

Key Issues to consider for a Shareholders' Agreement

Introduction

The items set out below reflect some of the most important issues to be considered when contemplating entering into a shareholders' agreement. This document is intended to act as a guidance tool to make obtaining legal advice a more efficient and cost effective process, but is not a substitute for specialist legal advice.

When reviewing this document, please note that:

- (A) although this deals with the main general points which arise, the matters below are unlikely to be an exhaustive list of everything which you will need to consider for your company; and
- (B) just because an issue is raised in the list below does not mean that it has to be dealt with in a shareholders' agreement – some of the items below may be inappropriate for your particular situation.

1. Shareholders

- 1.1 If the Company is already incorporated, who are the current shareholders and what are their percentage interests?
- 1.2 Who will be the Shareholders on completion of the Shareholders' Agreement?
- 1.3 What will be their percentage interests?
- 1.4 How will they acquire their interest:
 - 1.4.1 by purchasing existing shares
 - 1.4.2 by cash subscription for new shares
 - 1.4.3 by transferring assets to the company in exchange for new shares
- 1.5 At what price/value will these interests be acquired?
- 1.6 Will individual Shareholders interests' carry differing rights?
 - 1.6.1 dividends
 - 1.6.2 rights to appoint directors

1.6.3 special voting (including veto or consent) rights

- 1.7 Will any Shareholders have the right to increase their holding through options or similar arrangements (there may be structures that are more tax effective than options, these can be discussed)? If so, what are the other criteria under which the options will vest and be exercisable?
- 1.8 How much equity will be made available for employees?
- 1.9 What will be the criteria for the grant and exercise of options by employees?
- 1.10 What should the quorum for shareholder meetings be?

2. Directors

- 2.1 If the Company is already incorporated, who are the current Directors?
- 2.2 How many Directors will the Company have on completion of the Shareholders' Agreement?
- 2.3 Who will appoint them?
- 2.4 Will there be a Chairman of the Board? Who will appoint him/her? Will he/she have a casting vote?
- 2.5 Will the Boards of any known subsidiaries be constituted differently to that of the Company?
- 2.6 What should the quorum for board meetings be?

3. Consent/Veto Rights

- 3.1 It is common to provide that there are certain matters which require either unanimous consent of the Shareholders or the consent of a particular majority.
- 3.2 Sometimes one Shareholder may have a veto right over a decision that particularly affects him or her.
- 3.3 It is also possible to differentiate between matters which require the approval of a particular majority (e.g. two thirds or 75 percent) and those requiring unanimous consent.
- 3.4 Another approach (less common) is to split responsibility for such matters between the Board and the Shareholders – less important matters require the approval of a particular majority of the Board and more important matters require the approval of a particular majority of Shareholders. This approach is suitable where there are a larger number of Shareholders than Directors but can be an unnecessary complication where the number of Shareholders is small and are all represented on the Board.
- 3.5 A 'shopping list' of such matters is attached for consideration – it is not suggested that all of these will be relevant. In addition, there might be others which are appropriate to the Company that are not mentioned.

4. Share Transfers

It is common to restrict the free transfer of shares. Some or all of the following principles may be used:

4.1 *Pre-emption Rights*

No shares can be sold unless they are first offered to other Shareholders pro rata. Exceptions are usually made for Transfers to a company 100% controlled by a Shareholder or to a trust for the benefit of that Shareholders' immediate family.

4.2 *Deadlock*

4.2.1 If the directors cannot reach agreement or if a shareholders consent is not obtained for a matter over which they have a veto right there may be mechanisms to resolve the deadlock.

4.2.2 Once a deadlock has taken place there is usually a period to resolve the deadlock and if it cannot be resolved then provisions will allow for an exit. For instance the Company may be wound-up, or shareholders may be able to serve a 'Roulette Notice' in which they offer either to buy the other shareholders' shares or to sell their own shares at a given price, or a majority shareholder may have a 'call-option' allowing them to purchase the other shareholder's shares.

4.3 *Lock-ins*

Shareholders agree not to attempt to dispose of their interest for a minimum period. Alternatively, any attempted sale before the end of the lock-in period enables other Shareholders to exercise their pre-emption rights at a penal price. Transfers after the lock-in will be made at market value.

4.4 *Mandatory Transfers*

Shareholders can be forced to sell their shares in circumstance such as where they:

4.4.1 fail to comply with their obligations under the Shareholders Agreement;

4.4.2 are convicted of a criminal offence;

4.4.3 do anything to damage the business or bring it into disrepute;

4.4.4 become insolvent or bankrupt.

4.5 *Leaver Provisions*

Shareholders can be compelled to transfer their shares when their employment terminates, for example:

4.5.1 if termination is due to death, normal retirement, ill-health, mutual agreement with the other Shareholders or due to termination by the Company (other than for good cause) the shares will be sold at a fair market price;

- 4.5.2 if termination is due to dismissal for good cause or to the Shareholder resigning without the approval of the others, the shares will be sold for a penal price, e.g. nominal value.

4.6 *Tag and Drag*

Drag rights confer a right on a specified majority of the shareholders (usually by reference to their aggregate shareholdings) to require the remaining shareholders to offer their shares for sale to a third party proposing to acquire a specified percentage of the issued share capital of the company. Tag rights confer on the minority shareholders a right to require that shareholders selling such specified percentage of shares to a third party procure that that third party also makes an offer to purchase the minority shareholders' shares.

5. **Non-Compete**

- 5.1 Shareholders will usually agree not to compete with the Company while they remain Shareholders and for a period after ceasing to be Shareholders:

- 5.1.1 What should be the scope of the restrictive covenant? Should it be a relatively standard non-compete clause covering being engaged in a competing business or should it also cover specifically, for example, soliciting or dealing with customers, employees, and/or suppliers?

