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SHAREHOLDERS AGREEMENTS

Use of Shareholders Agreement

A shareholders agreement is an agreement between the members of the company to exercise their rights as shareholders and their voting rights in such a way as to give effect to the terms of the agreement. Sometimes the company itself is a party to the agreement.

Shareholders agreement are highly desirable when a company is managed, controlled and / or owned by a relatively small number of people. This is because the general default company law rules which apply, where nothing to the contrary is agreed, are more appropriate to larger businesses with a total separation of managers and shareholders and with a relatively large number of shareholders who treat their shares as an investment only.

The “default” position under company law and standard memorandum and articles of association gives minimal rights only to shareholders. These default rights comprise little more than the right to vote at general meetings, to receive dividends if declared by the directors, to receive any surplus of assets on a winding up and to obtain certain information about the company.

Company law generally gives the holders of more than 50% of the shares almost complete control over the affairs of the company. A shareholders agreement can increase shareholders’ rights and can be negotiated to include whatever the shareholders as a whole agree. The essence of a shareholders agreement is that the shareholders contract to exercise their voting rights to achieve the objects of the agreement.

Many private companies are financed and managed in a manner that is more like a

partnership than a company. One shareholder or shareholder bloc may hold a majority of the shares. Another common scenario involvers a number of the shareholders involved in management and other shareholders who are not involved, but who want to keep close control of and have a certain level of involvement in the company's affairs. These scenarios call for an appropriate shareholders agreement to protect the minority or "outsider" shareholder.

Shareholders agreements are also commonly used to regulate a joint venture, when a corporate structure is used. They are also used in the context of venture capital and equity investments. In this latter context, the agreement has the purpose of protecting the investor who does not take an active part in the business. Many of the same types of clauses appear in each these agreements but with other clauses tailored to the nature of the relationships and the particular circumstances.

Potential Abuses by the Company Controllers

The default company law position is that the holders of a bare majority of the shares control the company. They can fire the directors and take complete control of the company at any time. They need only declare dividends when they wish. The may choose to pay themselves such salaries as they wish. They may choose to may give themselves overly favourable employment contracts. The may spend company money in a wasteful way or in a way that is in their exclusive interests.

Private companies, unlike public companies which are listed on the stock exchange, are not subject to detailed disclosure obligations and scrutiny. Their directors can more easily run the company in a way which is abusive of the interests of the minority or "outsider" shareholders.

A minority shareholder has rights to make an application to court to challenge oppressive management by the majority. However the expense and impracticality of taking take court action based on "oppression of the minority" shareholders is a considerable practical barrier.

Memorandum and Articles of Association

A Company's Memorandum and Articles of association is the "constitution" of the company. It defines the relative rights of shareholder and directors and the various types of shares that exist and the rights they enjoy. The Memorandum and Articles of Association are a contract between the company and the shareholders. They are filed in the Companies Office. The shareholders are automatically bound by its terms on becoming shareholders.

Many of the provisions in the standard Memorandum and Articles of Association reflect the model of the larger company. It would be possible to put many of the kinds of matters commonly inserted in shareholders agreements in the Memorandum and Articles of Association. However, there are disadvantages with this approach. They are limited to matters that arise in a strictly company context. They can usually be amended by a resolution of the shareholders passed by 75% in value of the shareholders. The document is not confidential because it is available in a public register.

Shareholding Rights and Structure

The capital clauses in a Company's Memorandum and Articles of association offer flexibility in relation to how the ownership rights in the company are defined and divided. It is possible to create a wide variety of classes of shares with different rights.

A Shareholders' key rights are to dividends, return of capital in a winding up and the right to vote at general meetings. It is possible to recast the income, capital and voting rights in a flexible way depending on the requirements of the situation. It is possible to create preference shares which have first call on the income and/ or capital of the company. It is possible to create shares, which can be redeemed by the company. It is possible to issue loan stock that can be converted into shares.

The default company law position is that the directors are free to issue new shares on such terms as they see fit. Although they must act in good faith in the interests of the company as a whole, they may in practice dilute minority shareholders. Company law does give shareholders the right of pre-emption on the issue of new shares. However,

this is often reversed by changing the company's articles or by resolution shortly after the company is formed. A shareholders agreement should therefore control the issue of new shares, so that shareholders are not diluted without the opportunity to subscribe for new shares.

Finance and Dividends

A company need not pay dividends, unless the board of directors sanctions it. Therefore, the shareholders agreement may provide an agreed dividend policy. There may be a business plan which sets out the parameters of future dividend payments. There may be an obligation to pay a fixed share of earned income as dividends. Alternatively, there may be no provision or obligation to pay dividends on the basis that it may be better to leave this to the judgment of the directors at the relevant time.

An important function of a shareholders agreement is in relation to future finance. Finance may be by way of a mixture of equity or debt. A shareholders agreement may state whether the parties are obliged to provide further equity or loans or to guarantee company debt.

The shareholders may be obliged to contribute money to the company at the outset, when the company is set up and the agreement is signed. There may be provision for future cash calls. If one shareholder contributes funds and another does not, this may affect the relative share of equity of each shareholder.

Shareholders will not generally wish to commit themselves to further or unlimited injections of capital. They may commit to give guarantees. One shareholder may be willing to inject capital so that there is an adjustment of relative entitlement to the equity / ownership of the company.

Shareholders will often loan monies to the company in addition to subscribing for shares. Loans can be repaid and interest can be paid on more favourable terms from a tax and company law perspective. Capital paid into a company cannot be easily withdrawn. Interest on loans are generally a taxable expense, and are therefore subtracted from

profits in computing tax liability. In contrast dividends are not deducted in computing company tax.

If shareholders are to be required to give guarantees for the benefit of the company, this should be set out. Limitations and conditions should be provided for.

Involvement in Management

In the absence of the shareholders agreement , a minority shareholder would not have a right to participate in the management of the company. A shareholders agreement may provide for the right of each of a small number of shareholders to nominate a director. It may provide that there was no quorum for directors' meeting unless a director nominated by each shareholder is present. The shareholders may themselves be directors or they may nominate others to represent them.

The minority shareholder may have rights of access to the companies, books, management accounts and other information relevant to the management of the company,

Shareholders agreements commonly provide that each of a number of equal shareholders have the right to veto key proposals by the company. Sometimes the rights are only held by a shareholder who as a certain minimum percentage shareholding. The veto may be voiced through a shareholders meeting or through the representative directors.

- 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;
- Key service agreements

- Highly important or material contracts;
- Dealings between the company and shareholders, except arms length dealings
- Winding up.

Transfer of Shares

The transfer of shares can usually be vetoed by the directors of the company. Therefore, shareholders agreement usually regulate the transfer of shares. Shareholders may wish to prevent outsiders coming into the company. They may preclude share transfers entirely or allow them only in limited circumstances. Alternatively, they may provide that shares must be first offered to other existing shareholders, before being sold to outsiders.

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 made in the event of transfer. There are other mechanisms for valuation in the scenario where the relationship of the parties has broken down which are discussed in our note on joint ventures

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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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