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Companies: Considering a Shareholders' Agreement

What is a shareholders' agreement?

A shareholders' agreement is a contract between the shareholders of a company in which the shareholders agree their rights and obligations.

It is easy to assume that nothing will go wrong in the future, and that you and the other shareholders will be able to resolve any differences if and when they arise. However, even close friends and family members can fall out and the company suffers as a result.

Without the right legal structure to rely on, if you fall out, you could end up with little or nothing to show for the time and money you have invested in the company. Even worse, you could end up with a costly legal dispute.

Every company has Articles of Association, but these are normally basic and very seldom offer a shareholder adequate protection.

How can a shareholders' agreement help?

A well drafted shareholders agreement can help prevent disputes from arising and, in the event that they do arise, can help provide a swift resolution.

Shareholders that leave

There is no implied right for the existing shareholders to be able to buy the shares of a shareholder that leaves the company and there are often no restrictions on to whom the shares can be sold. The agreement can include provisions preventing sale for agreed periods of time or requiring any employee shareholders who cease to be employed by the company to offer their shares for sale to the remaining shareholders. Of course, the provisions of the company's memorandum & articles of association must at all times, be adhered to.

Dispute resolution

Agreements may contain a mechanism for resolving disputes, such as referral to a third party expert or arbitrator, or a buy-out mechanism whereby one shareholder (or a group of shareholders) buys the shares of the other at a price determined in accordance with the agreement.

Rights of veto

Shareholders who are not directors may want to have the right to veto important decisions about the company and its business. Without a vote on the board or a shareholders agreement, they may have little or no say.

The shareholders agreement can provide that certain fundamental decisions, whether or not they would ordinarily be taken by the directors or the shareholders, cannot be made unless all shareholders, or a specified majority of shareholders, agree to them.

Non-compete provisions

A departing shareholder could use the knowledge, experience, and contacts they have acquired from the company to set up a competing business and take the company's best customers and employees.

To guard against this, a shareholders agreement can restrict departing shareholders from setting up in competition with the company and poaching customers and employees for a period of time after they have ceased to hold shares in the company (and whilst they hold shares).

Avoiding deadlock

Where a company is owned and jointly managed by any even number of individuals, there is a risk that the company can be deadlocked, and it cannot move forward. These scenarios are one of the most common causes of expensive litigation.

A shareholders agreement can include deadlock resolution provisions to resolve a deadlock quickly and effectively.

Defining the exit strategy

Buyers of private companies usually want to acquire all of the shares (and not just, say, 85 per cent). However, some of the shareholders may not wish to sell.

Shareholders agreements commonly include "drag along rights" entitling a majority shareholder to compel the minority to sell their shares as part of a sale. In addition, minority shareholders often have "tag along" rights which enable them to require that a new buyer also buy their shares, to prevent them being left behind with the new buyer.

In the event of death

Another extremely important consideration is what should happen if one of the shareholders dies? A number of undesirable situations could arise if no agreement is in place. For example, the surviving shareholders may wish to purchase the shares of a deceased shareholder, but the executors of that person may not wish to sell them. This leaves open the possibility of the deceased shareholder's spouse or personal representatives getting involved in the running of the business. Alternatively, the executors of the deceased shareholder's estate may want to sell the shares to the remaining shareholders, but the remaining shareholders may not be able to afford them.

Setting out the company's business plan

A shareholders agreement can include provisions for the adoption of a business plan for the company, containing inter alia, the obligations of shareholders for additional funding, the nature of the business of the company, the territory of its activities etc.

Benefits

Companies which have more than one shareholder would therefore be advised to put in place a shareholders agreement to provide the members, directors, and the company a clear guidance as to what will happen in certain circumstances.

- The ability to reduce the amount of potential conflict between shareholders. Disputes are hugely distracting, and ultimately can affect the company and its viability. The agreement will provide a clear mechanism for the resolution of the disputes either through the transfer of shares or dispute resolution provisions for example in the event of a deadlock. This in turn assists with helping the company to be run smoothly and profitably.

- It provides greater protection to shareholders over and above the standard articles of association both in terms of how the company is run, decision making, minority shareholder and majority shareholder rights.
- The content of the agreement is private between the parties i.e. it is not placed on a public register such as the Registrar of Companies, unlike the articles of association.
- The shareholders agreement can also detail any protections for minority shareholders and indeed provisions to aid majority shareholders in particular if an offer for the company is made.
- Finally, it can help attract investment into the business. Investors will be encouraged by the clarity that such agreements can provide.

For more information on how your company might benefit from a shareholders agreement, or to update your current agreement, connect with us.

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