SHAREHOLDER AGREEMENT GUIDE

Three facts about shareholder agreements:

a) There is no requirement in law for members of a company to have a shareholder agreement. A shareholder agreement is a good way of agreeing what will happen in various scenarios that occur in the life of a company.
b) Without a shareholder agreement the company owners will need to look to the Companies Act 2006 to determine their rights - which inevitably means having to consult a business lawyer.
c) A shareholder agreement does not need to be registered anywhere. It is a private, confidential contract between company owners.

1. Shareholding Ownership of the Company

The shareholder agreement will set out who owns the shares and in what percentages.

2. Construction of the Board of Directors

Any shareholder (or group of shareholders) owning 51% of the company has the power to remove any director or appoint new directors to the board. The shareholder agreement can give protection to a minority shareholder (holding 50% or less of the voting rights) against being removed without consent.

3. Key Decisions

Some key decisions in a small company have a big impact on all shareholders. The shareholder agreement can ensure that these 'big' decisions cannot be taken without the unanimous consent of all of the shareholders. For example (not an exhaustive list):

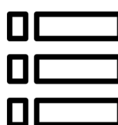
a. Should a shareholder be allowed to be involved in a competing business? Or in any other business (competing or not)?

b. Should a single director/shareholder be allowed to authorise any payment on behalf of the company that is greater than (e.g.) £1,000?

c. Should a single director/shareholder be allowed to engage or dismiss an employee?

d. Should a single director/shareholder be allowed to change the nature of the business?

e. Should a single director/shareholder be allowed to admit a new shareholder into the company?



4. Creating different classes of shares

The company can create different 'classes' of shares and allocate different rights to each class. For example:

(i) Non-voting shares; (ii) shares that only benefit from a sale of the company (e.g. to tie in senior employees who you don't want to give voting shares to); (iii) shares that receive flexible dividend payments;

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5. Voluntary Transfer of Shares

Sometimes a shareholder will decide to voluntarily leave the company (e.g. due to relocation, lifestyle change, personal circumstances). This section deals with what happens to his shares if he does. For example:

a. Other shareholders may get an option of first refusal to buy the shares

b. The shareholder agreement may state that other shareholders must buy the shares from the departing shareholder

6. Compulsory Transfer of Shares

There are very, very few circumstances in company law where a shareholder must sell his shares back to the company or to another shareholder – even if he has abandoned the company or breached his duties.

A shareholder agreement sometimes sets out a list of events which trigger a compulsory sale. For example:

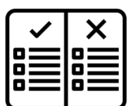
a. The death or critical illness of a shareholder

b. Bankruptcy

c. A shareholder is absent for an extended period or abandons the company

d. A shareholder commits an act which is akin to gross misconduct under an employment contract

The shareholder agreement can also set out what price should be paid for the shares if this happens – for example, many companies decide that the price should be less than market value if the transfer of shares is the result of one of these 'compulsory' events.



7. Rules for Selling the Business

A buyer of the company will almost always want to buy 100% of the shares. However, there is no requirement in company law for all of the shareholders to sell their shares – effectively, one shareholder (even a minority shareholder) can block the deal for the rest of the shareholders.

A shareholder agreement will often specify that if a majority of the shareholders wish to accept an offer to buy the company then all of the shareholders must sell their shares.

8. Sharing the Profits/ Allocating Dividends

In company law the profits of a company (i.e. what is left after overheads and salaries have been paid) are split between the shareholders in proportion to the shares that they hold (this is called "dividends").

A shareholder agreement can specify how the dividends are to be paid (for example, if the directors cannot otherwise agree on whether to pay out or to invest).

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9. Shareholder Protection

Upon the death or critical illness of one of the shareholders there are some potentially undesirable outcomes. A shareholder agreement can give options to avoid these pitfalls, for example:

a. The survivor may wish to purchase the shares of the deceased shareholder but the personal representatives of that person may not wish to sell them;

b. The widow(er) of the deceased shareholder may wish to have involvement in the running of the company which the survivor may not appreciate.

These options form what is sometimes called a “cross-option clause”. They work by giving the remaining shareholders an option to buy the shares of the departed shareholder and the executors or personal representatives have an option to sell those shares to the surviving shareholder(s).

The secondary problem is to ensure that there are sufficient funds for the survivor(s) to purchase the shares. This is best achieved by both parties taking out life insurance on the life of the other. This would usually be arranged by an IFA (independent financial advisor).

10. Deadlock

Mediation provisions should be included. In the event of ongoing deadlock that can’t be resolved by mediation then there might be a range of options, for example:

a. a casting vote to be given to the chairman of the board;

b. arbitration;

c. a “Texas shoot-out” buy out clause – whereby each party sends a sealed cash bid to an umpire within a specified number of days stating the maximum price at which they are willing to buy the shares of the other party. The sealed bids are opened together by the umpire, and the highest sealed bid "wins", and that bidder must then buy (and the "loser" must sell) the other party’s shares in the company;

d. a voluntary winding up of the company, which will occur by default if one of the other options is not chosen.

What to do next?

A good shareholder agreement starts from £2,500 + VAT.

If you know what you want to do (or even if you and not yet sure) email David Hughes, who can arrange a phone call, or video chat to discuss your requirements.

A draft shareholder agreement takes about a week or two to prepare, plus whatever time you need to discuss the draft internally between the shareholders.

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