fact sheet

Do I need a Shareholders' Agreement and, if yes, what should it cover?

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Preliminary

A question frequently asked by people going into business for the first time or bringing in new shareholders is "Should we have a Shareholders' Agreement?".

This Fact Sheet covers the key issues to be considered in answering this question.

The first question: should I retain 100% ownership?

This decision should not be taken lightly. Shared ownership, particularly of an owner-managed or family business, will complicate the relationships between people. Before taking this step the implications (e.g. remuneration, dividend policy, rules on departure etc) will need to be carefully thought through.

The prospective shareholder may be an employee and becoming a shareholder may increase that person's motivation and help grow the company. On the other hand the prospective shareholder may bring vital investment capital.

An institutional investor will almost invariably require a Shareholders' Agreement giving it additional rights to those generally enjoyed by a minority shareholder. It will also carefully structure its investment, for example, via loans which may be secured or convertible into ordinary (sometimes called equity) share capital. It may also choose to invest in preference share capital. In addition the ordinary shares it acquires will often be of a different class to those held by the management and those shares will generally carry special rights.

This Fact Sheet is concerned principally with the issues facing companies which do not have institutional investors. However, many of the points raised will be relevant to owner-managers considering taking in institutional investment capital and for business angels looking to make an investment, perhaps for the first time.

Reading these notes will show you that there are many aspects that could be covered by a Shareholders' Agreement, or outside one. As these notes conclude "provided the budget allows it, the services of an experienced corporate lawyer may be money well spent."

Either way, at the very least these notes should highlight for you the main issues and choices, and explain some of the terms the lawyer will use. They should help you decide whether you need a Shareholder's Agreement at all, and if not what aspects you should still cover.

I am/will be a controlling shareholder: Do I need the protection of a Shareholders' Agreement?

A controlling shareholder is someone who holds more than 50% of the voting shares: a Shareholders' Agreement is rarely a protection that a controlling shareholder will need.

Such a person has a fundamental power in relation to a company: the power to hire and fire the Directors of the company. Since it is the Directors who are responsible for the management of the business this gives the person (or persons) who hold 50.1% of the votes the ability to control the company. So if, in the opinion of the 50.1% controlling shareholders, the Directors are *not performing*, the Director(s) concerned can be removed.

The removal of a Director may not be risk free: employment claims may arise and there may occasionally be shareholder claims (e.g. in a quasi-partnership company) that to do so would be unfairly prejudicial. However, the ability to appoint and remove Directors is a very powerful right and responsibility.

Indeed it is sometimes joked that the only real function of a Venture Capitalist is to sack the Chief Executive.

So if I have less than 50.1% of the votes do I need the protection of a Shareholders' Agreement?

Perhaps is the answer to this question.

The reason for wanting a Shareholders' Agreement will generally be to assert veto rights: so that contrary to the general law the powers of the Board to run the business (or the shareholders to exercise their own power - see below) are curtailed.

This may be fine in legal theory but the commercial context of the business of the Company must first be understood.

A business that will need new funding may be crucially dependent on a minority investor regardless of the percentage of ordinary shares initially held. An astute investor may also have loaned money (rather than just invested share capital) and that loan may have become repayable with the result that the investor is in a very strong position commercially: they could require the winding-up of the company so that the loan can be repaid. The business may also be critically dependent on the business knowledge and skills and client relationships of a single Director. The exercise of a legal right to dismiss such a person may in practice be impossible without causing irreparable harm to the business.

The shareholders (and their advisers) must first understand these commercial and economic realities before deciding whether a Shareholders' Agreement is needed.

What about the 50/50 (or partnership) company?

A particularly difficult area can be the company which is to be owned 50/50 by two shareholders.

There may be sound commercial reasons (see previous section) which dictate that it would be "better" for one of the partners to have a controlling interest. This could be achieved by the holding of one extra share or by that

person's appointment of an extra Director to represent their interests or to be appointed as chairperson of the Board. A chairperson has generally had a second (or casting) vote in the event of equal votes on any issue at both Board Meetings and Shareholders' Meetings. For companies incorporated after 1 October 2007 this is (rather oddly) no longer permitted in relation to votes at Shareholders' Meetings.

Where 50/50 ownership is commercially right then a "deadlock structure" may achieve rough justice. This subject is covered more fully below.

So does the Board have absolute power?

No, the Board does not and the following points need to be remembered:

1. Changing the Constitution
The constitution of a company is comprised in its Articles of Association (this is the rule book for the company's internal affairs and decision making).

