

## **SHAREHOLDERS' AGREEMENTS – AN OVERVIEW**

### **PREFACE**

The purpose of this note is to summarise the issues which a shareholders' agreement can deal with, together with an explanation as to why shareholders typically enter into such agreements.

A shareholders' agreement is a highly valuable means of regulating the relationships between shareholders of a company. A well drafted shareholders' agreement will contain provisions to deal with issues which are not provided for, or not appropriately provided for, by the Company's other constitutional documents or current company law. This agreement is a contract which is typically made between the shareholders of the company as well as the company itself. Unlike the memorandum and articles of association of a company, it is not generally required to be filed at Companies House. It allows shareholders to make private agreements which are, therefore, not in the public forum, and to regulate their affairs in ways which they may not be able to do in the Articles of Association. Shareholders' agreements, between the shareholders, are generally stated to supersede the effect of the Articles of Association. It is therefore advisable for such an agreement to be as comprehensive as possible from the off.

### **KEY ISSUES WHICH CAN BE ADDRESSED**

The following is an overview of the main issues which are typically provided for under a shareholders' agreement:

#### **Company details and board constitution**

1. Basic information required is the name and address of each shareholder, the company bank, the company's accountants, company's year end, and the company's authorised share capital, its issued share capital and number of

shares held by each shareholder together with a description of the business' activities.

2. Shareholders' entitlement to be or to appoint a director in the company, and rotation of these appointments.
3. Whether the company has a chairman, and entitlement to a casting vote if there is an equality of votes at a board meeting.
4. Prohibition on the shareholders dismissing a director.
5. The quorum for directors' and shareholders meetings and any special notice required for the calling of these meetings/how often should board meetings be held.

### **Day to day issues**

6. How often board meetings should be held.
7. Whether each director has a right to hire and fire, and whether there are limits on e.g. hiring a senior employee.
8. What time a shareholder is expected to contribute to the business.
9. Who the company's accountants and bankers should be.
10. What decisions require unanimity, and what require a simple majority.

### **Dividends and Funding**

11. What payments are to be received from the company – are these dividends only, can they include salaries and directors' fees, and if so do all directors receive equal directors' fees, fees in relation to their shareholdings, or no fees at all i.e. only payment for employment, and payment of dividends.
12. Shareholders' requirements to provide the funding for the company and if applicable what amount of funding is each shareholder committed to provide, when and how? It is important that the Shareholders Agreement clearly specifies these and further ensure that these commitments are made to the other shareholders and not the company itself. This avoids the situation whereby a liquidator could compel a shareholder to contribute funds to an insolvent company. The agreement may provide default provisions applicable where a shareholder fails to meet his financial commitments to the company. These may include; payments of default interest, loss of voting rights or other

rights as a director/and or shareholder and reduction (and possibly compulsory sale to the other shareholders) of the defaulting shareholder's shareholding.

13. Shareholders' obligations to act as guarantors on any finance taken out by the company, if a bank requires guarantees, and if so is this equally or in proportion to shareholdings?

### **Minority Protection**

14. Matters in relation to board resolutions can only be passed by a unanimous resolution of all of the directors. Examples might involve acquiring another business, altering Memorandum and Articles of Association, acquiring or disposing of assets, altering the share capital of the company, or offering further shares, agree business plans, declare a dividend or employ anybody.

### **Restrictive Covenants**

15. Do the shareholders wish to have a provision whereby any one of them (or all of them) are subject to restrictions to protect the company's legitimate business interests? The restrictions might involve restrictions against poaching staff, approaching customers after leaving, or working for competitors. If so, the restrictions will need to be reasonable in terms of time periods and distance.

### **Transfer of Shares**

16. Provisions dealing with where a shareholder wishes to transfer any of his/her shares. A first option is typically given either to the company or to the other shareholders to acquire those shares on a particular valuation basis. The valuation basis can be set out, and may either be a valuation determined by the company's accountants, or according to a set formula such as a multiple of gross profits.
17. A shareholders' agreement can contain provisions whereby an individual leaving the company is obliged to offer his shares up to the company or to the existing shareholders. Again these shares will be offered up on a particular valuation basis, and this may depend upon the circumstances in which the individual is leaving. Some shareholders' agreements provide for a "bad

leaver" provision if, for instance, a shareholder/employee has been in breach of the terms of his employment contract.

18. In terms of valuation of shares, shareholders need to agree whether the valuation is affected by shares being a minority shareholding, i.e. if they are a minority they might be less valuable than a majority stake.
19. A shareholders' agreement can contain drag along rights and tag along rights. These provide that if the majority agree a sale of the shares in the company, they can oblige minority shareholders to sell at the same time and on the same terms; and tag along rights allow minority shareholders to require that their shares are bought at the same time as those of a majority are bought.
20. Shareholders' agreements should provide for options on death, known as put and call options, either for the other shareholders to have a right to acquire the shares of the deceased, or for the personal representatives of the deceased to require the existing shareholders to buy the deceased's shares. This prevents shares being passed to unknown parties; and by stating this to be an option rather than an immediate right, prevents an immediate inheritance tax liability arising.
21. Shareholders' agreements can provide that shareholders maintain life insurance policies for the benefit of the other shareholders to provide the funds by which his/her shares can be acquired on death, and in that case the details of the policy need to be provided.

### **Deadlock**

22. If there or there could be an even number of shareholders, a shareholders' agreement can provide a mechanism to apply in the case of the deadlock – either that there is an escalation mechanism where each party bids against the other to acquire the other's shares after warning the other, or that the company be wound up if there is a deadlock.

### **CONCLUSION**

This guide is a brief indication of the provisions which can be included in a shareholders agreement. It is by no means exhaustive and because a shareholders' agreement is not a formal statutory document it is open to the shareholders to insert

any other provisions which they feel appropriate. It is a document that is only relevant to the shareholders' circumstance and not be common to other circumstances. It is important that parties to a shareholders agreement clearly understand the legal implications of the relationship they are creating and the structure that is being put in place and where necessary take specific legal advice.