

A Client's Guide to Shareholders' Agreements

Who should read this?

If you are going into business with one or more others and either all or most of you are going to be working together in the business.

Why should I read this?

A relationship between business partners is like a marriage. Often it goes well but often it goes wrong. And when it goes wrong it can be costly and debilitating to resolve.

A shareholders' (or partnership) agreement is rather like a "pre-nuptial" agreement between a marrying couple. It sets out how you separate if the worst happens and what the consequences are for the business; how much is paid for it and over what period.

Another analogy is to an insurance policy. A shareholders' agreement is a form of bespoke insurance, not against business failure but against business relationship failure.

It is easy to overstate the risks, of course. But modern business life places tremendous pressures and strains on those owning and managing the business. Different visions for the business; different characters and different judgments about the relative importance of different types of contribution to a business can often be constructive and creative but there is a thin line between creativity and destruction.

A business will, of course, suffer if the owners fall out. And no "legal document" can either guarantee to prevent that or enable you to side step all the consequences.

But a shareholders' agreement can go a long way to help. It is natural, when in business, to focus on the positive and to think in terms of the opportunities the business offers. But there are two main advantages to a shareholders' agreement.

The first is that if you think about and agree how you will get "divorced" at a stage when your relationship is still strong, then the chances are that you will reach a fair solution; and will do so much quicker and more cleanly than you would when your relationship had broken down. The second is that, very often, the process of thinking about "divorce" and how you would deal with it; and discussing the implications, assists in avoiding the problem or at least in mitigating the consequences if and when it happens.

A frank discussion of mutual expectations over the medium and long term is rarely at the top of the agenda between business partners and having that discussion in a structured way is invariably beneficial. The process of agreeing a shareholders' agreement will prompt that debate.

Our business relationship is fine. Do we need a shareholders' agreement?

There is no legal requirement for a shareholders' agreement. Many businesses don't have one. And a shareholders' agreement won't usually provide a management blueprint. It will not tell you how to run your business. So the answer is: "no, you don't have to have one".

The problem with not having an agreement, as we see all too often, is that there is then no mechanism for resolving a dispute between business owners. When that happens then, at worse, the business can be paralysed and the value that has been built up is easily lost.

So what does a shareholders' agreement usually do?

There are usually six main issues that a shareholders' agreement covers (although you don't have to restrict yourself to those issues):

- **Directors** – who is on the board and what level of agreement is required to appoint new directors;
- **Information** – the right to information about the company's affairs and duties of confidentiality in relation to it;
- **"Restricted Matters"** – commonly a shareholders' agreement will list certain major issues on which the shareholders must be either unanimous or, say, achieve a 75% majority vote before a decision can be taken. Issuing new shares and major capital expenditure are two examples.
- **Exit** – this is the meat of any shareholders' agreement. You need to think about what happens on death; if someone is critically ill; if someone wishes to leave or if one partner stops pulling their weight. You also need to think hard about how a departing shareholders' "share" in the business is valued and who pays them.
- **Dividends** – setting expectations about the degree of profit that will be distributed and the amount to be ploughed back into the business.
- **Restrictive covenants** – commonly a shareholders' agreement will impose restrictions on a shareholder/partner who is brought out to prevent their damaging the goodwill for which they have been paid.

What follows applies principally to a company, although similar themes arise in a partnership. It assumes that the agreement is between people who will all be working in the business. Different considerations apply where one party to the agreement is an investor only.

Directors

Usually an agreement will stipulate that each shareholder must be both a director of the company and must work full time in the business (or whatever hours are agreed). If either of those conditions ceases to be met, the agreement will usually give the other shareholder(s) the option to buy that person out.

In my opinion this is usually the best structure giving "operational" director/shareholders the option as to whether or not they remain directors and/or the ability to appoint an alternate

director is rarely consistent with the underlying expectations in a business of owner-managers.

The agreement will also usually go on to require either unanimity or a given majority before any new director can be appointed. This is fine but it is important to think about the implications if you are considering making up a new director.

Any new partner or director in a business may affect the existing balance on the Board and it is much easier to appoint someone than it is to remove them.

In practice these risks are often partly mitigated by the next point.

Restricted Matters

In a shareholders' agreement you will usually find a list of what are considered major decisions and which therefore require a special majority or unanimity before a decision on them can be taken. Typically, these would include issuing shares, buying or selling a business, bank borrowing, charging the company's assets, major capital expenditure, the appointment or dismissal of senior employees and engaging in or compromising litigation.

There is no particular magic to the list. A balance needs to be struck between ensuring the key stakeholders in the business have a voice in decisions which affect their "stake" and setting up a structure which is a recipe for deadlock or which frustrates the business's development.