A change in the constitution will generally need the support of shareholders who hold 75% of the voting share capital; this is the percentage of the votes needed to pass a special resolution.

2. Issuing New Shares
The Companies Act 2006 did away with the concept of an authorised share capital and with the requirement that the Memorandum of Association set out a share capital clause. For companies incorporated before 1 October 2009 the share capital clause becomes an implied restriction in the Articles on the number of shares that can be issued. For companies incorporated after that date you should check the Articles for any restrictions.

Under the general law (Section 561 Companies Act 2006) new shares must first be offered to the existing shareholders pro rata to their shareholdings (a so called rights issue). This general requirement can be waived for any particular proposed share issue by the passing by shareholders of a special resolution: for a special resolution to be passed those holding 75% of the votes cast must vote in its favour.

It is common for the Articles of Association of a private company to exclude this general requirement but a minority shareholder may want to insist that new share issues are always preceded by a rights issue.

3. Winding-up the Company
A resolution to wind-up the company will need the support of shareholders who hold 75% of the voting share capital..

4. Buy-back of Shares
A company is allowed to buy-back its shares but needs the authority of an ordinary resolution (unless the articles specify otherwise) to approve the buyback contract.

What does this all mean in practice?

The key point to remember is that those who hold more than 25% of the votes can block the passing of a special resolution.

Remember it is a holding of <u>more than 25%</u> (i.e. 25.1% plus) that is needed.

Are there any other important percentage shareholdings?

Yes, there are several but one in particular should be remembered when issuing shares.

There are procedures in the Companies Acts which allow a person who acquires 90% of the ordinary share capital to acquire compulsorily the other 10%.

So a 10.1% shareholding gives the power to block a takeover and buyers almost inevitably want to acquire 100% of the company's shares.

There are in fact other procedures (but these require a Court Order), under which someone who acquires 75% shareholder support can acquire all the shares.

Do I need to know anything else about company law if I am a minority or majority shareholder?

Two other key provisions of company law should be remembered by all shareholders:

1. Secret Profits
Directors have very strict fiduciary duties and if they make a secret profit (e.g. by diverting a contract or business to themselves) they can be made to hand over that profit.

2. Unfair Prejudice (Section 994 Companies Act 2006)
The general law provides protection for a minority shareholder against the majority shareholders acting in an unfair manner.

Conduct covered might include:

- paying excessive Directors' remuneration;
- not paying dividends if the financial performance would justify it;
- issuing shares for the purpose of diluting a minority shareholder's interest;
- terminating a Director's employment in a quasi-partnership company;
- buying or selling assets from or to the Directors at an overvalue/undervalue; or
- failing to follow the constitution.

These are just examples of conduct of which the minority may complain.

The Court has very wide powers in relation to cases of unfair prejudice but the most usual is an order for the shares of the outgoing shareholder to be bought at *fair value*. Injunctions to restrain unlawful conduct may also be available. The existence of these remedies can act as a powerful weapon for the minority shareholder albeit generally only for those with the financial resources to assert their legal rights.

What does all of this mean if I am a controlling shareholder?

The voting thresholds described above need to be borne in mind when shares are being

allocated or issued.

If a founder allows someone to obtain a 10.1% shareholding they may be blocked from selling the company: a buyer may not be interested in less than a 100% acquisition.

The existence of the unfair prejudice protection also means that the majority shareholder must be careful not to act unfairly: if they do the minority shareholder may end up with the right to require that their shares be bought at fair value as determined by an independent accountant. This may be much more than the majority shareholder wants or is able to afford.

What protection, then, should a majority shareholder seek?

There are two key protections that should be considered:

1. A buy-back right
This would operate so that, for example, shares held by an employee-shareholder who leaves employment can be bought back.

The buy-back price could even be less than market value for an "early leaver" or a "bad leaver".

The valuer could also be the Auditors who may (it is often thought) be more likely to opt for a low valuation so as not to upset the majority shareholder. Ethical guidelines mean that the Auditors may have to refuse to act but this is only likely to be apply to larger companies.

The vast majority of private companies are below the threshold for a mandatory audit and will not have auditors. In this case the valuer may be specified in the Articles as accountants nominated by the Board or an independent accountant agreed by the parties or nominated by the President of an appropriate institute.

Remember a buy-back right is a call option in favour of the majority shareholder: they do not have to buy if they do not like the valuation. This is very different to a put option which effectively is the remedy for a minority shareholder judged by a Court to have been unfairly prejudiced. With a put option the majority shareholder must buy: an unfortunate position to be in particularly if the valuation is not to the buyer's liking or they do not have the cash.

