SHAREHOLDERS' AGREEMENT GUIDE

SPIRE SOLICITORS LLP

WHAT IS A SHAREHOLDERS' AGREEMENT?

A shareholders' agreement does what is says on the tin. It is an agreement between at least two shareholders in a company and is designed to provide a framework for how the company is run and how decisions will be taken, and the regulation of the shareholders' relationships including their rights and obligations towards each other and the company.

A shareholders' agreement works alongside a company's articles of association, but, unlike the articles of association, it is designed to be kept private and confidential. It is important, however, that the two documents should not conflict with each other.

WHY DO WE NEED A SHAREHOLDERS' AGREEMENT?

Disagreements are an inevitable part of being in business and whilst most can usually be resolved amicably, it is important to set out some ground rules before disputes arise so that expectations can be managed, and a process established from the outset. It is far simpler and far safer to do this with cool heads at the start of the business relationship before disagreements have an opportunity to escalate and seriously affect the operations of the business.

A shareholders' agreement can be a useful tool for when disagreements or disputes do arise, or to help manage exits and share transfers, or for succession planning.

WHAT GOES INTO A SHAREHOLDERS' AGREEMENT?

The terms of a shareholders' agreement will vary from company to company depending on the shareholders' priorities and what they want to achieve. What's suitable in relation to one company won't necessarily work for another.

It's important for each shareholder to use the shareholders' agreement as an opportunity to consider their tax position and review their Wills, particularly if the shareholders' agreement is being used as part of succession planning. We would also recommend putting in place or reviewing Lasting Powers of Attorney so that if a shareholder loses mental capacity, decisions can still be taken in relation to their shares.

WHAT SHOULD WE BE THINKING ABOUT?

Starting a discussion about a shareholders' agreement isn't always easy, particularly if things are going well and disputes seem unlikely. It is, however, worth taking the time to plan and create a "fall back" position as part of the company's contingency planning.

The following topic areas might be a useful starting point as part of your discussions.

How will decisions be taken?

The general position is that a company's directors are responsible for the management of the company and most of the decision making. You might, however, think about:

- whether each shareholder will have the right to be a director or appoint someone of their choice to the company's board of directors;

- whether a given number of directors or particular directors need to be present at board meetings for decisions to be validly taken;

- whether a particular director will be chairperson of the board, and whether the chairperson will have a casting vote if there is a tie; and

- how often and when will the board meet? How much notice should be given before each meeting?

Who will make decisions?

Company law requires that some decisions have to be taken by shareholders, but this still leaves directors with a lot of power. A shareholders' agreement can ensure that the directors must ask shareholders to approve some particularly important decisions. If so, will the consent of all, some, or only particular shareholders be required before these decisions can be taken.

Commonly, the following decisions might be "reserved" to the shareholders:

- changing the name or business of the company;

- issuing new shares;

- entering into particular contracts or purchasing assets over a particular value;

- hiring and firing key employees and other personnel; and

- taking action to wind up the company (unless it has become insolvent).

Do you want a policy for dividends?

Generally, the directors of a company will decide what dividends are payable and when. Some companies may have different classes of shares which allow for dividends to be paid separately on each share class.

A shareholders' agreement can give the directors flexibility to make decisions, or require that the company take a particular approach, or take certain matters into account before declaring and paying dividends. The company and its directors must always take account of the legal requirements for valid dividends, and their directors' duties, before a dividend is declared and paid.

Will share transfers be permitted or required in specific cases?

Will shareholders be allowed to sell or transfer their shares to third parties? If so, the outgoing shareholder might be required to first offer to sell their shares to the other shareholders. A shareholder might also be required to offer to sell their shares to the other shareholders if certain events happen, such as if the shareholder:

- becomes seriously unwell, loses mental capacity or dies;

- is made bankrupt;

- breaches the shareholders' agreement; or

- ceases to be a director or an employee of the company.

If including provisions which apply in the event of a shareholders' death, it is important to consider life insurance to cover the price payable. Each shareholder should also have:

- a Will in order to give certainty about who will own their shares, or the proceeds of sale, in the event of death; and

- a Lasting Power of Attorney so decisions can be taken in relation to shares if the shareholder loses mental capacity.

Some share transfers, such as transfers to specified family members or family trusts, might be expressly allowed, as this can sometimes help shareholders with their tax planning, but there might also be certain conditions which must be satisfied before such a transfer is permitted.

