Guide to shareholders’ agreements

A shareholders' agreement is an agreement between all or some of the shareholders in a company. It is a private contract and regulates the relationship between the shareholders, the management of the company, ownership of the shares and the protection of the shareholders. It may also govern how the company is run.

Why do you need one?

Shareholders' agreements are often used as a safeguard and to protect shareholders because (amongst other things) they can provide for what happens if 'things go wrong'. The absence of a shareholders' agreement opens up the potential for disputes and disagreements between the shareholders. Shareholders' agreements contain provisions that pre-empt disagreements and set out appropriate ways to address disputes. Too often, people set up companies with friends and relatives and do not consider protecting their interests in the company until it is too late.

Below are ten reasons why it is important to invest your time and money into getting a shareholders’ agreement.

1. Shareholders do fall out

At the start of a new business relationship, it is difficult to foresee a scenario in which the business partners would fall out or have difficulty making decisions. Unfortunately, disagreements do occur. It is easier to formalise and document the approach that should be taken if the relationship turns sour at the outset.

2. Regulate management of the company

The running of the company is generally left to the board of directors. However, the shareholders may believe that certain decisions should not be left solely to the directors' discretion and instead require shareholder approval, particularly if directors are not shareholders. For example, borrowing or incurring capital expenditure over a certain amount.

3. Offers protection for minority shareholders

A shareholders’ agreement can protect minority shareholders, for example, by preventing an allotment of new shares without unanimous consent, which would otherwise dilute their shareholding. The agreement may also contain "tag along" provisions, which enable a minority shareholder to "tag on" to a majority shareholder in a share sale situation.

4. Offers protection for majority shareholders

A shareholders’ agreement can also protect majority shareholders. "Drag along" provisions usually operate where an offer is received to buy all of the shares in a company, and the majority shareholders wish to accept that offer. The rights allow the majority to force the holders of the remaining shares to accept the offer on the same terms. Without this, the buyer may walk away.

5. Control the transfer of shares

A shareholders' agreement can also provide a mechanism which, where one shareholder wishes to sell their shares, effectively gives the other shareholders or the company (as the case may be) a "right of first refusal" over those shares.

This can be used to try and restrict who may or may not acquire shares in the company. This is a useful tool, particularly for small businesses that wish for the initial shareholders to retain the shares rather than allow external investors and unknown individuals to come in.

6. Potential to link shareholdings to employment

Often shares in a company are held by the directors or key employees of the business. If they were to resign or leave for whatever reason, you would likely want them to sell their shares. Otherwise, they will continue to benefit from the hard work of those who remain within the business.

A shareholders' agreement can provide a mechanism whereby a person's shareholding is linked to their employment, so if they were to leave, they must offer their shares up for sale. Otherwise, they are not required to sell their shares if they cease to be employed in the business.

7. Restrictions

If a shareholder seeks to exit the company, the remaining shareholders commonly wish for restrictions to apply to the existing shareholders' ability to set up or work in a competing business. These restrictions can be stricter than may exist in any employment contract and can be very valuable in protecting the company's interests moving forward.

8. Resolution of disputes

If disputes occur, specific provisions for dealing with conflicts can be laid down in the shareholders' agreement. These may include at what stage there would be a referral to mediation or who any arbitrator may be.

9. Demonstrates business stability

A shareholders' agreement can demonstrate stability for your business, showing that you have planned so that any dispute will be handled easily and swiftly. This is important, particularly for banks and other creditors looking to invest in your company.

10. Can offer a varied dividend policy

A shareholders' agreement can set out a varied dividend policy that may allow different dividends to be payable to each shareholder with different classes of shares. If this is the case, then the articles of association will also likely need to be changed, as explained in more detail below.

What are the risks of not having a shareholders' agreement?

Conversely, some of the main risks of not having a shareholders' agreement are:

- If things don't work out as planned, there will be difficulties with shareholders without a clear exit strategy.

- Shareholders who leave their employment with the company may be able to retain their shares (which may carry the right to vote at meetings or receive a dividend), which is often commercially undesirable.

- Minority shareholders are forced to rely on statutory rights, which, in practice, may be cumbersome and expensive to enforce.

- Minority shareholders may be able to block a sale.

- If there is a deadlock situation and no resolutions at the director or shareholder level, extreme measures such as winding up the company may be the shareholders’ only option, which can be extremely time-consuming and expensive.

- Shares are, at law, freely transferable unless the articles of association of a company, or any relevant agreement between shareholders, prevents this. So, without appropriate share transfer restrictions, the shares are at risk of transfer to unknown third parties.

- Reliance on common law confidentiality obligations, which may be more difficult to enforce.

- Departing shareholders' ability to set up a competing business, poaching employees or suppliers.

- The directors may be able to take decisions for the company in which the shareholders would want to be involved, such as excess capital expenditure, acquisitions or sales of other businesses or assets, making or receiving loans or other financial commitments.

How does a shareholders' agreement work with articles of association, and what are they?

Every limited company in England and Wales must have articles of association. Articles of association, or simply articles, are the written rules of the company that set out how it will be governed.

The main difference is that the articles are a statutory requirement which is a public document, whilst a shareholders' agreement is a private contract. A shareholders' agreement gives the parties more flexibility in terms of what private arrangement they wish to agree to, but they cannot override a company's articles.

Therefore, depending on the specific requirements and desired outcome of the shareholders' agreement, the article of association may also need to be reviewed and amended – for example, if you want different share classes and rights attributed to them (e.g. dividend rights), commonly known as alphabet shares.

Conclusion

In times of commercial uncertainty, which is often a cause of disputes and disagreements, there must be a clear procedure on how the company is run and how disputes are addressed. Please contact us for more information about shareholders' agreements and how they may benefit your business.