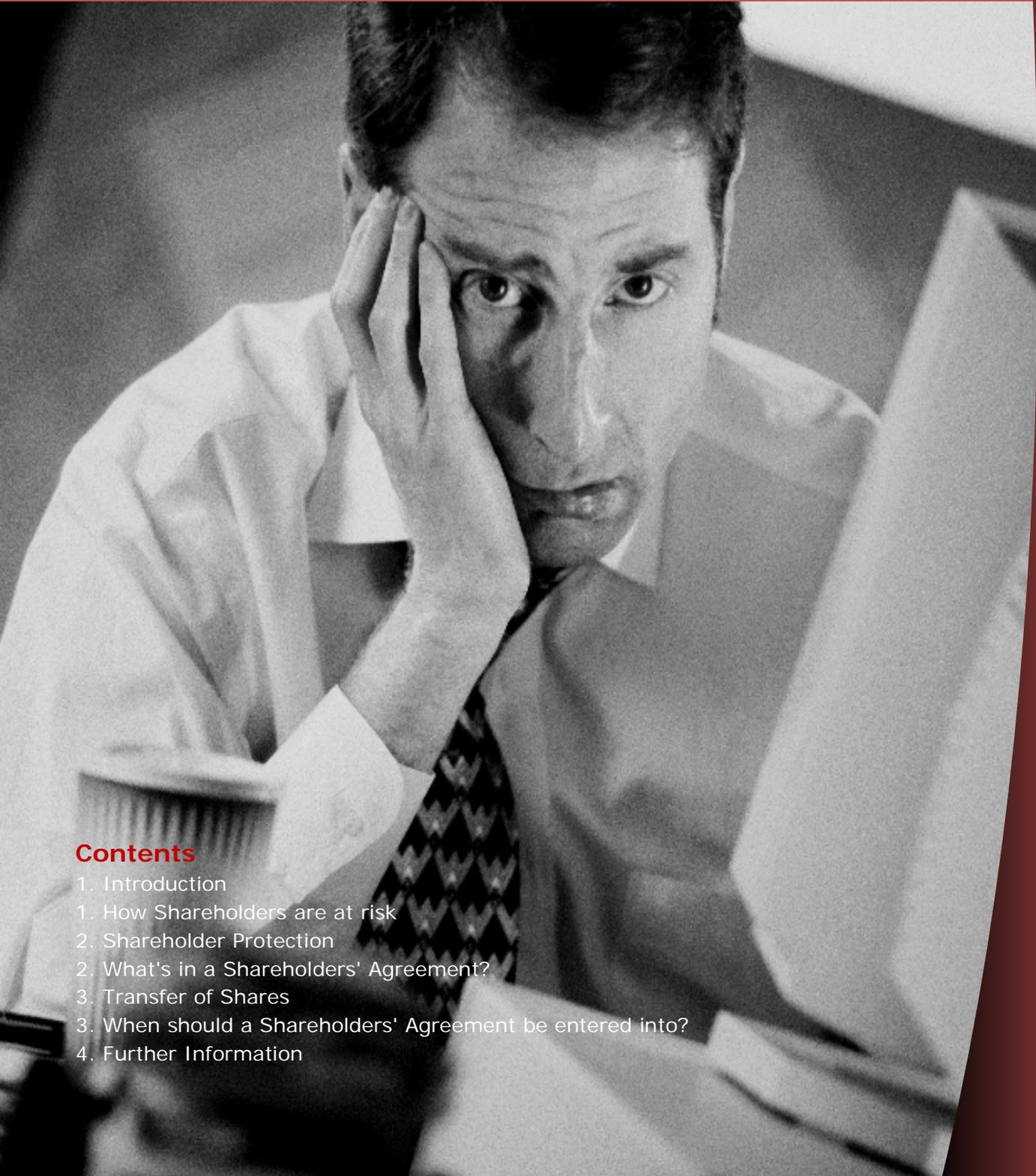


# The Facts on Shareholders' Agreements

- You should hope for the best, but plan for the worst

*Expert knowledge means success*



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**Note:** This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

## Introduction

When companies are set up, it's rarely for them to have only one shareholder - although the concept of a single-member private corporation is now allowed under UK law. This publication relates to shares in a private company (not a public company) and is intended for anyone who:

- owns shares in a private company;
- is thinking about buying shares in a private company;
- is thinking about selling some of their shares in a private company, or
- is about to set up a private company with other shareholders.

When people go into business in partnership, it's advisable to have a Partnership Agreement to govern how the relationship between the Partners is to work and how to deal with partnership assets when a partner dies or wishes to leave the partnership. If there is no written agreement, the 1890 Partnership Act provides the rules and regulations that have to apply.

But the Partnership Act doesn't apply to companies. This means that if there are two or more shareholders in a company, it is advisable to set up an agreement between them - called a "Shareholders' Agreement".

