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A Practical Guide to Shareholders' Agreements

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As well as the company's articles of association, a shareholders' agreement is a crucial document for any company as it details the rights and responsibilities of shareholders. A well-drafted and comprehensive shareholders' agreement is therefore essential to avoid potential disputes in respect of shareholders' interests. This guide to will run you through the basics and help you understand how to create a comprehensive shareholders' agreement.

What is a shareholders' agreement?

A shareholders' agreement is a legally binding contract between the shareholders of a company, which outlines the rights and obligations of such shareholders. The agreement serves to protect the interests of the shareholders and to provide a legal framework to facilitate the smooth operation of the business.

Why do you need a shareholders' agreement?

A shareholders' agreement is an essential part of corporate governance, as it provides a structure for the effective control and protection of shareholders' rights.

It serves as a proactive and preventive tool, addressing potential issues by incorporating requirements in relation to:

- relationship management by defining the rights, obligations, and expectations of each shareholder, preventing any future misunderstandings and/or conflicts;
- board decision-making by detailing the composition and powers of the board of directors, defining how key decisions should be made and be effective;
- protection of minority shareholder rights, safeguarding their rights through implementing veto powers and unfair prejudice provisions;
- control against potential ownership changes by specifying conditions and restrictions on the transfer and allotment of shares;
- exit strategies for both directors and shareholders alike, with the latter including, for example, leaver and sale provisions;
- dispute resolution, outlining the primary procedures for resolving disputes amongst shareholders to avoid potentially costly litigation;
- protecting company information, by introducing confidentiality obligations and restrictive covenants to prevent shareholders from engaging in competing activities;
- dividends and profit distributions, ensuring transparency and fairness through clear policies;
- succession planning in respect of the future ownership and management of the company;
- operational continuity, reducing the risk of disruptions caused by conflicts among shareholders; and
- future adaptability, allowing for amendments to the agreement to accommodate any potential changes in market conditions, ownership structure and business strategy as the company evolves.

It is important to note that whereas a company's articles of association is a public document by virtue of their filing at Companies House, a shareholders' agreement is usually private between the parties meaning that it can contain provisions which are confidential.

What is included in a shareholders' agreement?

Whilst it is important to tailor shareholders' agreements to the specific needs and circumstances of the company, a typical shareholders' agreements would include provisions relating to:

- shareholders' details, including names and shareholdings;
- the company's share structure, outlining the different classes of shares and the rights associated with each class, for example, voting rights;
- any conditions or restrictions in relation to dividends and/or distributions, and the process for declaring the same;
- the procedures for issuing new shares and any pre-emption rights of existing shareholders to purchase such shares before they are offered to external parties. It should be noted here that whilst there are statutory provisions in respect of the issue of new shares, these can easily be varied with sufficient shareholder authorisation meaning that if there is to be absolute protection then provisions must be agreed between the shareholders on a contractual basis. This will ensure that shareholders will definitely benefit from being offered new shares;
- similar optional pre-emption rights for share transfers. It is important to remember that there are no statutory pre-emption provisions in respect of the transfer of shares, and therefore shareholders may wish to include additional conditions as to who must be offered shares for sale first before the selling shareholder; and
- management and decision-making rules for both directors and shareholders such as any reserved matters requiring shareholder approval before certain actions are taken by the board (for example, altering the company's share capital, employing a highly-paid employee or changing the company's business strategies).

- the appointment, removal and resignation of company directors. Directors of a company generally hold most of the power in respect of the day-to-day control of the business and therefore it is important that shareholders can effectively dictate which individuals can be appointed to the board, and when they can be removed. Shareholders with large percentages of the shares may also require express rights to be appointed to the board and to perhaps remove others;
- share sales by a shareholder or the company, detailing the procedure for selling shares, as well as the applicable method for valuing the company and any events that trigger an exit, such as death, disability, or a disagreement among shareholders. As we mentioned above, a shareholders' agreement will detail how shareholders can transfer their shares, and it may also be appropriate for it to dictate the circumstances in which shareholders can be forced to sell their shares and at what value. Such provisions are sometimes referred to as compulsory transfers and the good leaver/bad leaver clauses;
- dispute resolution, defining the practice for resolving deadlocks or disagreements often through mediation or arbitration;
- confidentiality and non-competes, to protect sensitive company information and prevent shareholders from engaging in competing businesses. Whilst employment contracts are able to contain restrictive covenants for employees, shareholders' agreements will usually contain certain restrictive covenants which bind the company's shareholders even if they are also employees. It is accepted that restricted covenants in shareholders' agreements are more enforceable than in an employment context and therefore parties may wish to take advantage of this by including longer or more wide-reaching restrictions; and
- preventing smaller shareholders stopping the remaining majority from selling the business as a whole. The shareholders' agreement may contain drag-along provisions which permit a certain percentage of shareholders to force others to sell to a third party in order to ensure that a purchaser can acquire all of the shares. By reverse, we could also see tag-along and/or co-sale clauses whereby minority shareholders can tag along on a sale by a majority shareholder (usually a founder) forcing the buyer to also purchase the minority's shares in addition to the majority's shares.

