Guide to: Shareholders Agreements

A Shareholders Agreement is an essential business document. It is used to set-out the expectations and responsibilities of each shareholder, and provide clarity should an unforeseen circumstance arise. Below, we answer some of the common questions you may have about Shareholders Agreements.

What is a shareholders agreement?

A Shareholders Agreement is a private agreement between the shareholders of a company. It regulates the operation of the company and commonly sets out detailed rules in relation to matters which affect, or could affect, the shareholders and company.

Why are shareholders agreements important?

Shareholders Agreements are important, and typically prove most valuable, when problematic situations arise within companies (such as a breakdown in relationships, a shareholder who is committing misconduct, the death of a shareholder, disagreements on how to run the company going forward etc). This is because a well-drafted Shareholders Agreement will set out the rules and procedures to be followed by the shareholders giving a pre-agreed and prescribed outcome should a problematic situation ever arise.

Without a Shareholders Agreement, shareholders have to rely solely on company law, the company's articles of association and general common law which may not provide the desired outcome or even an outcome at all.

What sort of matters are covered in a shareholders agreement?

While it's always best for a Shareholders Agreement to be bespoke to the requirements of a company and its shareholders, the sort of matters which they deal with typically include:

- The management and operation of the company.
- The roles of any shareholders who are directors.
- Protection against deadlock.
- The transfer of shares and pre-emption rights.
- Good and bad leaver provisions.
- Drag and tag rights.
- The calculation and payment of dividends.
- Restrictions on shareholders should they cease to hold shares.
- Minority protection provisions.

What is deadlock?

Deadlock is a term used to describe the situation where a fundamental decision relating to the company cannot be made due to an equality of votes. Deadlock is a common area of dispute and arises where shareholders can't agree on the future of the business.

Deadlock can also arise and be most damaging where there are two equal shareholders and one has gone "rogue", or is being deliberately obstructive. One shareholder may be unable to take action against the other shareholder without their consent (which is unlikely to be forthcoming).

Deadlock can stifle and seriously affect a company and without pre-agreed provisions there is no prescribed remedy. A Shareholders Agreement can deal with deadlock, for instance by requiring any deadlocked matter to be referred to an independent expert with that expert able to apportion the fees as they see fit (i.e. if a shareholder has been clearly acting unreasonably). While engaging a third party to make decisions about the operation of a company may seem drastic, this regime is intended to promote/encourage sensible discussions between shareholders while also providing an ultimate remedy should agreement not be reached.

What are pre-emption rights?

Put simply, a pre-emption right is a right of first refusal to buy shares being sold by an exiting shareholder. Shares in private limited companies are personal property and so generally speaking a shareholder can transfer those shares freely.

A Shareholders Agreement will often provide pre-emption rights so that if a shareholder is selling their shares, the remaining shareholders have the first opportunity to purchase them (typically on a proportionate/pro-rata basis). A fixed valuation mechanism or regime can also be included to fall back on if a shareholder has set an unrealistic or unfounded price for their shares. A key objective of pre-emption is to avoid a shareholder selling shares to an unknown and potentially undesirable person (such as a competitor) under the noses of the existing shareholders.

As part of a pre-emption regime, payment terms can also be agreed so that the remaining shareholders pay the exiting shareholder over a fixed period. This is to minimise the cash-flow impact of buying a shareholder out.

What does good and bad leaver mean?

In many companies (especially those which are owner-managed), it is often desirable to make share ownership conditional on continued involvement in the company so that if a shareholder leaves for whatever reason, they must offer up their shares.

To deal with this, a Shareholders Agreement can contain prescribed events which require a shareholder to offer their shares for sale to the other shareholders. These events typically include death, ceasing to be an employee/director and breach of the Shareholders Agreement itself.

Different valuation mechanisms can then be applied depending on the circumstances relating to the event which has triggered the sale. For instance, a shareholder who dies or leaves due to ill-health may be considered as a good leaver and get full value.

Conversely, if someone has ceased to be a director or employee because of gross misconduct then they might be deemed to be a bad leaver and therefore a discount applied to their shares. Bad leaver provisions and the threat of not receiving full value for their shares should act as an incentive to a shareholder to act in good faith in their dealings with the company.

What are drag and tag rights?

Sometimes also called “bring along”, drag along is a mechanism whereby a prescribed percentage of the shareholders who want to sell their shares to a third-party buyer can force the remaining shareholders to sell to that third-party buyer (for the same price and on the same terms) so that the proposed buyer can acquire 100% of the share capital.

Buyers will almost always only want to acquire 100% of a company and the rationale behind drag rights is to avoid a situation whereby a minority shareholder (or group of minority shareholders) can frustrate a sale and therefore the exit route of the principal shareholders.

Drag along regimes can be tailored and conditions added to suit the requirements of the shareholders (such as price hurdles and notification requirements).

Conversely, “tag along” is a mechanism whereby minority shareholders can force other shareholders wishing to sell their shares to a third-party buyer to procure that the proposed buyer makes an offer to buy their shares on the same terms. As part of a tag regime, failure to procure identical offers usually means those who were originally proposing to sell can’t sell. Tag rights are intended to protect the rights of minority shareholders if drag rights are not exercised.

What is minority protection?

In summary, minority protection provisions give minority shareholders an effective right to veto certain fundamental decisions relating to the company which have the potential to prejudice/dilute a minority shareholder’s interest/stake in the company (such as changes to share rights, issuing shares, significant corporate changes, significant transactions, incurring borrowings etc).

These rights are very important and prevent minority shareholders being discriminated against and prejudiced by the majority. Even if a shareholder has 25% of the shares in a company this is technically a minority interest as the remaining shareholders could on their own pass a special resolution (this requires 75% of the voting shares) which could be used to make changes to the share structure to prejudice the minority shareholder.

While company law does provide for situations where shareholders have been unfairly prejudiced, this typically involves complicated and sometimes cost prohibitive legal advice/action. Minority protection is therefore often best addressed upfront in a Shareholders Agreement.

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