a company. It regulates the relationship between the shareholders, the management of the company, ownership of the shares and the protection of the shareholders. They also govern the way in which the company is run.

It may be usual to combine the use of a shareholders' agreement with a specifically drafted set of articles of association for your company.

Shareholders' agreements are often used as a safeguard and to give protection to shareholders, because (amongst other things) they can provide for what happens if 'things go wrong'.

An agreement can provide for many eventualities including the financing of the company, the management of the company, the dividend policy, the procedure to be followed on a transfer of shares, deadlock situations and valuation of the shares.

The absence of a shareholders' agreement opens up the potential for disputes and disagreements between the shareholders. Shareholders' agreements contain provisions that pre-empt disagreements and set out appropriate ways for disputes to be addressed.

Too many times people set up companies with friends and relatives and do not consider protecting their interests in the company until it is too late. The articles of association of the company may not offer a shareholder full protection.

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What different types of shareholders' agreements are there?

Company law is generally suited to the situation where the shareholders in a public company are separate from the board of directors, and comprise a number of holdings where no single shareholder or group of shareholders have control. In such cases the directors, having the necessary expertise, are brought in by the shareholders to manage the business of the company on their behalf. Even if the directors have shares in the company, they are likely to be motivated to act in the best interests of the shareholders as a whole rather than representing the interest of the largest single shareholder.

This is not necessarily the case in private companies. Generally, in small private companies there are usually few shareholders, and the shareholders are often the directors in the company. This is when a shareholders agreement becomes helpful because the minority shareholders, the majority shareholders, and those holding shares equally want to ensure that their rights are protected, usually in ways which are not covered in the articles of association of the company.

Minority or equal shareholdings

A large number of shareholders' agreements are designed to contain provisions intended to protect the minority shareholders (i.e. any person(s) with less than 50% of the issued share capital in the company) or those with equal shareholdings (i.e. 2 shareholders holding 50% each of the shareholding or a company with 3 shareholders who all hold 1/3 of the shares each).

A minority shareholder in a private company is a particularly vulnerable person. This is partly because there tend to be much fewer shareholders in a private company. This means it is more likely that control of the company will be held by one or two persons. There is generally no market for the shares of a private company, and a shareholder who is unhappy at the way a company is being run does not have the option of selling those shares. The concentration of control in one or two shareholders can lead to abuse of power, even where no single shareholder holds a majority.

For example, without a shareholders agreement a shareholder who is also a director could be removed from his position as director, by a mere 50% of the other shareholders voting him out. This gives him very little security, and would leave him with a shareholding in a company in which he no longer has any management rights. See below for an illustrated example:

Newco limited is a company with three shareholders A, B & C (A – 20 shares; B – 35 shares and C – 45 shares). They are all directors of the company. In addition to their salaries, the directors, as shareholders, receive annual dividends.

If A and B in the future no longer wish to deal with C for any reason, or for example, decide unreasonably that they no longer wish to work with him and they want to remove C as a director; they are able to do this. They can do this by passing (as shareholders) an ordinary resolution (a resolution requiring a majority of more than 50%).

Despite C holding the largest shareholding, he cannot prevent the passing of that resolution. C has lost his right to participate in the management of the company. C has no right to require A or B to buy his shares and no one outside the company is likely to be interested in acquiring them from him.

There are now remedies in the Companies Act which attempt to prevent such unfair conduct towards a minority shareholder, but these remedies are not certain and can prove extremely costly. It is far betterto prevent the situation arising in the first place. This is where a minority protection shareholders'agreement and minority protection articles of association could be used.

Majority shareholders' agreements

Shareholders' agreements are not just designed for those shareholders who hold less than 50% of the shares in a company. In many cases such agreements are drafted for the majority shareholder.

The majority shareholder may wish to curb the powers of the directors if he does not have a majority representation at board level, or if he does not take an active part in the running of the business.

In the alternative, the majority shareholder may not want to include any minority protection provisions but may want to be able to ensure that if a buyer for the company comes along he can sell all the shares in the company, forcing the other shareholder(s) to sell their shares. This would stop him being held to ransom by a minority shareholder. He may also wish to consider appropriate non competition and confidentiality covenants and provisions requiring financial input from other shareholders.

The advantages of shareholders' agreements

As has been previously mentioned if a Shareholders agreement does not exist, then any disputes between shareholders/ directors will have to be settled by what is contained within the articles of association.

The articles of association ("the articles") are one of the two constitutional documents of a company. The articles set out the rules as to how a company is run; for example: setting out the division of power between the shareholders and directors and the rights which each will have.

The shareholders' agreement gives a contractual remedy if its terms are broken; whereas articles may prevent the event happening in the first place.

