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shareholder agreements

This checklist summarises the key issues/considerations and highlights the broad range of issues that can be covered in a shareholder agreement.

What are Shareholder Agreements?

A shareholder agreement is used to set out the basis on which the shareholders agree who should be directors, what powers directors have, what happens if any of the shareholders wish to transfer their shares, what happens if shareholders die or wish to retire etc.

The Companies Act and the company's articles of association set out default positions on many but not all of these matters so a shareholder agreement is not a legal requirement.

What is the default position without a Shareholder Agreement?

The board of directors is responsible for the day to day running of the business and will typically make a very broad range of operational and strategic decisions without reference to the shareholders. Directors and shareholders are legally distinct roles although, in private companies, they are often the same people.

The quorum for a director's meeting is 1 where the company has only 1 appointed director and any 2 directors where there are 2 or more appointed directors.

Some matters require the decision of the shareholders. Shareholder(s) with over 50% of the voting shares have the ability to:

- appoint and dismiss directors, and therefore to load the board of directors in their favour
- sanction new issues of shares, subject to offering new shares pro rata to existing shareholders
- declare dividends

Shareholder(s) with over 75% of the voting shares have the ability to:

- change the Company's Articles, name, registered office
- disapply the requirement to offer new share issues pro rata to existing shareholders
- wind the company up.

More information

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The quorum for a shareholder's meeting is 1 shareholder where the company has only 1 shareholder and any 2 shareholders where there are 2 or more shareholders.

Shareholders are generally free to dispose of their shares however they wish, although the board of directors do have some rights to refuse to register transfers in the company records.

So why have a shareholder agreement?

The default positions are often not practical for private companies, especially where there are a number of minority shareholders. It is possible to establish alternatives to the default positions and this is typically done via a shareholder agreement and for many private companies, it is a good idea to have an agreement. What is usually covered in a shareholder agreement?

Board of Directors:

The following are often included in shareholder agreements:

- should board membership be restricted to shareholders and if so should there be a specific shareholding to qualify, e.g. 5/10/20% etc?
- should there be a maximum number of directors?
- who should be entitled to appoint/remove directors, is a 50% shareholder acceptable or do you wish to set another threshold?
- what is the board meeting quorum? Will the quorum require a specific shareholder to be present?
- is there to be a chairman of the board and does he/she have a casting vote?
- will each director have one vote? If not, what proportion will there be?
- are alternate directors permitted?
- how often will meetings be held?

Shareholder Rights:

Where directors and shareholders are the same people, the practical distinction of whether the decisions are made at board or shareholder meetings is often blurred. However, as board meeting decisions are made typically on a "one man one vote" rather than on a % shareholding basis or, in situations where the board and shareholders are not the same people, the shareholders may wish to impose veto rights that require specific matters to be decided on by the shareholders not the board.

These will be specific to each company but typically the areas requiring shareholder approval in shareholder agreements are:

- major capital expenditure
- any change in the nature of the business
- hiring/firing senior staff
- major new borrowing (and state what amount you regard as 'major' for this purpose)
- contracts outside the ordinary course of business or in excess of a specified value
- purchase of other businesses
- sale of the business
- grant of security/charges /mortgages
- the giving of guarantees
- material dealings with intellectual property
- disposal of assets
- changes to accountants/auditors

If shareholder approval is required in these situations what percentage applies?

It may also be the case that whilst a matter is required by law to be made by shareholders that the shareholders wish to apply a percentage majority for passing such as resolution that is higher than the default set by the Companies Act. Typically this will be:

- changes in the share capital of the Company
- changes in the rights of shares
- changes to the Articles of Association
- changes to the company name and/ or registered office
- issue of new shares
- dividend distribution policy and the declaration of dividends
- appointment/removal of directors

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If this is the case what percentage do the shareholders wish to apply?

Shareholders may wish to set specific requirements on the quorum for a shareholders meeting?

Transfers of shares:

Shareholder agreements are a good way of placing restrictions on how shares can be transferred.

The types of restrictions that could be considered are:

- can a shareholder transfer shares to his or her spouse/children/other relations/ family trust for tax planning purposes?
- can a shareholder transfer part only of his holding?
- where a shareholder wants to transfer his shares is he required to offer them pro rata to the other shareholders first, this is called "pre-emption"
- if pre-emption applies on what basis would those shares be valued, e.g. an open market value or net asset basis? How is that to be assessed if there is a dispute, usually disputes are referred to the company's accountants for valuation.

Consider if there any circumstances which would force a shareholder to transfer shares to the remaining shareholders, typical situations are:

- bankruptcy
- insanity
- being unable to carry out duties for 6 months in any 12 month period
- in the case of a shareholder who is an employee, resigning or being lawfully dismissed
- being in material breach of shareholders agreement
- being convicted or charged of a criminal offence punishable by imprisonment
- ceasing to be a director of the company
- death

With such forced transfers it can be difficult for the remaining shareholders to raise the finance to pay for the transferred shares. In the case of death or critical illness it is often possible to take out insurance but consider also whether a different valuation applies if the shareholder is a 'bad leaver' (e.g. he is leaves because of gross misconduct, criminal conviction, material breach of the shareholder agreement. Shareholder agreements often state in these circumstances that the value is the lower of the nominal value of the shares and the market/net asset value.

Also consider if an offer is made by a third party for all of the company's shares and a minority of the shareholders refuse to accept the offer, should the majority be able to force them to sell too (this is usually called drag-along)? What percentage constitutes a majority in those circumstances?

Conversely, should a minority be able to block the sale the majority shareholding unless the proposed purchaser makes an offer to purchase the minority's shares on the same terms (this is usually called a tag-along)? What percentage constitutes a minority in these circumstances?

Other points:

Should the shareholders agreement contain restrictive covenants, i.e. a clause preventing a shareholder whilst he is a shareholder and after he leaves the company from:

- competing with the business,
- approaching customers/ suppliers and staff,
- using confidential information and
- using the company's name or a similar name for another business?

If so for how long and are there to be any geographical restraints? These must be reasonable to be enforceable, what is reasonable will depend on many factors.

Are any or all directors / shareholders to be required to devote all or a specific part of their time to the business of the company?

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