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Shareholders' Agreements

Introduction

This article covers what issues you should consider and what the steps you will need to take to draw up a Shareholders' Agreement.

First some definitions.

A "Shareholder" is any person, company or other institution that owns at least one Share of a company's Shares.

"Shares" represent ownership of a company and each Share represents a vote in the company. Shares may also carry the right to be paid a dividend and allow the individual shareholder to benefit from the sale of the company.

A "Shareholders' Agreement" is an arrangement among a company's Shareholders describing how the company should be operated and the Shareholders' rights and obligations. It also includes information on the regulation of the Shareholders' relationship with each other, the management of the company, ownership of Shares and the obligations and protections of Shareholders.

A properly drafted Shareholders' Agreement should ensure that all Shareholders are treated fairly and that their rights are protected and will govern how the company is run.

Why have a Shareholders' Agreement?

When a new company is first incorporated, the initial Shareholders set rules about how the company is to be run by way of the "Memorandum and Articles of Association", a legal statement signed by all initial Shareholders confirming that they agree to form the company and establishing some initial rules.

However, Memorandum and Articles of Association documents (hereafter called the "Articles") are very generic in nature and are rarely altered or even discussed much by the initial Shareholders and whilst they do indeed offer some protection to the Shareholders, a Shareholders' Agreement allows many more control mechanisms to be put in place, and any conditions put into a Shareholders' Agreement will override anything contradictory in the Articles.

Below is a non-exhaustive list of some reasons why you should put in place a Shareholders' Agreement rather than just rely on the standard Articles already in place:

1. Confidentiality: The Articles are a public document whereas a Shareholders' Agreement is a private document and is therefore a much more suitable vehicle to address sensitive or internal company issues such as salaries and ownership structures.
2. Scope: The Articles provide only basic rights to Shareholders under the relevant company's law in the respective jurisdiction whereas a Shareholders' Agreement will be tailored to the needs of the Shareholders to address their unique situation.
3. Minority Interests: Minority interests, i.e. Shareholder(s) holding less than 50% of the company's shares, are not well protected under the Articles but under a Shareholders' Agreement they can receive proper protection and can still take an active role in the decision making process of that company. A Shareholders' Agreement can also bolster the rights of minority Shareholders to offer them pre-emption rights on the transfer and issue of new shares so as to ensure their shareholding is not diluted.
4. Better Binding Effect: The Articles can only bind a Shareholder in his/her capacity as a Shareholder and they may also be amended by the passing of a Special Resolution which could disadvantage a minority Shareholder. By contrast, a Shareholders' Agreement is subject to all the usual principals of contract law and cannot be amended unless agreed between all the Shareholders.
5. Finance: The Articles do not address how the company will be financed outside of the initial

share capital that the Shareholders inject into the company when they subscribe for their initial shares. A Shareholders' Agreement on the other hand provides for future financing such as loans from the Shareholders or Directors of the company, or from third party debt such as a bank loan, or from the issues of new sales to existing or new Shareholders.

6. Transfer of Shares: The transfer of shares can generally be vetoed by the Directors of the company; however terms can be added to a Shareholders' Agreement to regulate when and how shares can be transferred and at a which price.

7. Tag-along and Drag-along rights: A Shareholders' Agreement can provide for "tag along rights" meaning that if the majority Shareholder sells his/her shares in the company, the minority holders have the right to join the deal and sell their shares at the same terms and conditions as would apply to the majority Shareholder. Note also however that a Shareholders' Agreement can also provide for "drag along rights" that enable a majority Shareholder to force a minority Shareholder to join in the sale of a company at the same price, terms, and conditions as the majority Shareholder.

8. Dividends: Under the Articles there is no need for a company to pay dividends unless the Board of Directors authorises it whereas a Shareholders' Agreement could record a dividend policy such as paying out of all profits of the company to the Shareholders in the proportion of their shareholdings subject to the company retaining enough cash to operate the business for six months.

9. Dispute Resolution: The Shareholders' Agreement records the intentions and understanding of all the parties involved at the outset and even where a dispute does still arise, a Shareholders' Agreement can set out certain steps to make sure it is resolved as quickly as possible and in the most cost efficient manner, for instance by way of binding arbitration.

Identify the interests of the Shareholders

Shareholders invest in companies for a variety reasons and you should identify the interests of each party before drafting the Shareholders' Agreement. These might include:

- To benefit financially from the value of the company increasing
- To benefit financially from on-going employment as a Director by way of salary and bonus
- To benefit financially from receiving dividends
- To influence business strategy and direction and to have the challenge of owning and operating a business

Clearly an investor in the business whose involvement is limited to providing capital to the company, but who will have no day-to-day involvement (known as a "silent partner") will have very different expectations than a Shareholder who is quitting their established job to set up the new company.

