SHAREHOLDER AGREEMENTS

Shareholders in small or private companies can easily fall into dispute. Minority shareholders feel taken for granted by the directors and managers, and left in the dark about what is going on. Majority shareholders can be 'held to ransom' by the minority, unable to sell their shares. Shareholders with equal holdings can be in deadlock, unable to agree on important matters affecting the company's direction and activities.

This Guide explains how a Shareholder Agreement can help protect the rights of shareholders and resolve disputes in companies.

1. WHAT IS A SHAREHOLDER AGREEEMENT?

A Shareholder Agreement is a private contract between the shareholders of a company. The company's Articles of Association are the constitution of the company or governing framework, and give detailed instructions on how the company is to work. But many minority shareholders will wish to have a Shareholder Agreement as well, to govern how decisions are made.

Minority shareholders are vulnerable compared to a majority shareholder, and a Shareholder Agreement can help protect their position. An agreement might say, for instance, that a minority shareholder must be appointed to a particular role, such as auditor. Or it might restrict the majority shareholder's right to sell shares.

A Shareholder Agreement also helps shareholders get their money out of the business. The Companies Act 2006 did not say what should happen when a director who is also a shareholder wishes to sell his shares, or where they die or are dismissed. Should the shares be offered to remaining shareholders? How are they to be valued? What is the procedure for sale or transfer? Without a Shareholder Agreement, these issues will inevitably leads to disputes and possibly costly litigation.

2. WHAT ARE THE BENEFITS OF A SHAREHOLDER AGREEMENT?

A company's Articles of Association can theoretically be amended merely by a 75% majority vote of shareholders, which could leave minority shareholders exposed. By contrast, a Shareholder Agreement can be altered only if all parties to it agree, because it is a private contract. The Articles are also a public document, available for inspection at Companies House, whereas a Shareholder Agreement is not.

A Shareholder Agreement can also govern matters that do not relate to the company's constitution. For example, if the shareholders are concerned about a shareholder who is also a director leaving to work for a competitor, they can ask them to agree (in a Shareholder Agreement) that they will not do so for a certain period of time after their departure from the company.

The agreement can also specify that the shares of a shareholder who dies must be sold to the other shareholders. This would avoid the administrative inconvenience of the outgoing shareholder's family inheriting a stake in the company.

Finally, the fact that there is a well-drafted Shareholder Agreement can help attract investment into the business. Investors are encouraged by the clarity that the agreements can provide. Lenders too can be reassured by the presence of an agreement, since it will often provide an exit clause for them.

3. WHAT CLAUSES DOES A TYPICAL SHAREHOLDER AGREEMENT HAVE?

Every Shareholder Agreement is different, because they reflect the needs of the individual company and shareholders. But they will typically contain some or all of the following elements:

- **Dividends policy** - a Shareholder Agreement should state how shareholders are to receive the profits of the business, i.e. the dividends. It might state the percentage of net profit to be distributed annually. This is particularly important in companies where shareholders hold different classes of shares, and different percentage holdings.

- **Non-compete clauses** - a Shareholder Agreement allows the shareholders to formally exclude any shareholders from creating companies which directly compete with the company while they are a shareholder. Such a non-compete provision will often continue in force for a certain time after the individual ceases to be a shareholder of the company.

- **Drag along rights** – a clause allowing majority shareholders who want to sell their shares to force minority shareholders to sell also. This is to prevent deadlock on a disposal of the business – a purchaser will generally wish to obtain 100% of the shares.

- **Tag along rights** – a clause providing that when majority shareholders are selling their shares, any shares held by a minority shareholder must be sold also. This prevents minority shareholders becoming trapped in a company which is controlled by new shareholders, where they had no control over their purchase of the shares.

- **Good and bad leavers** – the agreement can dictate the price at which a departing shareholder's shares are purchase, depending on whether they are a 'good leaver' (such as retirement) or a 'bad leaver' (such as going for wrongful behaviour). The agreement will define those terms, and specify how the price is calculated.

- Right to **appoint or remove directors** – a clause giving minority shareholders the right to appoint or remove directors.

4. HOW CAN SHAREHOLDER AGREEMENT HELP RESOLVE DISPUTES?

If the relationship between shareholders has broken down, and one or more of the shareholders wants to sell their shares, a Shareholder Agreement will often have a mechanism to achieve this. It might specify how to value the shares of the outgoing shareholder, and say if the process differs according to whether that person is also an employee of the company, or is selling their shares due to retirement, or they have been dismissed for misconduct.

A Shareholder Agreement will often also specify the way shares should be valued if they have been inherited from the original shareholder, for instance by asking the company accountant to value them.

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