2. A Drag Along right
A provision can be inserted in the Articles under which the sale of a specified percentage (often 75% but sometimes 50.1%) can trigger the compulsory acquisition of the minority shares at the same price per share.

It is recommended that a drag along provision is included in the Articles even if the controlling shareholder holds 90% or more of the equity. This is because the compulsory purchase procedures in the Companies Acts are cumbersome and can be expensive to operate.

But surely if I hold 75% of the votes I can insert a drag along provision if and when I choose to sell? Why bother now?

Any change to the Articles by special resolution must be exercised in the best interests of the company as a whole. Case law has established that a change to the Articles, to insert a compulsory acquisition provision, may be challenged in the Courts under this rule.

After all buying someone out against their wishes runs counter to the general rules on ownership: the owner decides when they sell. Indeed the Companies Act procedures include the right for the minority to apply to the Court to stop the procedure. It is best, therefore, to insert such provisions in the Articles before the minority shareholder acquires their shares.

I have heard about a tag along right: what is this?

A tag along right is the right of a minority shareholder to block the sale of a 50.1% interest unless a like offer has first been made for the 49.9% interest.

Generally, a majority shareholder will be happy to concede the inclusion of a tag along right perhaps as a quid pro quo to the drag along.

Care must be taken though in the framing of the tag along right. From the majority shareholder's perspective it should be the right to insist only on a like for like offer. So the minority should not be able to insist on cash if the majority offer is one in shares and if the offer is of deferred consideration (or an earn out) the tag should be similarly limited.

What does all this mean, though, in relation to pre-emption provisions on transfer?

Private company Articles will frequently include rights of first refusal on share transfers in favour of existing shareholders.

Where such rights are included they should exclude transfers made under either drag along or tag along provisions.

Should I know anything else about pre-emption rights on share transfers?

First of all they do not have to be included. The Articles can either allow free transferability (those of a company whose shares are publicly traded must allow this) or give the Directors a veto on transfers to persons of whom they do not approve.
Secondly, where they are included certain "permitted transfers" may be allowed outside those pre-emption provisions. In addition to drag and tag along transfers "permitted transfers" may include those to family members or perhaps, in the case of founders, transfers between founders.

Where family transfers are permitted but buy-back rights are included in relation to the shares of leavers, the Articles will generally

apply the buy-back to the family-held shares too.

What about valuations on share transfers?

There are two alternatives. Either the seller is allowed to specify the price or the seller must agree the price with the Board failing which a valuer will be engaged.

In the case of buy-backs (or compulsory transfers) there is really no alternative to using a valuer in the event the price cannot be agreed with the Board.

I have heard about Russian Roulette clauses (or Put/Call Articles). What are these?

This is a mechanism sometimes included in the Articles of a company owned 50/50 to act as a deadlock breaker. They work on the basis that if there is a deadlock (e.g. evidenced by the failure to pass a resolution at two consecutive Board Meetings) the deadlock breaker can be triggered.

Either party can offer to sell their shares at a price specified by them and, if the second party does not agree to buy, they must sell at the same price.

Such provisions may sound fair and may produce a rough form of justice for two corporations with equal buying power. However, where one party is (or becomes) impecunious the provision may allow the financially stronger to buy the shares of the weaker at a considerable undervalue if they cannot raise the funds to buy.

But do we need a Shareholders' Agreement?

This Fact Sheet has so far described provisions which are frequently included in the Articles of Association. The Articles represent a contract between the shareholders. It can be changed by a 75% vote of those shareholders but subject to well-established rights designed to protect the minority from being unfairly treated.

Frequently those general legal provisions will be sufficient to provide a base level of protection. Alright but what extra protection might we want to include?

One method of protecting an employed-minority shareholder is to give them an employment contract with a minimum notice period.

Sometimes a Shareholders' Agreement may also include a dividend policy. This may provide some protection against the failure of the Board to pay interim dividends or recommend final dividends to the shareholders. Other protections can include:

1. a right to appoint a Director to the Board (or an observer to attend Board Meetings);
2. a right to information (e.g. monthly management accounts); and/or
3. a list of items which whilst generally within the power of the Board (or shareholders viz 75% of vote) are to be decided upon by a specified majority of the shareholders.

A word of warning: beware of the tyranny of the minority

For the inexperienced an easy trap awaits; namely the inclusion of a long list of veto items.

Whilst such protections may be appropriate for an institutional investor making a large capital investment it will often be imprudent to give similar power to an individual who is not a professional investor.

For anyone needing any corporate or technical legal support, there is no-one better to work with.

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