If a shareholder is required to offer to sell their shares to the others, what price will be payable? It is normal to draw a distinction between "bad leavers" who, for instance, breach their contract of employment, and "good leavers" who leave a company through no fault of their own, such as if they are made redundant. Typically, the price payable to "good leavers" will be the "fair value" in either an agreed amount or otherwise determined by accountants and based on the value of the whole company. In contrast, "bad leavers" might receive a discounted price for their shares.

What happens if someone wants to buy the company?

Shareholders' agreements commonly contain Drag Along and Tag Along rights.

A Drag Along right is designed to ensure that if a set percentage of shareholders, or even particular shareholders, want to sell their shares to a third party, they can require the other shareholders to also sell their shares on the same, or specified, terms.

The most common form of a Drag Along clause allows shareholders holding a majority of shares to require minority shareholders to sell their shares if a third party wants to buy all of the shares in the company. It is common that the minority shareholders will receive the same price per share as the majority. This means that the minority shareholders cannot effectively block a deal or hold out for better terms, but are also not disadvantaged.

Tag Along rights are typically designed to give protection to the minority shareholders by ensuring the potential buyer must offer to buy all of the shares at the same price per share. This means that minority shareholders have an exit route as an alternative to being left holding shares with an unfamiliar majority shareholder, which may have little or no value.

What happens if the shareholders cannot agree?

If certain key decisions are to be taken by the shareholders, what will happen if they cannot agree? This is most relevant if some decisions must be taken by unanimous agreement, as there is a risk that one shareholder could hold the others to ransom. You might feel that mediation (or another form of dispute resolution) is enough to focus minds, but it's also not uncommon to see provisions allowing for the compulsory sale or purchase of shares if the company has become deadlocked.

Will shareholders be subject to any restrictions?

It is common for shareholders to be subject to restrictions on what they can do both whilst they are shareholders and for an agreed period afterwards. These kinds of clauses are sometimes called restrictive covenants and need to be carefully considered and clearly drafted. Courts will generally only allow enforcement of restrictions which protect legitimate business interests and go no further than reasonably necessary to protect these interests. In the case of a restriction against competing with the company, thought should also be given to applying these restrictions only in a specific geographic area where the company operates.

Common restrictions include prohibitions against working or holding shares in businesses which compete with the company, or poaching key staff or customers.

Are the shareholders required to contribute to any personal guarantees which are called in?

If a lender is giving finance to the company, it may require that all or some of the shareholders give a personal guarantee for the money owed to the lender by the company, particularly if they are also directors of the company. A personal guarantee is designed to avoid the company's limited liability by making the 'guarantor' personally liable for the company's debts if the company does not or cannot pay. If multiple individuals each give a personal guarantee, it is common that the lender can choose who to pursue for the full amount owed. As a result, the shareholders may agree between themselves that if a guarantee is called in, they will each contribute towards the amount which is required to be paid to the lender. If so, the contribution that each shareholder is required to make should be considered and agreed.

Next steps

Thank you for taking the time to read this guide and for thinking of us in connection with your shareholders' agreement.

We will provide you with a questionnaire which summarises the key considerations outlined above. We hope that this will provide a useful framework for your discussions. Please do feel free to fill out your replies and return a completed copy of the questionnaire to us by email either to the fee-earner with whom you have been dealing or to info@spiresolicitors.co.uk.

When responding to our questionnaire, it is helpful if you can provide us with as much detail as possible. If you have any queries, please do feel free to contact us.

Your completed questionnaire will help us better understand your requirements and allow us to give you an idea of the fees to draft your shareholders' agreement. Once we receive your completed questionnaire, we will contact you to agree a quote and our other terms of engagement, including timescales.

It is our usual practice to act for the company when drafting shareholders' agreements on the basis that we are documenting an agreed position between the shareholders. Each individual shareholder is, of course, welcome to take their own independent legal advice if they have any concerns, but we are not usually able to advise any shareholder independently of the others.

When we discuss your requirements, we will consider whether it might be better to include some provisions in the articles of association of the company rather than in a shareholders' agreement. This is not always necessary. Sometimes, however, it can help ensure particular points are enforceable against a third party if they are included in the company's articles of association. We will discuss your requirements with you on a case-by-case basis.

ROGER MARGAND

PARTNER

ROGER.MARGAND@SPIRESOLICITORS.CO.UK

DD: 01603 677 025

JAMES HOPGOOD

SOLICITOR

JAMES.HOPGOOD@SPIRESOLICITORS.CO.UK

DD: 01603 677 026

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