Some of the problems with having no shareholders agreement and just relying on the standard articles of association are as follows:

- there is nothing to prevent a director from being removed by 50% of the shareholders by an ordinary resolution
- in law a company cannot promise to do or not to do certain things. A shareholders agreement could be worded to bind the company
- all major executive decisions by the directors are made by a majority, including decisions to change the nature of the business. Therefore even though they may be a majority shareholder, as a single director they could be outvoted
- even if the articles are made to protect shareholders etc, they can be amended by a 75% majority of the shareholders, in which case they could take any protection away from a minority shareholder in the articles, by passing a special resolution
- it is very difficult to deal with the resolution of any deadlock through the articles

This is why it may well be preferable to have detailed provisions in the shareholders' agreement to cover such issues.

Some of the common issues dealt with by a shareholders' agreement

There are usually provisions which require certain matters to be approved by all the directors/shareholders before being acted upon, for instance, varying the salary of any directors, entering substantial business contracts or commencing legal proceedings.

There is usually a clause stating what the dividend policy of the company should be, and you can consider what percentage of the post tax profits should be paid to the shareholders each year, and provide for when the company doesn't have to pay a dividend i.e. if the company would not then be able to pay its debts. It may also provide for example, if a shareholder ceased to be a director and/or an employee but remained as a shareholder they would want to see a certain percentage of the profits declared as a dividend.

Occasionally a 'tag along' right is included (i.e. the outgoing shareholder can be required to procure that a third party purchaser offers to buy the remaining shareholders' shares on no less favourable terms as he is getting for his shares). Conversely, the minority may be forced to accept such an offer ('drag along' right). A third party purchaser is likely to want to purchase the whole of the shares in the company. This is beneficial for majority shareholders, when ensuring they can leave the company without needing to worry about having to persuade all the other shareholders to sell.

There is usually a clause that has the effect of allowing the company to bring an action against, for example, a misbehaving director – which may not have otherwise been possible if that person was the majority shareholder and controlled the board.

There are usually restrictive covenants on the shareholders which prevents them from competing with the business of the company. Generally, restrictive covenants between shareholders, are more easily enforced than those between employer and employee.

You may wish to have an obligation upon shareholders to provide further funds to the company, if the company requires it and to specify the form in which this funding is to be provided.

A usual provision when any of the shareholders have given a guarantee for the company's liabilities and obligations, is that if those guarantees are called upon to be satisfied, the shareholders will split the cost according to their respective shareholdings.

It is usual to agree who the auditors and bankers, where the registered office and what the accounting reference date of the company should be and that these matters should not be changed unless unanimous agreement is reached.

One of the main issues to consider is what should happen if one shareholder wants to leave the Company. Without any such clause in a shareholders agreement a shareholder who leaves may be able to sell his shares to anyone, leaving the remaining shareholder(s) running a company with someone he does know, or the other shareholders could refuse to allow the shareholder to sell his shares. It is therefore important to have a set route in terms of how shares are to be sold. Firstly, you should decide on whether shares must be offered to the remaining shareholders first. This is common and the most practical option in most cases. This way, if one of the shareholders wishes to leave the company then the other(s) will have the option to purchase the shares from them.

Most agreements provide for the outgoing shareholder to place a value on the shares, which failing agreement on the price, would then be referred to an independent expert (i.e. the auditors) to determine a reasonable value.

The next decision would be whether the remaining shareholder(s) would be bound to buy the shares of the outgoing shareholder? They may not want to, or be able to afford to, in which case you need to decide if they would have a choice or not. Problems may arise in terms of funding the purchase if they are bound to buy and this may not be ideal.

If the shareholder refuses to buy the shares, there can always be a provision that the shares are then offered to the company who must buy them back if there is sufficient cash/bank facilities.

You may also wish to consider whether the shares could be sold to a third party, though this could bring about its own problems. However, this may not be as onerous as having an unhappy shareholder 'locked in' to the company. The shareholders' agreement helps iron out such issues before they arise by setting out a clear structure to the sale or transfer of shares.

If there is no particular way out of the shareholding, or if there is a stalemate between shareholders or directors in any respect, then the shareholders' agreement can provide for what happens if there is a 'deadlock', and this could include the above situation where a shareholder is 'locked in' to the company. An expert would review the situation and advise on a course of action which the shareholders must then follow. Deadlock provisions are important to all agreements in general, but can be even more important when there are only two shareholders holding 50% of the shares each, as in this instance deadlocks may occur more frequently.

You need to consider whether any of the directors are so important to the company that the loss of that person would damage the company's business. In such cases there is the possibility of the company having some form of insurance against this; for example, key man insurance? Would the cost of this insurance be justified in relation to the benefits?