Advantages and disadvantages of shareholders' agreements

Although an essential instrument, shareholders' agreements are not without issues, and it is therefore important to weigh any potential advantages and disadvantages when considering the specific needs and characteristics of the company.

Advantages	
Clarity and certainty, having written rules reduces any ambiguity and potential misunderstandings between the shareholders and/or company.	The protection of the company's business and any sensitive company information by implementing concrete restrictions within the agreement.
Flexibility, while each agreement will be similar to a certain extent, they can still be customised to suit the company's unique requirements.	Continuity and succession planning, providing for the orderly succession of ownership and management within the company.
Confidentiality, unlike articles of association which must be publicly available on Companies House, generally shareholders' agreements may remain confidential for the attention of the company's shareholders only.	Control over decision-making, enabling shareholders to have a say in key decisions by requiring their approval in respect of certain critical company matters, and precluding their control from being unnecessarily diluted through incorporating anti-dilution provisions.
Legal compliance, ensuring that the company's affairs are well-regulated and comply with any applicable laws and regulations.	Financial transparency, establishing clear guidelines in respect of the distribution of profits, ensuring fairness in dividend payments.
Minority shareholder protection, ensuring that majority shareholders cannot take advantage and providing a level playing field for those with smaller stakes in the company.	Promoting investor confidence, attracting new investors by demonstrating that the company has an effective and transparent governance framework to safeguard their investments and the company's business.
Clear exit strategies, outlining clear procedures and mechanisms for selling or transferring shares.	

Disadvantages	
Inflexibility, often unanimous or majority consent may be required to make any minor amendments to the agreement once in place, but equally some may say this is a benefit.	Certain non-binding provisions, which may lead to challenges in enforcing specific obligations.
Potential for disagreements, although primarily designed to prevent disputes, the agreement may not completely eliminate disagreements in every instance and it still relies on good communication and trust among shareholders.	Enforceability, unless carefully drafted, the enforceability and effectiveness of the agreement may be subject to the legal systems of the jurisdiction in which the company operates.
Dependency on good faith, in that the ultimate success of the agreement depends on all parties abiding by its terms and acting in good faith.	The shareholders' agreement is a document between shareholders and does not attach to the shares in the same manner as the articles of association do, meaning that it may not adequately bind any transmittees or insolvency practitioners in the event of the bankruptcy or insolvency of a shareholder.

Absence of a shareholders' agreement – what are the risks?

Inconsistent and undefined terms

Although such a small typographical amendment, there can be a great difference between defined terms with a capital letter at the beginning of the word and undefined terms all in lower caps, with one letter affecting the whole construction and meaning of a provision.

For example, "Shareholders" could be defined as only including the holders of preferred shares in the capital of the company, thereby precluding any ordinary shareholders from voting if "Shareholders" is used rather than any "holders of shares in the company" in the following clause:

"Each of the Shareholders severally undertakes to the Company and the Investors that they shall exercise all voting rights and powers of control available to such Shareholder in relation to the Company to procure, in so far as they are thereby so able to do so, that save with Investor Majority Consent, the Company shall not effect any of the matters referred to in this clause."

Equally, it is important to ensure that defined terms are used consistently throughout the shareholders' agreement but also across the company's constitutional documentation, so as to avoid, for example, Investor Majority Consent being defined as the consent of 50% of the company's shareholders under the shareholders' agreement, but 75% of shareholders in the company's articles of association.