We can advise on what is appropriate in particular circumstances and suggest a possible list.

Information & Confidentiality

This is usually the least contentious issues. A shareholders' agreement will almost always give all shareholders the right of access to all the business's information but subject to a reciprocal duty to maintain that confidentiality as regards the outside world. On occasion, with particular businesses, there is a need for greater sophistication. You should of course bear in mind that the duty of confidentiality will prevent disclosure by one shareholder alone, to a potential buyer of shares. This can often limit the options of a shareholder who wishes to leave or be bought out but is struggling to reach agreement with the others. From the point of view of the company however it is the right thing to do. It is unlikely to be in the company's interests, for example, to have its confidential information disclosed to third parties.

Exit

This is normally the hardest issue to address. But it is also the most important by far. The question of exit covers four distinct but overlapping issues:

- What should the triggers be to someone being bought out of a business?
- Should the triggers lead to the obligation to buy/sell or merely the option? And, if only an option, what then if the option is not exercised?
- How should the price be calculated?
- Who should buy and over what period?

The answer to one question informs the answers to others, inevitably.

Starting with the first however:

Q1: What are the triggers to buy out?

A: The traditional answer is death, lunacy, insolvency, breach of obligation(s). These answers are not wrong. Clearly in any of those circumstances the chances are that the other proprietors of a business will at least expect to have the ability to buy the other out, even if they do not exercise that right. And, to that list would usually be added long term illness, voluntary resignation and an unresolved dispute. I will deal with death/illness separately.

The more difficult question however is whether there really needs to be a defined trigger event at all. Forcing one member of a business to leave is a difficult, time consuming and risky exercise. It is rarely undertaken frivolously. Equally, as with a husband/wife divorce, when business partners fall out with one another it is rare for the "fault" to be clear. More commonly, and quite naturally, each party blames the other. In those circumstances a shareholders' agreement which requires a defined "breach" of obligations is often of no use, as no one will accept that the fault is theirs. Any notice served alleging fault is likely therefore to be disputed.

My personal view is therefore to advise shareholders to consider "no fault" divorce provisions. What that means in practice is allowing one shareholder to be removed by a notice served by all the others, regardless of whether a clear cut breach of agreement can be identified.

This idea often takes some getting used to. Business partners are fearful that the right will be exercised capriciously or in a way that cheats them out of their fair share of the business in a run up to a sale. With the right safeguards in place, and bearing in mind the disruption and damage to value that can be caused by change, my judgment is that these risks are usually more apparent than real.

Management stability and harmony are important factors in maximising value with a view to a sale. Moreover, it is perfectly possible to provide in the agreement that if the business is later sold on to a third party (say within a year, or two years) then the person who was bought out receives all or part of their "share" of the sale proceeds if it exceeds what they were paid. This is often called an "overage" provision.

There is another good reason too for adopting this approach: legal costs. It is tempting when addressing this subject to seek to draw distinctions between different "trigger" events based on perception of likely fault. So, shareholders will sometimes suggest the price paid should vary depending on whether trigger is, for example, death, breach or resignation: that the period for payment should vary and that whether the other shareholders' have to buy, or not, should differ.

Sometimes this can be appropriate. But more often it is unnecessary and, most significantly it adds greatly to the legal costs of preparing an agreement. A single solution is the best way of keeping costs down.

Death and critical illness

Depending on the age and health of the shareholders it is common to address the risk of a shareholder director, dying or being unable to work through illness by insuring against those

risks. Such insurance is frequently tied into “put and call” options. This means that if a shareholder dies (or becomes critically ill) then he has the option to “put” his shares onto the others (i.e. require them to buy) and the others have the option to “call” the shares (i.e. to require the deceased/ill shareholder to sell).

Typically the insurance policy is placed in trust for the other shareholders and the price paid for the shares is the sum assumed. This avoids arguments at the time about the company’s value and also provides the cash. The risk is that the insurance does not keep up with the value of the company or, worse, that it cannot do so because the health of a shareholder makes it impossible or uneconomic to increase the insurance to appropriate levels.

In practice this is a risk that often has simply to be taken. Ensuring a good level of insurance at the outset is a prudent thing to do. In each case appropriate tax advice must also be taken.

Q2: Should the triggers lead to an obligation to buy/sell or merely the option to do so?

A: My advice is to start on the assumption that it is only an option to buy that is triggered, not an obligation, but that if the shares are not bought then the existing shareholder does have the right, eventually, to appoint an administrator to force a sale of the whole business and realise that way.