Usually, a shareholders agreement contains rights and obligations of each party, such as:

- amount and terms of investment - particularly important for investors who don't work in the company;
- dividend policy - to ensure that appropriate dividend payments are made even though voting power might otherwise prevent any dividend being paid at all;
- composition of the board of directors - to ensure, for example, that appointments are made at arm's length;
- reporting - ensuring that timely management reports, monthly accounts, annual budgets are made available to the shareholders;
- liquidity (exit) plans;
- warranties - to convince new investors that the facts presented to them are right; and

- matters requiring investor's approval - such as appointment of auditors, employment contracts, major asset purchases, major debt obligations and significant variations of plans).

The objective of a Shareholders' Agreement is to clarify the relationship and protect the interest of each party (shareholder) in the company. Obviously, the cooperation of all the shareholders is crucial to the success of a company. Whilst the responsibility to make decisions for a company rests with its directors, a shareholder may rightly require that some decision-making powers be removed from the discretion of the directors and be given to all of the shareholders.

Two books on the subject may be worth reviewing:

- Shareholders' Agreements in Practice, by Chris Ryan, Katherine Reece Thomas, published by Butterworths Law, ISBN: 040698252X.
- Shareholders Agreements, by Graham Stedman, published by Sweet and Maxwell, ISBN: 0752003860.



## How Shareholders are at risk

Situations will almost always arise that the shareholders never contemplated. For example, if the company needs more capital, there may be disagreement about how the additional capital will be raised. Some shareholders may demand a right of first refusal if another shareholder wants to sell his/her shares to a third unknown party. If the shareholders get into a disagreement, and there is no written Shareholders' Agreement, it may be extremely difficult if not impossible to require another shareholder to sell his/her shares.

Shareholders can enjoy the profits of a company through receiving dividends without having to do any work. As such, the success of your business may be in jeopardy when disagreements or unexpected events occur which cannot be resolved. If you do not adequately protect yourself, you may discover that your fellow shareholders have a different philosophy than you with respect to the business. Unless you have a written Shareholders' Agreement in place, it will be very difficult and very expensive to resolve any disagreements that arise among shareholders.

## Shareholder Protection

A Shareholders' Agreement is distinct from the company's constitution enshrined in its Memorandum and Articles of Association. Without a Shareholder's Agreement, the company would be controlled solely by the exercise of shareholding or directorship rights through its constitution, which are generally insufficient to govern and control the business activities, as opposed to administration of the Company as a legal entity. The potential for disputes between the shareholders or other events to detrimentally affect the performance of the company is increased where there are no mechanisms in place to govern potential business activities and management of the company.

You should hope for the best, but plan for the worst. If you are conducting business using a company, a Shareholders' Agreement should be prepared and signed by all the shareholders to help protect your interest as a shareholder and thereby help ensure the success of your business. It's also very desirable that the company itself is a party to this agreement.

A Shareholders' Agreement sets out the rights and obligations of shareholders of a company, and commonly covers matters governing the management and structure, initial and continued funding, administration, and business activities of the company.

As part of the process of establishing a business, acquiring an interest in a business, or admitting another party into an existing business, the new and (if any) existing shareholder(s) in the company should seriously consider a Shareholders' Agreement, because it:

- is a significant and very helpful document in setting up a business, or in acquisitions of partial interests in businesses;
- it provides a mechanism for setting out the principles upon which the shareholders intend to run the business and deal with unforeseen circumstances and contingencies.

If there is a dispute or uncertainty on how to proceed in a particular situation, the shareholders can refer to the Shareholders' Agreement for guidance. In the event that the agreement doesn't cover the circumstance and the situation can't be resolved by the

shareholders, an arbitration clause can be inserted in the agreement that requires the dispute to be referred to an independent third party.

## What's in a Shareholders' Agreement?

Your Shareholders' Agreement should describe the duties and responsibilities of the shareholders, methods of making shareholder decisions, and ownership of shares. In addition to any specific wishes of the shareholders, your shareholders' agreement will also include:

- Date of the agreement
- The parties (shareholders and others, including the company itself)
- Definitions (to clarify terms)
- Recitals including purpose and background information
- Business and affairs of the company
- The company structure - including the composition and rights of the different classes of share capital of the company, and its internal rules.
- The appointment of directors - the power of each shareholder to appoint a director or directors, and the authority of such directors when making decisions. May also cover situations where additional directors are appointed in the event of additional shares in the company being issued to third parties.
- Management of the company - the appointment of the company management (eg director, managing director), and requirements on the company management to prepare financial and management reports for the shareholders (eg monthly financial statements to be prepared in accordance with generally accepted accounting principles applicable at the time).
- Shareholding restrictions and the transfer of shares - this may include a provision that, if one shareholder dies or wishes to sell its shares in the company, the other shareholder has the first option, on certain terms, to purchase the shares. Other provisions may include prohibitions on transfers of shares or interests in shares except in certain circumstances, the procedure for the transfer of shares and the procedure for calculating a fair value for the shares.

