LAVELLE COLEMAN

Lavelle Coleman Solicitors
20 On Hatch, Lower Hatch Street,
Dublin 2, Ireland.
t +353 1 644 5800
f +353 1 661 4581
dx 109010 Fitzwilliam
e law@lavellecoleman.ie
w www.lavellecoleman.ie

KEY SHAREHOLDER AGREEMENT ISSUES

Introduction

This note deals with some key issues that arise in the negotiation of shareholders agreements. It is particularly relevant to the scenario where the company constitutes a joint venture vehicle. It is also relevant to a private company with two or more shareholders, each with a significant holding. Many of the issues mentioned also arise where one or more of the shareholders are investors.

Funding

Funding will usually be a key issue. The requirements will depend on the existing and future cash needs of the company and on tax considerations.

A subscription for ordinary shares and loans is the simplest and most common method for funding new businesses. The contribution may be by way of cash and non cash assets. Loans offer greater flexibility than taking shares. For this reason, the proportion of funding provided by shares may be higher than that provided by way of capital.

It is possible to provide for more complicated funding structures, where there are outside investors who are not involved in management. They could for example receive one or a combination of preference shares, ordinary shares and loan stock with rights to convert to shares. The terms of the shareholding rights can be structured in any way desired to reflect the risks and rewards that such investors take.

The parties may need to consider future finance. They should agree insofar as possible whether or not they are willing to provide future finance. If so, the time periods and monetary limits for further finance should be specified. A passive investor will not generally wish to commit to future financing.

Outsiders such as banks may require guarantees. The shareholders agreement should set out the extent to which the parties are prepared to make guarantees available to banks and other funders in respect of the company's borrowings.

If there are likely to be future financial commitments (which would be typical where there is significant capital expenditure), default procedures should be considered for circumstances where one party fails to make the requisite contributions. Default provisions may include payment of interest, loss of voting rights, buy out or ultimately reduction of the defaulting shareholder's share of the company.

Management Rights

A right to participate in management is usually important to a shareholder who is actively involved in the company's business. Different considerations will apply depending on the shareholding balance. With 50/50 shareholding, equality of representation and voting rights may be deliberately engineered. Minority or 50 / 50 shareholders may wish to have the right to veto major business decisions.

The board of directors runs the business of the company. 50 / 50 shareholders will expect to nominate equal number of directors and to be entitled to equality at board level. If one shareholder has made a significantly greater contribution and /or has a higher shareholding, that shareholder might want a final say such as the right to be or to nominate a chairman with a casting vote, the right to appoint a majority of directors or the right for its directors to have "weighted" voting rights.

Generally, directors owe obligations and legal duties to the company and not to the shareholder who nominated them. Their obligation is to act in the company's best interests. This potential conflict of interest can be particularly acute in the case of a joint venture company. The Companies Act 2006 has facilitated certain modification of director's duties, if authorised by a non-interested director.

Deadlock Resolution

Deadlock can arise in a 50 / 50 shareholding or joint venture company where directors take different views on a matter. There is no easy solution. There are a number of well known mechanisms to deal with this scenario. The chairman of the

Board of Directors may be given a casting vote. This is usually not acceptable in a 50/50 shareholding.

An outsider may be given a swing vote. A suitable person with appropriate business expertise must be available and parties must be able to agree on the appointment either at the outset or at the time the dispute arises. There may be a role for mediation, which is a non-binding dispute resolution mechanism. In the case of a joint venture, it may be feasible to resolve deadlock by reference to the chief executive of the joint venture shareholders.

Another possibility is for reference of matters in dispute to a mediator, expert or arbitration. The expert or arbitrator may be appointed by agreement or by an independent body, appropriate to the nature of the dispute. This is usually inappropriate for business decisions where there is no right or wrong answer. The arbitrator may not generally have a sufficient knowledge of the business and may only be a short term solution, unlikely to resolve basic differences.