The purpose of the Shareholders' Agreement is to therefore restrict the freedom of action of the Directors and the Shareholders in order to protect the rights of all so identifying the interests of all parties is crucial.

Identify Shareholder Value

Different Shareholders will bring different skills and attributes to the company.

One Shareholder could bring funding but not want to have any involvement with the day-to-day running of the company.

One Shareholder could bring little funding but could bring all the skills required to manage the day-to-day operations of the company.

One Shareholder could bring little funding but could have the ability to create some significant value in the company such as designing its website or its technology backbone.

One Shareholder could bring no funding but could bring a valuable patent or other intellectual property to the company.

There is also the concept of "sweat equity" which is where a Shareholder is given some or all of their shares for free or at a discount in return for their working for the company for free or at a discount to their usual salary. It is the preferred mode of building equity for cash-strapped entrepreneurs in their start-up ventures since they may be unable to contribute much financial capital to the company.

Clearly the more each Shareholder brings to the table, vis-à-vis each other, will denote the proportion of the company that they should be entitled and this is a discussion, often a difficult one, that all the Shareholders need to have with each other.

Identify who will make decisions - Shareholders or Directors?

Shareholders can be as active or passive in the running of the business as they like but they need to set clear boundaries with each other and the Directors as clarity of decision making is crucial.

Conflicts of interest can occur when a person who is both a Director and a Shareholder makes an operational decision that benefits him or her, but not all Shareholders. It is often difficult to ascertain whether he/she was acting as a Director (with a fiduciary duty of care to the company and to all Shareholders) or as a Shareholder (and therefore not accountable to his/her fellow Shareholders). A Shareholders' Agreement should therefore set out the decisions that Directors and Shareholders may and may not make without agreement from other Directors and Shareholders.

Decide how the voting power of Shareholders should add up

Traditionally, one share "buys" one vote. The Shareholder who has more than 50% of the shares can make decisions and controls the company although for some decisions, holders of more than 75% of the shares must agree. However, this isn't always what the Shareholders want, sometimes it can be beneficial for everyone to have an equal say and sometimes it can be beneficial to give a greater say proportionately to someone who has contributed more.

The Shareholders' Agreement needs to set out what is a "majority" in the context of needing consent. Voting rights can be set in relation to the number of Shareholders irrespective of their actual Shareholdings (so for example 3 of 4 Shareholders need to agree) or can be set in relation to the shares the Shareholders hold proportionally to each other (so for example Shareholders holding at least 50% of the shares need to agree).

Decide on the issues that the Shareholders' Agreement should cover

Below is a non-exhaustive list of some of issues that are commonly addressed in Shareholders' Agreements:

- How are the shares divided amongst the Shareholders?
- How much capital did each Shareholder inject into the company?
- Did any Shareholder inject "sweat equity" and if so, how is that valued?
- Is a "capitalisation table" or "cap table" needed? This is a table providing an analysis of the founding Shareholders' and initial investors' percentage of ownership, equity dilution, and value of equity in each round of future investment.
- Are there vesting provisions, i.e. shares that may be subject to cancellation if a Shareholder or employee quits?
- Are Shareholders allowed to pledge or hypothecate their shares, i.e. use their shares as a security for

one of their financial obligation without transferring or delivering title or possession of the shares?

• What is the nature of the company's business and what are the commercial objectives of the company? Can these change and if so how?

• Do the Shareholders agree that the company is the sole commercial vehicle for doing the company business?

• Do the Shareholders agree not to work for other companies that compete with the company for so long as they are Shareholders?

• What restrictive covenants should the Shareholders be subject to after ceasing to be Shareholders in the company such as engaging in a competing business, soliciting clients and employees etc.?

• Does a Shareholder have to do anything else for the company such as perform any services, if so under what terms?

• What are Shareholders' rights in respect of access to information, financial statements, reports, etc.?

• How are disputes to be resolved among Shareholders? Will there be binding arbitration or some other mechanism?

• How will the company be funded outside of the initial capitalisation? Where will the working capital come from?

• Are there any financial obligations on the Shareholders such as bank guarantees?

• What, if any, are the terms regulating the raising of capital to avoid diluting existing shareholdings?

• Who is on the Board of Directors of the company? A Board of Directors is a body of elected or appointed members who jointly oversee the activities of a company or organisation.

• Are outside Board Members allowed?

• Who is appointed the Managing Director?

• What are the rights to appoint and remove Directors?