Another extremely important consideration is, what should happen if one of the shareholders dies? A number of undesirable situations could arise if no agreement was in place, for instance:

- The surviving shareholder(s) may wish to purchase the shares of the deceased shareholders but the executors of that person may not wish to sell them
- This leaves open the possibility of the widow/personal representatives having an involvement in the running of the business, or the right to appoint themselves as director, which the surviving shareholder(s) may not appreciate
- The executors of the deceased shareholder's estate may want to sell the shares to the remaining shareholders, but they may not be able to afford it, and then the shares could be sold elsewhere

A common way to avoid such situations is that the shareholders take out a life insurance policy each and enter a 'cross option agreement'. The life insurance policy could then be transferred into separate trusts. If one of the shareholders then died the proceeds of the policy would automatically pass to the surviving shareholder(s). The 'cross option agreement' could then state that the surviving shareholder(s) would have to use the proceeds to purchase the shares from the personal representatives of the deceased shareholder, who in turn would be bound to sell them. This would benefit all parties because the surviving shareholder(s) would then own the shares and the family of the deceased would receive the money. This would also prevent the situation were the surviving shareholder cannot afford to purchase the shares.

The transferability of shares. Should these be at the absolute discretion of the directors or should there be rights for the shareholders to transfer to family members and into say trusts for the benefit of their families. What would be the position on death if you do not have cross option agreements?

You will need to consider at what point the various shareholders are looking to exit the company? You may wish to consider drag-along and tag-along rights. On what terms will the sale be effected; for example, how will the shares be valued?

Checklist of common items to be covered in bespoke shareholders' agreements/articles of association

Company

- Name
- What the business of the company consists of.
- Obtain copies of the most recent articles and memorandum of association
- Amendment to the articles of association required?
- Minimum/maximum number of directors?
- Chairman of the board having a casting vote
- Changing the rights attached to the shares.
- Amendment to the memorandum of association required?
- Alteration to the objects of the company?
- Increase in authorised share capital
- Authorising the directors to allot shares (s.80 Companies Act 1985 (CA))
- Removing pre-emption rights under s89 CA

Shareholders

- Share capital of company (classes, nominal value and authorised / issued amount).
- The names of the shareholders.
- Shareholdings of each shareholder.
- Will all shareholders enter into the shareholders' agreement?
- What happens if a shareholder wants to leave?
    - Does he have to offer his shares to remaining shareholders? Do they have to accept?
    - Does the company have to buy back the shares if other shareholders reject?
    - Can the shares be offered to a third party?
- What happens on the death of a shareholder?
    - Cross options linked to life insurance policies?
    - Shares offered to other shareholders and, if not purchased, estate to be able to transfer them freely?
    - Other options?

Directors

- What are the names, addresses and employment positions (if any) of the directors?
- Do the employed directors have / or require service agreements?
- Entrenched directors? (i.e. as long as a shareholder / particular shareholding have a right to appoint a director)

Shares

Do / will any of the shares in the company have any of the following rights attached (and if so, state which rights apply / you wish to apply in relation to each share):

- Redemption rights (i.e. a right to require the company to purchase the shares, shares with such rights are similar to a loan to the company).
- Voting (e.g. particular weighted voting rights regardless of shareholding).
- Dividend (e.g. a right to receive a (fixed) dividend prior to the other shareholders).

Board Meetings

- Regularity of holding them (who can require one to be held)?
- Quorum (minimum amount of attendees) for meetings generally?
- Saving provision regarding quorum to prevent deadlock?
- Decide on any special matters requiring specific consent (e.g. all directors unanimously agreeing / 75% majority OR matters requiring the consent of all the shareholders (if shareholders are likely to be different from the directors, e.g. directors are their nominees rather than themselves))? These could include:
    - Restrictions on dismissing employees
    - Changing the name of the company
    - Enter into or vary any bank or other overdraft or borrowing facility
    - Enter into any long term or abnormal contract or any contract with any of the shareholders or undertake or assume any liabilities other than those necessary in the ordinary course of business
    - Sell or dispose of the whole or a substantial part of the company or its assets.
    - Dividends: is a dividend policy required whereby a minimum level of profits is declared by dividend, unless agreed unanimously otherwise?
    - Transferability of shares: e.g. without the consent of (all) directors (perhaps with exceptions regarding transfer to spouse or trust for tax purposes)
    - Alteration of articles or memorandum of association or resolutions being passed which would have an effect inconsistent with these documents.
    - Create fixed or floating charge except in the ordinary and proper course of business;
    - Borrowing or making a loan in excess of £[amount to be agreed]
    - Enter into a contract involving expenditure on capital or the realisation of capital assets which will exceed £[amount to be agreed].
    - Engage employees at a level or remuneration exceeding the rate of £[amount to be agreed] per annum
    - Increase the level of remuneration to a rate exceeding £[amount to be agreed]
    - Create or acquire a subsidiary.
    - Does or permits to be done any act or thing whereby the company may be wound up
    - Allotment of new shares, nature of business undertaken, etc, etc, as required
    - Initiate any litigation or arbitration to settle or dispose of a claim brought by or against the company exceeding [£]

General

- Who will be the company's auditors?
- Who is the company Secretary?
- Who are the company's bankers?
- What is the registered office?
- What consents (director and/or member) will be needed to change any of the matters raised in the previous 3 points?

Disclaimer

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