- 5.1.2 What should be the restricted period and geographic area?

- 5.1.3 Should the non-compete restrictions be different for individual Shareholders?

- 5.1.4 Do any Shareholders have competing interests for which exception should be made?

- 5.2 The maximum period for which such a covenant will be enforceable would be 5 years after a party has ceased to be a Shareholder (at the most). The scope should not be more than is reasonable to protect the goodwill of the Company and should not be such as to prevent the party subjected to it from earning a living. Generally the restrictions can be more robust when applied to an individual who has equity in the business rather than to an employee.

6. **Funding**

- 6.1 How will the Company be funded?

- 6.2 Are any of the Shareholders required to advance any funds to the company, and if so, on what terms?

- 6.3 The raising of funding, by issuing further equity or by borrowing, is usually a matter for majority / unanimous approval, although it is common to agree at the outset the medium term funding requirements and how they will be met so that Shareholders have accepted the cost/dilution implications of known funding needs.

- 6.4 If it is intended that Shareholders are to introduce funds by way of loan:

- 6.4.1 To what extent should there be a binding commitment in the contract to introduce those funds on Completion / at some point in the future (as

opposed to an expression of intent, or requiring that any loan funding only be entered into with unanimous/majority consent)?

- 6.4.2 In what circumstances should that loan be repaid (for example, by a particular date, or when the company hits a certain target)? What if the lender Shareholder leaves the Company?
- 6.4.3 Should the shareholders agreement specify the basic terms on which the loan should be made? (For example, interest chargeable.)
- 6.5 Are any of the shareholders obliged to provide any personal guarantees or other security for the obligations of the company? If so to what limit? In such circumstances, are the shareholders to have an obligation to indemnify each other in respect of any liability under guarantees or other security given for the obligations of the company so that such liabilities are borne in proportion to the shareholdings?

7. Dividends

Is the shareholders' agreement to include a dividend policy specifying a minimum or maximum percentage of the profits available for distribution in each financial year to be distributed?

EXAMPLES OF ITEMS WHICH MAY BE SUBJECT TO SPECIAL CONSENT OR VETO RIGHTS IN A SHAREHOLDERS AGREEMENT

The Company shall not do any of the following without [a Majority Approval (e.g. 67%, 75% or 100%) of Shareholders] [the prior approval of [x] [at least one of x and y]]:-

1. alter, modify or add to the Articles or the Memorandum of Association or any other documents of incorporation or regulation of the Company;
2. pass any resolution for the winding-up of the Company or make any proposal to make a voluntary arrangement within its creditors or petition for an administration order to be made in relation to the Company;
3. appoint or dismiss the Auditors;
4. create, issue, purchase or redeem any share or loan capital, grant any option to subscribe for shares or issue any securities with rights of conversion into shares;
5. vary, modify or abrogate any of the rights attaching to any of the Company's shares for the time being;
6. make any change in the Company's capital structure, including any increase in its nominal share capital, reduction of its share capital, or sub-division, consolidation or conversion of any of its shares;
7. pay any fees or any other remuneration to Directors or any person who is a connected person of any such Director; or
8. pay any dividend or distribute any assets of the Company (other than in accordance with the agreed distribution policy);

9. pass a resolution whereby its classification or status may be changed;
10. move any business currently conducted in the United Kingdom outside the United Kingdom;
11. begin or settle any legal or arbitration proceedings, other than routine debt collection;
12. give any guarantee or indemnity;
13. grant any power of attorney;
14. incur expenditure exceeding £[] or its capital account;
15. borrow any money (except borrowings from its bankers not exceeding £[]);
16. make any payments out of, or drawings on, its bank account (except routine payments);
17. make any loans;
18. prepay any loans;
19. factor or assign any book debts;
20. change the accounting reference date;
21. change the basis of accounting;
22. pay remuneration or expenses to anyone other than as proper remuneration for work done or services provided;
23. make any gift or political or charitable donation;
24. enter into any leasing, hire purchase or deferred payment agreement;
25. create or redeem any mortgage, charge, debenture or other security;
26. dispose of or grant any option or right of pre-emption in respect of its assets except in the ordinary course of trading;
27. enter into or terminate any partnership or joint venture;
28. allow any insurances to lapse or do anything which would make any policy void or voidable;
29. enter into any agreement which cannot be terminated by the Company without penalty within 12 months of its commencement;
30. enter into any abnormal or unusual contract or commitment including any which:
 - 30.1 is outside the ordinary course of business;
 - 30.2 is unlikely to be profitable;
 - 30.3 is of a long-term nature;

- 30.4 would have extended payment terms;
- 30.5 would involve a total outlay over the term of the contract in excess of £[];
- 31. depart from the ordinary course of trading in any way;
- 32. reorganise or change the nature or scope of its business;
- 33. enter any agreement restricting its freedom to do business as it thinks fit;
- 34. make any claim, disclaimer, surrender, election or consent [of a material nature] for tax purposes;
- 35. grant any lease or third party rights in respect of any property or transfer or dispose of any property;
- 36. create any interest over any property (including a security interest);
- 37. change the terms and conditions of employment of any director or senior employee i.e. an employee with a gross annual salary of [£] or above;
- 38. employ or terminate, without good cause, the employment of any person;
- 39. dismiss any senior employees;
- 40. enter into any service agreement which is not terminable on three month's notice (or less) without compensation;
- 41. make, or announce any proposal to make, any change or addition to any retirement, death or disability benefit of any of its directors, employees or former directors or employees (or a dependant of any such person) or to the Company's pension scheme;
- 42. enter into, or vary the terms of, any agreement with a trade union.

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