The reason I say that is simply that the price for the shares is usually unknown and I think it is dangerous to have in place an agreement which could, at any time, and over a long period be used to trigger a contractual obligation on the part of some shareholders to pay an unknown sum of money to another. This assumes that some element of goodwill is to be paid for. It is goodwill that generates price uncertainty. In some businesses the value of the business on the open market may far exceed the ability of its shareholders or the business itself to fund the buyout of an exiting shareholder. At the same time it is probably unreasonable to expect a departing shareholder to stay locked into the business forever quite apart from the disincentive effect this may have on the remaining shareholders.

There are at least two further alternatives. The first is that the giving of notice, at any rate by the majority, obliges those serving the notice to purchase the shares of the person on whom notice is served. This has the undoubted advantage of focussing minds on the implications of serving notice and is sometimes popular for that reason.

The second is not to oblige either buyers or sellers to proceed unless they are happy with the price, but to give the seller the right to sell to a third party if their shares are not bought. The “right” solution always depends on the particular context but often my advice is that the alternative is illusory and best avoided. There is in practice no market for a minority stake in a private company and that means that this “solution” will often leave a departing shareholder locked into a company against either his wishes or those of the majority. This is not the benefit that a shareholders’ agreement should provide.

A different possibility entirely and often a popular one, is the use of a “roulette” provision. A roulette clause gives any shareholder the right at any time to specify a price for the shares and to give the other shareholders’ notice stating that price and giving them the option either to buy or to sell at the specified price. This works best in a two person company.

The roulette notice will give the shareholder on whom it is served a period of time to decide whether to buy or to sell and will state that if they fail to respond they are deemed to have agreed to sell (or to buy).

The beauty of the clause is that it is not linked to fault; it forces the person serving notice to specify a fair price and it will lead to one party or the other leaving the business. The disadvantages of it are its uncertainty (the person giving notice doesn't know if they will buy or sell) and the risk is that it favours a financially stronger party.

Q3: How should the price be calculated?

A: There are essentially two alternatives, Either a departing shareholder is paid "their share" of the company's net asset value, or they are paid an open market value. An open market value can either be left to determination at the time by an independent valuer or the agreement can provide a formula: commonly a multiple of average profits or EBITDA over a period.

What the correct answer is depends very much on the business and the context. A net asset valuation may be entirely appropriate for certain business. Property is the obvious example. More difficult is the question of whether it is "fair" or require the remaining shareholders to pay an "open market value" when one shareholder leaves.

The essence of a "partnership" business is usually one of share reward for shared effort. It is a different issue when one person is no longer able to contribute that effort, for whatever reason. The market in private companies is volatile and uncertain. Prices can vary considerably, not least because of sentiment and appetite in the capital markets. Many private businesses, particularly "people" businesses can be sold only on "earnout" terms which spread payment over some years dependent on ongoing performance. Moreover, even a successful business may well not generate the cash to facilitate a "full value" goodwill payment to an existing shareholder without burdening either the business or its shareholders with a substantial debt. The position is further complicated if two or three shareholder wish to leave in quick succession. That in itself may well have a very significant impact on value. A shareholders' agreement should not act as an incentive to be the first to leave. And finally, of course there is always the uncertainty about how sustainable any given value is and whether it could realistically be achieved if the business went to market. It is one thing for all shareholders to make a decision jointly to accept a given price from a third party after testing the market. It is another for the remaining shareholders to pay out one shareholder based on a valuation.

There is no simple route through these questions. Commonly however the components would be these. Firstly a "lock-in" period is agreed. That could be anything from one to five years or more. During that period it is agreed that only a limited value is placed on the business, possibly only NAV. After that period a price closer to but not necessarily open market value is specified. For example, a specific discount could be applied to market value or a formula agreed which reflected a discount or valuation assumptions specified which had the effect of limiting the value.

As with so many of these discussions the guiding principle ought to be the best interests not of the individuals, but of the business. It will always be in the business's interests that it is coherently and cohesively managed. Shareholder/director disputes are not in the business's interests and so it makes sense to provide a structure which enables a dissentient shareholder to be bought out. Equally it cannot be in the business's interests to burden either it or its shareholders with an unmanageable level of debt. A buyout structure which did this would not be wise.

The question of price is inextricably linked to the final and key question:

Q4: Who pays for/buys the shares?

A: In practice of course there are only two options: the other shareholders or the company itself. Most business people, quite naturally, want to use the company's money to "buyback" the shares of a shareholder who is leaving. If the shareholders themselves have to buy the shares then they will have to pay for them out of their post tax income. An analysis of the tax issues is beyond the scope of this briefing but with the main rate of income tax at 40% plus national insurance and the highest rate at 50%, it is fairly obvious that most shareholders would need gross (pre tax) income equal to roughly double the price they have to pay for shares to leave them with the relevant net (post tax) income.

With company tax rates much lower and without the needs to dip into personal income it is easy to see why the company is often the preferred purchaser.