• Who are the officers and managers of the company?

• How are compensation issues such as the remuneration of Directors and other staff managed?

• What are the operating guidelines or restrictions form such matters as budget approvals, banking spending limits, borrowing lending limits etc.?

• What rights does the Managing Director have to run the company? Will he/she be responsible for the overall management of the company or does it have to be following an agreed business plan, and if so, agreed by who, all Shareholders, a majority of the Shareholders etc.?

• Are there certain acts that require the agreement of the Shareholders before the company does them such as borrow any money from a third party, or commit to or incur capital expenditure in excess of a certain amount, or appoint a Director or increase the salary of a Director, or take any step to dissolve or liquidate the company, and if so agreed by who, all Shareholders, a majority of Shareholders etc., i.e. what types of decisions require unanimous Board of Directors approval and/or unanimous Shareholder approval?

• Are other agreements required as well such as Employment Agreements, Confidentiality Agreements, and Intellectual Property Licensing Agreements etc.?

- What constitutes a quorum for meetings of the Board of Directors, i.e. how many Directors are required to make a decision that will be considered binding on the company?
- What is the company's dividend policy?
- What is the exit strategy of the company and how is that covered in the Shareholders' Agreement? Options could include:
  - Sale of the company either in one lump sum or by way of an "earn-out" structure whereby the sellers must "earn" part of the purchase price based on the performance of the business following the acquisition. In an earn-out, part of the purchase price is paid based on the target company achieving certain financial goals over a specified period;
  - Management buyout whereby a company's existing managers acquire a large part or all of the company, often using money provided by a third party such as a private equity firm;
  - A sale of the business out of the company;
  - A sale whereby some Shareholders buy the others out;
  - A public placing of shares by way of an Initial Public Offering;
  - The assets are sold and the company wound up.
- What are the restrictions on new equity issues, e.g. anti-dilution aspects and pre-emptive rights?
- Are there drag-along and tag-along provisions?
- How will the transfer of shares be handled?
  - Can Shareholders offer their shares to third parties?
  - Can Shareholders only offer their shares to each other and if so at which price and in which proportion, the same as their existing shareholding or something else?
  - If a share value cannot be agreed is there a formula to fall back upon to value the company and therefore the shares? Is there a mechanism to refer to a 3rd party such as the company auditor?
  - What are the circumstances in which shares will automatically be transferred, e.g. if a Shareholder leaves the business or joins a competitor?
  - If there are Shareholders' loans, how would these be dealt with if the Shareholder leaves?
  - What happens to the shares of a deceased Shareholder?
- What provisions are in place in case of deadlock between the Shareholders? One option is a so called "shotgun" clause where the Shareholder declaring the deadlock could be required to make an offer to buy out the shares of the other Shareholder and that Shareholder can either choose to accept the offer and sell, or alternatively must choose to buy out the first Shareholder at that same price thereby putting the onus on the initial Shareholder to make a sensible offer.
- One further alternative is to allow that in case of deadlock, the Shareholders demand that the company is wound up or sold at any time which is a drastic measure but would form the backdrop to negotiations.
- What is the liability exposure of the company and is there any corporate indemnification and/or insurance?

Some Do's & Don'ts

- **Don't** confuse Shareholders' issues with management issues.
- **Don't** confuse return on capital with return on labor (i.e. cash investment vs founders' time commitment).
- **Don't** assume that everyone will always be agreeable, you all are in it together now but things can change over time, especially when the company has some value, agree the exit strategy now!
- **Do** make sure everyone's objectives and visions are compatible.
- **Do** separate the roles of Shareholders, Directors and Managers.
- **Do** use a qualified lawyer to draft the Shareholders' Agreement.
- **Do** take tax advice.

Questions to Ask

When reviewing a Shareholders' Agreement, it is a good idea to ask a few key questions to ensure that you are getting what you are expecting from the deal. Ask yourself?

1. Am I happy with my ownership stake? Am I being fairly rewarded for my contributions?
2. If I am the key founder, am I treating others fairly?
3. Can I get out of this deal if I need to, i.e. can I sell my shares?
4. Can I buy more shares and gain more control if I'd like to?
5. Am I going to be able to live up to my obligations?
6. Will I be able to exert sufficient influence to protect my investment?
7. Are their mechanisms in place in case of deadlock?
8. Is my exit strategy covered?
9. What is my total financial exposure and legal liability (present and future) on this deal?
10. What is my future upside on this deal? Do the rewards outweigh the risks?

Contact Us

For further information and advice, please contact us for a complimentary legal enquiry with our specialist senior commercial solicitor.

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