



LEGAL GUIDE - THE IMPORTANCE OF INVESTING IN A BESPOKE SHAREHOLDERS' AGREEMENT

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We cannot stress enough the importance of a comprehensive Shareholders' Agreement tailored to your company's specific circumstances and requirements. This Legal Guide sets out the issues commonly dealt with in a Shareholders' Agreement and the risks of failing to deal with these issues up front before a dispute arises and relationships become strained.

The dangers of a "standard" agreement

There are many "standard" Shareholders' Agreement templates available and, whilst the quality of these templates will of course differ, it must be borne in mind that they have been purposefully drafted in generic terms in order to appeal to a wide range of companies. The Shareholders' Agreement that is created will therefore by definition not deal with all of the particular risks facing each individual company. This will mean that, when the company comes to rely upon the Shareholders' Agreement to resolve a dispute further down the line, the Shareholders' Agreement will likely fail to deal with the issue at all or, if it does, will not necessarily deal with it in the way that would be ideal for the parties concerned. As will be apparent from the below, having a Shareholders' Agreement is not simply a box ticking exercise as they can be invaluable in enabling a company to trade trouble free by resolving disputes quickly and without cost or disruption to the business.

The following issues are commonly clarified within a Shareholders' Agreement:

Shares and Shareholders

Not all shares are created equal and a Shareholders' Agreement can define the different types of shares in a company and the rights and obligations that attach to them, such as a class of non-voting shares or commercial decisions on which only a certain class of shareholder can vote (e.g. director removal).

A Shareholders' Agreement can also detail (in much the same way as a contract of employment) the obligations and entitlements of each class of shareholder with regard to, for example, their required day to day involvement in the operation of the company or any additional right to company information or documentation over and above that of a normal shareholder.

Transfer of shares

Restrictions on the transfer of shares to third parties are extremely common (referred to as "pre-emption" rights) and will often dictate that, before shares can be offered for sale to a third party, they must first be offered to the existing shareholders on the same terms. Whilst pre-emption restrictions can be extremely complex in their structure and can be a valuable tool for retaining stability within a company, the general premise is that shareholders want to be in business with people they know and trust rather than an unknown investor.

Decision making powers

It is not uncommon that a founding party or serious investor will want to keep strict control over “their” company by, amongst other mechanisms at their disposal, detailing the specific decisions on which their consent is specifically required. These decisions might range from changing the company name to removing that founding party or investor from the board of directors or otherwise excluding them from company management. Alternatively, a Shareholders’ Agreement might set out the decisions that require the agreement of all or a certain class of director (at board meeting) or shareholder (at general meeting).

Deadlock

Deadlock occurs where no majority exists, whether at board or general meeting. Whilst often the case in small two person companies where the parties are unable to agree on an issue, deadlock can also occur in much larger companies wherever an even number of votes or shareholdings exist.

Deadlock is extremely common and can be fatal to a company as the impasse can leave a company unable to make and implement decisions and can seriously damage relationships. In many cases, the existence of deadlock can cause either of the parties to take matters into their own hands in order to move the company forward (in the way that that party thinks is appropriate but the other might not), which can lead to an irretrievable breakdown in relationships and the end of what might have been a profitable company.

A Shareholders’ Agreement should carefully set out how the company will resolve a deadlock situation, whether by affording a “chairman” the casting vote to break the deadlock or including either a “Russian Roulette” or “Texas (or Mexican) Shoot Out” provision, which each detail the process by which either party to a deadlock might buy out the other in order to continue trading the company. Decisive action is needed if deadlock is to be resolved quickly and disruption to the company minimised.

Funding and Investment

The issue of money is unsurprisingly the cause of many a disagreement and it is best agreed in advance as to how the parties intend that the company will be funded, whether through external funding or through director or shareholder contributions (and in what proportions). As with many of the provisions of a Shareholders’ Agreement, there is huge benefit to having clarity up front on the expectations of the parties.

Exit Strategy

When parties set up in business together, they will each have expectations from that business, which might well differ. The sooner this fact is acknowledged and provided for, the better. For example, where one party wishes to build and sell a business for a quick profit, a dispute is likely where, 2 years down the line, the other party refuses to sell or cannot afford to buy out the other shareholder.

In the above situation, mechanisms such as a “put” or “call” option can help resolve the issue by entitling a shareholder to require that another shareholder buy their shareholding (a put option) or force the other shareholder to sell their shares to them (a call option). These options can be expressed to occur after a certain time or event and can include any amount of detail as to the process to be followed to avoid disagreement down the line.

Company Sale

It is often a reality that a company is more valuable as a whole. A Shareholders’ Agreement can therefore be used to regulate the circumstances in which shareholders can be forced to sell their shares. For example, a “drag along” provision will entitle a majority shareholder to force the minority shareholders to also sell their shares (i.e. so that the purchaser receives the whole company) and, conversely, a “tag along” provision will prevent a minority shareholder from being left behind by forcing the purchaser to also buy the minority shareholder’s shares (i.e. in addition to the majority shareholder). Advance thought should therefore be given to the company’s future saleability to ensure that its value can be maximised.

Share Valuation

In the event that a shareholding is available for sale, whether by consent or as a result of (for example) a default event or put / call option imposed by a Shareholders’ Agreement, a Shareholders’ Agreement can set out the method of share valuation to be followed. Share valuation is the subject of many a shareholder dispute and the advance agreement, whether using an agreed methodology or third party to value the shares, can avoid substantial dispute.

A Shareholders’ Agreement can also include the often controversial “good” and “bad” leaver provision, which values a departing shareholder’s shares differently depending on whether the shareholder is leaving by consent of their own volition or as a result of a breach of their employment or the Shareholders’ Agreement.

Restrictive Covenants

Whilst common to employment contracts and director service agreements, restrictive covenants can usefully be deployed within a Shareholders’ Agreement, whether to ensure confidentiality or to restrict competition in respect of “legitimate business interests”. Careful consideration should be given to ensure the proportionality of any restrictive covenant as, if deemed excessive, they can become unenforceable.

Managing Disputes

Finally, whilst a comprehensive and bespoke Shareholders’ Agreement will help avoid the majority of company disputes, it must be acknowledged that grounds for dispute might still arise. Advance agreement within the Shareholders’ Agreement as to how disputes should be resolved, whether by mediation, arbitration or reference to a third party, can avoid time, cost and disruption to a company in the event of dispute to enable it to continue to trade.

SEEK SPECIALIST LEGAL ADVICE

The possibilities and benefits of a Shareholders' Agreement are endless and careful consideration must be given as to the parties involved and their expectations to ensure that both they and the company itself are protected in the future.

Barnes Roffe Legal Limited are company specialists with a depth of experience advising shareholders, directors and companies and would be pleased to discuss your situation on a no obligation basis. Please contact Rebecca Gardner, Corporate Commercial Partner, on 020 3735 6706 or rg@brlegal.co.uk.