Where none of the above mechanisms are sufficient to resolve the dispute, a last resort may be to trigger the termination of the joint venture. This will involve transfer and sale of shares or liquidation and winding up of the company's assets. The whole business may be sold to an outsider. In a liquidation the assets are sold, the liabilities paid and any surplus proceeds are distributed.

Termination and Buy Out

One party may wish to buy the other out, so as to continue the business alone. Each party may wish to buy out the other. There are a number of mechanisms that can be used to determine who buys out whom and what price is paid.

Put and call options entitle the holder of the option (which may be in favour of each party or one party) to acquire the interest of the other. The price may be expressed as fair value or may be ascertained by reference to a formula.

The so called "Russian Roulette" option is a variation of a mutual put and call option. The party making the offer on deadlock may serve a notice on the other requiring the receiving party to purchase his share or alternatively to sell the receiver's shares to

the person making the offer at the price set out. The purpose is to ensure a fair price is offered at which the offering party is equally willing to buy and to sell at. This would only be appropriate for companies with two shareholders parties of equal financial strength, so that either party could afford to buy out the other at the relevant time.

A further option is a "Mexican" or "Texas" shoot out. Under this mechanism, the initiating party may serve a notice stating that he is willing to buy the other out and specifying the price at which he is prepared to buy. The receiving party then has a period in which to serve a counter notice, either stating he is prepared to sell at the specified price or that he is willing to buy the shares of the initiating party at a higher price.

Both parties may make simultaneous sealed bids with the person whose bid is highest being entitled to buy out the other. Alternatively the bidding process can be run as an auction with the parties raising their bidding in competition. This is a mechanism which is open to misuse when one or other party does not have resources or desire to buy.

If a joint venture has irretrievably broken down, the parties may decide that it be wound up and its assets distributed. As a termination mechanism, this may have the advantage of concentrating the minds of the parties on resolving the dispute without a complete termination of the relationship. It may be better to agree a deal than to see the business or venture die.

Minority Protection

Minority shareholders rights under Company Law are minimal, so it is usually desirable to provide on increased level of rights. Typically, a party with a shareholding in excess of say, 30%, might seek rights of veto over such major changes as the following:

- Change in articles of association;
- Issue of new shares;
- Capital expenditure in excess of specified borrowing limits;
- Major disposals of changes in the nature of the business;
- Dividend distribution below or above an agreed level;

- The appointment or dismissal of key personnel and directors;
- Highly important or material contract;
- Dealings between the JVC and shareholders, except arms length dealings.

Additional protection of minority shareholder may be by a put option for the minority shareholder by which the majority can be obliged to purchase the minority's shares in accordance with a predetermined formula. This will prevent a minority shareholder being "locked in".

Transfer of Shares

In many private companies, the shareholders will not wish to allow for the free disposal of shareholdings. An unrestricted right to sell could lead to the substitution of an incompatible party. This may inappropriate to a business that depends on personal factors. Therefore, most shareholders agreement restricts the transferability of shares.

There may be a complete prohibition on the transfer of shares. This may apply for a period or indefinitely. Transfers may be allowed subject to conditions or with the consent of all or a number of shareholders.

The transferability of shares may not be completely prohibited, but may be subject to pre-emption rights (i.e. right of first refusal) for other shareholders. It is standard to require that a shareholding is bought as a whole or not at all, so as to prevent splitting into small shareholdings.

Issues will arise in relation to the terms upon which shares should be transferred. The share price may be fixed by an expert or a fair price. This could be on a multiple of earnings or a net asset basis. Issues will arise in relation to taking over loans and guarantees already entered, in the event of transfer.

A minority shareholder will generally seek a "tag along right" under which it can require a majority shareholder to include its minority stake in any sale it purposes to a third party. This is to ensure that all shareholders are treated equally on a sale. It also prevents the majority selling their controlling stake in the company, without giving the minority pro rate value for their shareholding.

Another provision commonly inserted is a “drag along right”. This allows a majority or (perhaps a smaller group) to require that all shareholders sell their shares if an third party wishes to buy the company. An alternative is that the shareholders can buy out at the same sum themselves.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.

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