Unfortunately this may not work as well for the seller from a tax point of view. A seller will usually want to pay capital gains tax on the sale of their shares which, if they qualify for Entrepreneurs Relief, reduces the effective rate of tax being paid to 10%. But when a company buys back its own shares the seller is usually treated as if they received a dividend from the company and pays income tax.

If certain conditions are met then HMRC will charge capital gains tax instead of income tax. However central to those conditions is that the buyback is for the benefit of the company and not to achieve a tax advantage for the company. It must be doubtful, where a structure is pre-ordained in a shareholders' agreement, whether HMRC will accept that the conditions for capital treatment of a payment for shares are met.

The situation is further complicated by the fact that the law states that a company must be able to account for a payment it makes to buy back its own shares out of its distributable reserves. Even if the payment is taxed as capital, in other words, the company must be in a situation where it could have lawfully declared a dividend for the same amount.

There is, of course, no guarantee that at any given future point the company will be able to satisfy this requirement.

Given these issues surrounding a company buyback, the most common arrangement in a shareholders' agreement is to provide for the remaining shareholders to have the obligation to buy but to state expressly that the shareholders can nominate another party as the buyer, including the company itself, subject to the seller's tax position being unaffected.

What the remaining shareholders have to accept here, of course, is that they may have to pay for the shares themselves. This is of course significant principally if the answer to Q2 above is that the seller should be able to oblige the buyers to buy, whatever the price. In any event shareholders' agreements will often provide for deferred payment terms for shares or for purchase in tranches over a period to give the buyers a chance to raise the money. If the company is buying back its own shares then a purchase in tranches is permitted but deferral of payment, for shares already bought, is not.

Exit-Conclusions

The basic issue is clear enough. If a shareholder leaves, a structure is needed which values their shares and facilitates the purchase of them. Beneath that broad statement lie a number of detailed questions. The answers will vary from business to business, but there are two guiding principles. The first is: "keep it simple". Easy to say but not always easy to do. The second is: ensure that, ultimately, a departing shareholder does have a way out, even if that is via administration. Ultimately the core reason for a shareholders' agreement is to provide an exit route.

Dividends

This is by no means essential to a shareholders' agreement, but the question of the extent to which, if at all, dividends are to be declared by a company is usually of course one for the board. In the absence of a majority in favour, no decision is taken, just as with any other board matter. If there is an expectation at the outset that dividends will form part of each director/shareholder's income then it is as well to specify this. Usually this is done by stating that at least a given percentage of profits, or a given percentage over a certain threshold, will be distributed by way of dividend unless otherwise agreed.

If at the time circumstances dictate differently and there is a consensus to distribute a greater or a lesser proportion of the profits then this can always be done.

Restrictive Covenants

The last of the six main topics for a shareholders' agreement is the extent to which, if at all, a departing shareholder should be subject to restrictive covenants over and above those which would be reasonable merely by virtue of the departing shareholder having been a director and employee of the company.

Any departing employee will continue to be subject to duties in relation to the company's confidential information, but this is usually amplified and made express in a shareholders' agreement.

In the case of employees the courts are generally reluctant to uphold restrictions which are more than the absolute minimum necessary to protect the legitimate commercial interests of the company. In general therefore outright bars on working for competing businesses and lengthy time periods or wide geographic restrictions are unlikely to be upheld when imposed on an employee.

The attitude of the courts to covenants is different though when they are imposed by a buyer on the seller as the price for the payment for a business. Although subject to competition law issues (which are beyond the scope of this article) the courts tend to be less willing to intervene in a sale because the parties are perceived as being in a more equal bargaining position and particularly if the covenants were part of the price of the [seller] receiving a substantial capital sum for his/her shares.

Covenants imposed in a shareholders' agreement fall into neither category. Clearly there is greater equality of bargaining position than with an employee but they are not being negotiated as part of a purchase at the time of the purchase. They are pre-determined. And they may apply in circumstances where very little is actually being paid so the exiting shareholder is not able to live off their capital and needs to work elsewhere, quite probably in the same industry, in order to earn a living.

The watchword with restrictive covenants has to be "caution". If covenants are too onerous the courts will simply strike them down. They will not rewrite them. So, better to have covenants which do not go as far as one might like but stand a reasonable chance of being upheld.

Commercially, buyers often feel more comfortable about covenants where payment for the shares is made over a period and the covenants run during that period. The assumption is that any seller will think twice about testing the enforceability of covenants where there are monies still to be paid to them.

Summary

Shareholders' agreements are a valuable tool in helping to set expectations among business partners and to manage the fall out if irreconcilable differences emerge. In this way they contribute to the development and maintenance of business value. They do not, of course, guarantee business success but they are a valuable investment for the future.

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