SHAREHOLDER AGREEMENTS

Setting up a new company, or joining an existing company at director-level, may feel like the beginning of a beautiful friendship. But inevitably, there will be differences of opinion over business strategy and board appointments. A Shareholder Agreement is meant to provide a framework to clarify these issues, yet many small businesses operate without any such Agreements, particularly family businesses and companies set up by friends.

The main areas covered by a Shareholders Agreement are:-

- What decision require 100% unanimity of Shareholders, what require 75% in favour and what require 51% in favour.
- Special Voting Rights. What special and important decisions by the Board require unanimous or majority (and if so, by what majority?) What special and important decisions by the Shareholders require unanimous or majority (and if so, by what majority?) Does the Board need shareholder approval for certain decisions?
- Appointment and removal of Directors. Is consent of all shareholders required for an extra appointment to the Board? Or removal?
- What happens on the death of a Shareholder? Should there be an obligation to buy out his shares and if so, at what valuation? Funded perhaps by life policies?
- What happens to his shares on retirement of a Shareholder, whether this is on age grounds, or of someone who wishes to leave early to go and do something else?
- If one Shareholder defaults in his obligations or leaves, should the others have an option to buy him out? What happens on departure of a Shareholder-employee? Should the valuation of his shares be reduced if he is a “Bad Leaver” (e.g. one who is dismissed for gross misconduct or who goes off to compete with the business)? Should a “Bad Leaver” be given the same value per share for his shares as a “Good Leaver” (e.g. one who dies or retires from work on age grounds)?
- What if he has joined in personal guarantees to a bank or finance company?
- If say 70% of the Shareholders want to sell the business, can they “drag-along” the unwilling Shareholders with them into the sale?
- If say 70% of the Shareholders want to sell their 70%, can the other 30% “tag-along” and compel a purchase of their own shares at the same price per share?
- What if one Shareholder has given a guarantee for the Company; should he be able to ask the other Shareholders to reimburse him, pro-rata, if the guarantee is called upon.
- Restrictions on competition while a Shareholder and afterwards (and if so for what period?) ie, what non-compete covenants will there be both while a Shareholder and after transferring the shares.
- Business Management issues.
- Dispute resolution procedure e.g. commercial mediation

It is surprising that so many of our client companies don’t have Shareholder Agreements, Friends and family members who are in business together cannot envisage falling out, which is why they are reluctant to address potential conflicts. But when fall-out does occur in these types of business, there is a lot of emotional involvement, and it can get very personal.

In some cases, arguments can be difficult to resolve. Conflicts can arise for a number of reasons one of the shareholder-directors may not be pulling his weight, the value of shares may be in dispute, or someone may simply decide to leave the Company.

One of the most common causes of resentment is the drafting of fresh talent into a company on a salary plus-share-options basis, which is perceived as diluting Shareholder value. Another is the remuneration of directors through salary which for non-director-shareholders means less return on their investment. Essentially, if you have put money into a company, you need a Shareholder Agreement covering distribution policy in order to ensure that you are paid a return out of the Company's profits."

Without a Shareholder Agreement to resolve such disputes, court proceedings may be started, although they rarely reach a court hearing. Resolution is generally reached by negotiating or commercial mediation, with the remaining Shareholders offering to buy out the disputing Shareholder at a fair value.

But where a company is run by two friends with equal shares 50/50, a major dispute can leave the business in complete deadlock. Litigation is one solution, but an alternative is a "Russian roulette" clause, where each party bids for the other's shares. That, too, has a drawback: if only one party can afford to buy at a reasonable price, they could offer a lower price knowing that the other person cannot afford to offer more.

Just as dangerous as having no Shareholders Agreement, is having one that is never reviewed and becomes out of date. Agreements normally include a restrictive covenant which prevents departing Shareholders from setting up in competition. New Shareholders who are brought in at a later stage but not signed up to the Shareholder Agreement could pose a threat. You could have a disgruntled Shareholder – a director who is a key player in the company – who decides to cut his losses, walk out, and set up in competition.

How the Company's share value is calculated, should be reviewed regularly to take into account any changes to the nature of the business. Early on, most of the Company's value often lies in its fixed assets, such as its land and buildings. As the business grows and expands, less tangible assets such as trading and goodwill may account for the majority of its value – and valuation provisions in the Shareholders Agreement may need to change to take such shifts in share value into consideration.

But beware, without proper thought and regular review, a minority shareholder that becomes difficult, could hold the Company to ransom.