

Key Issues to Consider When Entering into a Shareholders' Agreement

A well-drafted shareholders' agreement can be a useful document for regulating the relationship between shareholders and serve as a roadmap for those points in a company's life where the shareholders and directors are required to take decisions that can significantly affect the running of the business and, ultimately, the value of the shares in question.

This article examines a few of the key issues to consider and a checklist of questions to keep in mind when considering entering into a shareholders' agreement.

Routine Decisions

A shareholders' agreement can serve as a manual for how the business should operate at shareholder and board level, and is a good opportunity to set out the preferred structure for decision making at these levels.

- **Shareholders**

At shareholder level, it is important to establish the proportions in which shares are to be held and the rights and restrictions attaching to those shares, as this will essentially govern how each shareholder can vote at shareholder meetings.

One option may be for shareholders to all hold the same class of shares. This generally means that those shares have exactly the same rights in respect of dividends, attending and voting at shareholder meetings. The power of individual shareholders to approve a decision or to receive a proportion of any dividend is then usually determined simply by the percentage of shares they hold.

Conversely, it may be more appropriate for shareholders to hold different classes of shares with different rights. This can be useful when the shareholders agree that certain shareholders should have a greater share in profits or should wield more influence, for example by having weighted voting rights or the ability to appoint more directors to the board.

- **Directors**

The board is tasked with undertaking the day-to-day activities of a company. Although many boards prefer to operate on an ad hoc basis (and many do so even when there is a structure in place), there are certain benefits to setting out a basic structure and process.

Some of these are commonplace, and will usually be otherwise governed by the articles of association, such as the minimum and maximum number of directors, or the number of directors needed for a board meeting to be quorate.

Other elements may be more bespoke, such as where shareholders have indirect control over the board by way of appointing representative directors. Here it will be necessary to set out how many

directors each shareholder can appoint, and rules for what happens should the decisions of the appointed directors be deadlocked.

The process for calling and holding board meetings can sometimes become a practical hurdle, so it may be helpful to work out the preferred method beforehand so that everyone is on the same page. Things to consider include the frequency of board meetings in a year, what method and timing is favoured for giving notice of the meeting, and where meetings should take place. It may be for instance that the preference is for meetings to be held remotely, or in a flexible manner, as opposed to the more traditional approach of requiring them to be held at the company's offices.

- **Dividend Policy**

Unless otherwise agreed by the shareholders, dividends are usually split in proportion to each shareholder's holding. If the shareholders have a certain dividend policy in mind which differs from this (e.g. one shareholder will get a higher percentage than others), it may be helpful to agree this at the outset, to save future quarrels about who is entitled to what amount. It may also be useful to spell out exactly how frequently dividends should be occurring, especially if the company is a start-up or currently struggling, and it is not in the best interests of the company to be distributing profits at this stage.

- **Budgets and Business Plans**

Budgets and Business Plans are essential tools for reviewing the profitability and efficiency of a company and establishing the best direction to take the company in for the next period. The period in which these plans are prepared and implemented (e.g. quarterly, annually etc.) will depend on the nature of the business and how much it needs to be kept under review. It is often easier to ensure that the budget and plan for each period is prepared on time when there is a specific process to follow and a deadline to meet, so don't underestimate the usefulness of setting this out in a shareholders' agreement rather than leaving it to be managed ad hoc.

Big Decisions

Certain decisions are by their nature hugely significant to the constitution, nature and profitability of the business.

- **Reserved matters**

To ensure that the business is being managed appropriately on matters of strategic importance, the shareholders might wish to reserve certain decisions for their approval. The checklist in **[BOX 1]** provides a short, inexhaustive list of example reserved matters.

Some key issues to consider are:

- whether the reserved matters should be split into different 'tiers' which require different levels of shareholder (or board) consent (for example, unanimous approval or approval from a specific shareholder).

- whether the list should be limited to standard corporate governance matters (e.g. alterations to the share capital or constitution of the company) and financial decisions (e.g. borrowing limits) or if there are any commercial or industry-specific matters which should be reserved.

- **Exit Events**

Often, a shareholders' agreement is entered into at the start of the shareholders' relationship with one another, when the future looks positive and the interaction between shareholders is (at the very least) cordial in nature. Inevitably, as with all relationships, there will be times when difficult decisions need to be made about the company, when shareholders are not aligned in the direction they wish to take the company, or when one or more shareholders' wish to exit the company altogether.

This is why it is important, however distasteful or unnecessary it may seem at the time, to draft the shareholders' agreement with a view to future-proofing the company and protecting the best interests of shareholders in the event of a breakdown in communication between shareholders or an exit event. It may not always be possible to draft the agreement in a way that will avoid disputes in the long-term, but it should be possible to draft it so that it provides a clear path through those issues.