- Adding new parties to the Shareholders' Agreement, and additional shareholders - usually achieved by what's called a Deed of Adherence.
- Restrictions on the activities of the company (eg "major activities" involving substantial amounts, or affecting the nature or structure of the company) unless such activities have the unanimous approval of the directors of the company.
- Dividends and the provision of additional funding by the shareholders - the methods and the proportions in which the shareholders will provide funds to maintain the company, the amount of the profits to be allocated as dividends each year, and a procedure for resolving disputes that arise in respect of these matters.
- The rights of shareholders and directors - including shareholders' access to records, and any variations or additions to the statutory powers, rights and duties of shareholders and directors.
- Dispute Resolution: For example, a provision dealing with the resolution of disputes involving matters which could lead to substantial injury to the company as a going concern, and which seem incapable of satisfactory long-term resolution by mediation or negotiation. Such a provision could expressly include disputes such as disagreements over Company financing, dividends, or the management and direction of the Company, and would provide a mechanism for resolving such disputes.
- Non-competition provisions - preventing shareholders from setting up a business in competition to the company within a prescribed time period and geographical distance from the company.
- Confidentiality - including provisions relating to the exposure of company documents both during the period of the Shareholder Agreement and following the termination of the Agreement.
- Duties of the shareholders with regard to the company and each other in the event of the company being liquidated.
- Ownership and transfer of shares - pre-emption, right of first refusal etc.
- Retirement, divorce, bankruptcy, incompetency, or death of a shareholder.
- Insurance (including Key-man cover).
- Arbitration provisions.

## Transfer of Shares

A Shareholders' Agreement should specify what will happen in the event of the death or disability of one of the shareholders. As well as providing for a smooth transition of the business, such agreements generally establish a purchaser for the shares of the deceased, a formula for determining the purchase price of the shares, and a method for funding the purchase. With proper tax planning, the buy-out can be arranged to minimize the cash flow drain to the company and to the survivors, and to minimize or defer the tax liability of the estate.

Life insurance is generally the most efficient means of funding a buy-sell agreement or share repurchase on the death of a shareholder - check with us for help in developing a plan that is appropriate for your situation.

## When should a Shareholders' Agreement be entered into?

Shareholders should enter into a Shareholders' Agreement as soon as possible either immediately before or after an investment is made. If you wait until a disagreement arises, it's likely to be too late to get the disputing shareholders to agree. Shareholders' Agreements are commonly used in two scenarios:

### A Joint venture between two or more persons- where the parties to the venture agree to set up a Joint-venture Company or partnership

The Shareholders' Agreement (commonly called a "Joint Venture Agreement" in this circumstance) provides a supervening (additional) set of rights and obligations, independent of the joint venture company's constitution (if a joint venture company is used). The Shareholders' Agreement sets out those rights and obligations (and any other details) that are inappropriate for inclusion in the constitution, or that the parties wish to remain confidential. The confidentiality arises because the Shareholders' Agreement, unlike the Constitution, doesn't have to be filed at Companies House and consequently is not available for public inspection.

## A Company with several or numerous shareholders

The Shareholders' Agreement sets out the shareholder's rights and obligations in relation to the company, and is essential to govern the management of the company, and to protect the interests of all the shareholders in the event of changing circumstances. For example, if all the shareholders of the company are also directors of the company and one of the shareholders decides to resign from their position as director, but remain as a shareholder - that person would still be able to enjoy the benefits of the remaining directors' efforts in managing the company, without the need to assume the risks and potential liabilities facing directors under present company law. The Shareholders' Agreement could require that, if a shareholder wished to relinquish their position and resign as a director, then that shareholder would be obliged to offer their shares to the other remaining shareholders.

A Shareholders' Agreement is particularly useful in situations where a company has no majority shareholding, because of the correspondingly high potential for the company to be adversely affected by disagreements between shareholders. The Shareholders' Agreement could specify the management structure of the company, and provide a dispute resolution mechanism for resolving disagreements between shareholders.

Therefore, a Shareholders' Agreement is a valuable tool for providing a procedural framework to govern the internal management of a company or joint venture. Such an Agreement is essential where there is no clear majority shareholding in a company, to ensure the efficient management of the company and to minimise the potential for management disputes to detrimentally affect the company.

Because a Shareholders' Agreement has the additional advantage of not being available to

the public, unlike the company's constitution, sensitive details regarding the role of the parties in company management, the rights and obligations of the parties or rights attaching to shares may be set out in the Shareholders' Agreement.

For the reasons set out above we consider that a Shareholders' Agreement is an important element in establishing, at the outset of a business arrangement, a sound operating platform to enable the future success of the business venture.

## Further Information

In order to protect the legal interests of the other shareholders, each shareholder should seek and obtain separate legal advice.

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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