No pre-emption rights in share transfer events

Without provisions in a shareholders' agreement which specifically govern the pre-emption rights of existing shareholders in the event of share transfers, no such rights shall be implied. Accordingly, in the absence of an agreement, company shares subject to a transfer can be offered externally to third parties, without being offered internally or back to the company in the first instance. There will be a high degree of flexibility on dealing with the transfer of shares where no express provisions exist. Having no shareholders' agreement could therefore be detrimental to existing shareholders, who would have a minimal degree of control over how a shareholder looking to transfer their shares does so in practice. Shares could be offered to a third party who has conflicting business interests and intentions to current members, which could result in disruption and hinder the overall morale amongst shareholders. If the shares being transferred constitute a high proportion of the company's overall shares and have high voting powers attached, this could have strong bearings on the outcome of key company decisions.

Company members should therefore ensure that a shareholders' agreement is drafted, which expressly sets out the pre-emption rights of existing shareholders to be offered shares initially, to ensure a degree of manageability when dealing with shares in a transfer event. The agreement should also provide rules for "compulsory transfer" situations, whereby a certain event will automatically trigger a share transfer, such as an existing shareholder ceasing to be employed by the company. Without provisions outlining the steps to take in these circumstances, a shareholder who leaves the company would still have their shares, which would be clearly problematic to other shareholders as they would continue to benefit from the company's overall performance without contributing personally to the company.

Drag along and tag along provisions in the sale of a company's shares

In the event of a company being sold, with the buyer seeking to acquire the entire issued share capital of the company, problems may arise if minority shareholders are unwilling to sell their shares to the prospective buyer. Having a shareholders' agreement means that a "drag along" clause can be included and relied upon if necessary. The purpose of this clause is to allow a majority of shareholders to force a minority shareholder to sell their shares to a prospective buyer on the same terms, in an event such as the one outlined above. Drag along provisions afford certainty to majority shareholders in that should they wish to sell an entire company's share capital at some stage in the future, they will have the security of being able to enforce a sale should a dispute arise.

Contrastingly, having a shareholders' agreement can also provide security to a minority shareholder, who can force a prospective buyer to also purchase their shares, should any shareholders' agreement include a "tag along" clause to that effect. Without such a clause, a buyer purchasing a company may only look to purchase the majority shareholding so that they have sufficient voting rights, without looking also to purchase the shares of any members with a minority shareholding. A minority shareholder will be able to "tag along" to a majority shareholder in such a situation.

Regulating the management of the company

Company directors have effective day-to-day management of the company and in turn are responsible for making a number of key business decisions. Having a shareholders' agreement allows company shareholders to retain control over who exactly can be appointed in office as a director, as well as having authority to remove a director from office, should a situation arise which prompts such action to be taken.

Without a shareholders' agreement in place, it will be harder to regulate directors and their powers, particularly where a director is not themselves a shareholder. It may not be in the shareholders' interests to allow directors an unfettered right to make company management decisions. Provisions can therefore be included in a shareholders' agreement which stipulate that certain company decisions can only be instigated through resolution of the company's members, thus limiting the directors' powers.

Handling disputes and enforcing restrictions

Shareholders should carefully construct a shareholders' agreement so that should any dispute arise between the company's members, there are clear provisions on how this will be handled and what procedures shall be taken in order to resolve the matter. Provisions to this effect ensure stability and uniformity about how the company will act in certain circumstances, increasing shareholder confidence. Without such an agreement in place, there may be ambiguity about what steps need to be taken and what powers each respective shareholder has in such a dispute. There is also the risk of a lack of consistency when handling disputes, damaging shareholder trust and confidence, which could tarnish shareholder relations.

Disputes may ultimately cause a shareholder to sell their shares and leave the company entirely. Another principal benefit of having a shareholders' agreement is the ability to include terms restricting a leaving member's activity, such as working for a competing business. Typically restrictive covenants contained in a shareholder's employment contract (if employed) will be less enforceable than any restrictive provisions contained in a shareholders' agreement. There is also scope to contain restrictions of a stricter nature than would typically be included in an employment contract.

Conclusion

Shareholders' agreements are a valuable document and promote the long-term success and stability of a company by establishing a well-structured business environment in which to grow. It is highly recommended to seek legal advice from an early stage for the reasons as detailed above and to keep the agreement updated as the company evolves to ensure its continued relevance and enforceability.

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