Issues which should be addressed at the outset include restrictions and/or rights on transfers of shares, how to resolve conflicts between shareholders and/or directors, and what the exit provisions should be. Exit provisions may outline a specific agreed process (if the business or venture is to be limited in time), and/or what happens if one or more (but not all) shareholders decide to exit the business. An explanation of some of the more common transfer, conflict and exit provisions is in **[BOX 2.]**

It is important to ensure that these provisions are drafted in a clear a manner as possible, as inevitably these are the provisions which will be heavily scrutinised in the event of shareholder conflict or exit. The mechanisms which govern these provisions can sometimes be unwieldy and, if not drafted correctly, contradictory. It can be a helpful exercise to run through hypothetical problem scenarios and check that the provisions 'work' (and be comfortable with how they work) before finalising the shareholders' agreement.

A key issues checklist is included in **[BOX 3]**, which can be used as a quick reference point for some of the most common issues to consider at the outset of drafting a shareholder agreement.

- **Articles or shareholders' agreement?**

There is of course the question of whether certain provisions are suitable for inclusion in a shareholders' agreement which, as a general rule is kept private between the shareholders, or should be set out in the articles of association of the company, which are in the public domain.

There's no hard and fast rule as to whether a provision should be in a shareholders' agreement or in the articles. The decision will depend on how much shareholders' want a potential buyer or investor in the company to be 'on notice' that certain rights and restrictions are attached to the shares in the company – putting the rights in the articles will ensure third parties are aware of such matters. Conversely, there may be elements of the arrangement which are viewed as commercially sensitive, so a shareholders' agreement is a better home for them.

BOX 1

KEY ISSUES CHECKLIST

Shareholder rights:

- Voting
 - Who has what percentage of shares?
 - Will there be any weighted voting and by how much?
- Dividend policy
 - How often will dividends be declared? Are there any percentage requirements?
- Exit/conflict
 - What is the proposed exit strategy, if any?
 - What provisions will be included in respect of share transfers? e.g. should drag and tag rights, pre-emption rights or compulsory transfer events be included?
 - Will there need to be a good/bad leaver mechanism to determine value for exiting shareholders?
 - What will happen where shareholders are in a deadlocked conflict?
- Reserved matters:
 - Will these be split into tiers of matters requiring different levels of consent?
 - Which matters require unanimous consent or a specific shareholder's consent?
 - Are there any commercial or industry-specific matters which should be reserved?

Board composition and day-to-day management:

- Board composition:
 - How many directors is each shareholder allowed to appoint?
 - What is the maximum number of directors?
 - What is the maximum quorum for meetings?
- Board meetings:
 - What will be the process for calling board meetings?
 - Can meetings be held remotely?
 - How often should meetings be? Should there be a minimum number per year?
- Budgets/Accounts:
 - Will there be an annual/quarterly budget? Will the budget be agreed at Board or shareholder level?
 - Will the shareholders be provided with management accounts (and if so, how often)?

BOX 2**SUMMARY OF KEY EXIT PROVISIONS**

Pre-emption rights: existing shareholders in a company will have a right of first refusal on the issue of new shares by the company, designed to protect them against dilution of their shareholdings.

Deadlock: deadlock provisions can be included to govern situations where the parties to a shareholder agreement have an irreconcilable conflict. The mechanism is often used in 50:50 joint ventures where a conflict arises over the management of the joint venture, and sets out a process for resolving the conflict.

Compulsory/mandatory transfers: this provision can be used to ensure that where certain events happen to one shareholder (such as becoming insolvent or committing a material breach of the shareholder agreement) the other shareholder or shareholders will have a right to buy that shareholder's shares at fair value, as determined by an independent valuer.

Good Leaver/Bad Leaver: a shareholder agreement might contain provisions which determine the value of shares for a shareholder who exits the arrangement by reference to the circumstances of their exit. Those shareholders who are 'Good' leavers will usually get more value for their shares than 'Bad' leavers (who often will not be entitled to any value).

Whether a shareholder is classed as a 'Good' or 'Bad' leaver will depend on how broadly the clause has been drafted. A 'Good' leaver will usually mean someone who has left on grounds of death or disability, or who has been determined a 'Good' leaver by the remaining shareholders. 'Bad' leavers are often shareholders who have caused damage or loss to the business. It is common however to simply to categorise 'Bad' leavers as any shareholders who are not 'Good' leavers.

Drag/tag rights: drag rights are provisions where a majority shareholder who wants to sell his shares to a specific buyer can compel any minority shareholders to sell their shares to the same buyer ('dragging' them along). Conversely, tag rights are provisions where minority shareholders can 'tag along' to any sale by a majority shareholder to a third party.

BOX 3

EXAMPLE RESERVED MATTERS

Below is a short list of the most common reserved matters, although of course these are only a guide. Some may be unnecessary, or there may be other more business-specific matters which should be included:

- Variation of articles or share rights
- Increase or reduction of share capital
- Allotment of shares to third parties
- Change of name/registered office
- Change of nature of business
- Business plan/budget variations
- Share bonus scheme arrangements
- Entry into contracts above a certain value/outside the normal course of business/not on arm's length terms
- Granting of security
- Borrowings over a certain amount (or at all) and making loans/guarantees
- Acquisitions/mergers/public offerings
- Winding up the company

If you would like support with drafting a shareholders' agreement or in relation to a dispute or other matter, speak to one of our specialists today.

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