Think Ahead ACCA

Technical factsheet

Shareholders' agreements

A company must adopt articles of association in order to be registered at Companies House, as they provide a basic framework of rules by which the company is governed. Many, if not most, small companies adopt the version of model articles derived from the Companies Act in force at the time of their formation. (Currently, model articles are under the Companies Act 2006, the previous ones being Table A under Companies Act 1985.)

These standard articles are a fairly basic set of provisions which are best suited to companies where there is a clear separation between ownership and management of the business. Unfortunately, they are often insufficient to deal with the many issues that may arise in a small company where the majority shareholders are also the directors, and in joint ventures. In fact, where any company has more than one shareholder, they are often also advised to make a shareholders' agreement in order to further regulate the way the business is to be conducted.

There is no legal requirement to conclude such an agreement, but having one often turns out to be invaluable in dealing with any disputes or unexpected events that arise, as well as providing protection for the shareholders' investment and establishing a fair relationship between the shareholders.

What kind of disputes?

The most common issues that arise in practice are:

- where a party or parties are being excluded from the management of the business
- where the shareholders disagree over how a key matter should be taken forward, eg the sale of the business, or a change in direction of the business
- where a shareholder(s) feels that a company is being run for the benefit of other members of the company, excluding them
- where there is a breakdown in the relationship between the shareholders or a deadlock so the company cannot operate
- where the parties wish to go their separate ways and cannot agree on the terms.

What is a shareholders' agreement?

It is a simple contract or agreement, entered into by some or all of the shareholders in a company, which governs the relationship between them. Usually, all shareholders agree to it, but in some cases it may be all of the shareholders in a particular class. It sits alongside the articles but can cover a wide variety of matters not normally provided in the standard documents. It creates a contractual relationship between the parties, and a legal obligation on all parties to comply with its terms.

- Not only is it very flexible in terms of content, but a shareholders' agreement cannot be changed without the consent of all the parties, whereas the articles of association can be changed by special resolution (requiring 75% of eligible shareholders). This makes the shareholders' agreement invaluable in protecting minority shareholder rights, as the arrangement is binding on all shareholders and cannot be altered without their consent.
- In law, a company cannot bind itself or promise to do or not to do certain things, but this can be achieved through a shareholders' agreement.
- Company law provides that a director can always be removed by a simple majority of shareholders (ordinary resolution), but the agreement can prevent such a step being taken without the agreement of all shareholders.
- The contents of a shareholders' agreement can be kept confidential, whereas the articles are registered at Companies House and are a public document.
- The agreement can cover deadlock situations, as explained below.

- Breach of the agreement allows the other shareholder(s) to make a claim for damages in a simple contract, outside the more complicated provisions of company law protecting minorities, which are expensive and cumbersome.

It is worth bearing in mind that, although clients are often unwilling to spend money on having such an agreement drafted, the professional adviser may wish to attempt to persuade them of the benefits. At the beginning of a new business relationship, it may be difficult for clients to foresee that they may fall out, or have difficulty in making decisions. They are often so carried away with the excitement of the venture that they do not explore what is being planned in the detail that is needed. This is where the skilled adviser comes in; reminding clients about what might happen is part of risk assessment and is an important part of the value you bring as a professional.

Lenders and investors are likely to feel that the fact that the parties have agreed a sensible and practical shareholders' agreement upfront tends to indicate a mature and professional approach to their business. It may well help in convincing them that the business is likely to be stable going forward and give credibility to the founders who have made such a provision.

What are the key advantages of a shareholders' agreement?

- **Resolution of disputes**
  It is not uncommon for disagreements to arise within small owner-managed companies, which are often run by members of the same family, close friends or long-term business associates. Disputes may arise about many things, such as how much work is being done, and by whom; there may be disagreements about salaries, dividends, admitting new shareholders, the number and choice of directors or the direction of the business. Such provisions may include the stage at which a dispute is referred to mediation, or the identity of any arbitrator. There will also be an exit mechanism so that if the shareholders cannot agree, a shareholder may sell their shares to the other shareholders at a fair valuation or the agreement may provide a route to selling the business.

  This aspect is particularly important in dealing with the 50:50 company, where two shareholders own half the shares each, which will include many joint ventures. The danger here is of deadlock; it becomes impossible to take any decisions if the parties fall out and since no one has a majority, the situation quickly becomes untenable. If the parties are unable to compromise or reach any workable agreement, it will usually threaten the future of the business. The shareholders' agreement can provide a mechanism to break the deadlock by including a binding process, which will result in one party buying the other out or the business being sold quickly. There are a range of different clauses that may be used, mainly involving either some form of mechanism by which each shareholder makes a bid to buy the other's shares, or where a third party makes a binding decision about what happens next. It is critical that such clauses are carefully considered and professionally drafted in order to best fit the particular circumstances of the company.

- **Key decisions within the company**

  The standard model articles and indeed company law generally focuses on the power of the directors to take all but a few major decisions in the management of the company. The only key powers retained to the shareholders are to change the constitution by special resolution, or to remove a director by ordinary resolution. Since this requires at least 50%+1 share, in effect, any minority shareholder(s) have little power to influence decisions. In small companies, power tends to be concentrated in the hands of one or two people who hold the majority of the shares, and any minority shareholder has few options if this power is abused; there is usually no market for a minority shareholding in a small, private company.

  Some articles of association provide minority protection provisions of the kind outlined in this factsheet, but since they can be changed freely by special resolution, it is key to provide this protection via a binding agreement between the members. Normally, therefore, the shareholders' agreement will provide that certain key decisions can only be taken with the agreement of all shareholders, regardless of the size of their holding.

  In particular, most shareholder agreements will provide that the following cannot take place without the agreement of all shareholders:
    - the issue of new shares
    - appointment or removal of directors
    - transfer of assets into or out of the company
    - directors' remuneration/bonuses etc

- new borrowing
- change to the nature or scope of the business
- entering substantial business contracts
- launching legal proceedings

It is obviously important that such provisions do not place excessive restrictions on the directors as they must have the freedom to manage the business without the necessity of checking with the shareholders at every turn. However, such clauses should prevent underhand behaviour or decisions that result in significant loss of value to the business.

Example: Irvine v Irvine

The case of *Irvine v Irvine* is a very typical small family company dispute that cost a great deal of money to litigate.

The petitioner, Patricia Irvine, along with a trust in favour of her three children, held just under 50% of the shares in a private company, CIHL, and Ian Irvine (her late husband's brother) held a bare majority. Patricia argued that Ian Irvine that conducted, and continued to conduct, the affairs of CIHL in a manner which was unfairly prejudicial to her interest and the interest of the trust in three respects. First (and principally), Ian had procured the payment to himself of what she described as 'excessive, unreasonable and unjustified levels of remuneration'. Second, and as a consequence of the first, the shareholders (in particular she and the trust) had either received no dividends at all or, in the case of one year, inadequate dividends. Third, she said that Ian had failed to run CIHL in accordance with the requirements of the Companies Act 1985.

The case resulted in the court concluding that Ian had conducted the affairs of CIHL in a manner that has been prejudicial to the petitioners' interests. The judge found that he drew more by way of remuneration for the years 1996 to 2004 than he should and that, in consequence, he prevented Patricia and the trust from receiving as much by way of dividend as they would have received – consistently with the historic policy of profit distribution – if the remainder of the profits (after deduction of Ian's proper remuneration and the annual sums actually carried to retained profits) had been paid out by way of dividend.

The court also found that various procedures that should have been carried out under the Companies Act had not been, and that Ian had indeed not run the company in accordance with the legislation. It ordered that Ian should buy out the shares and this then led to further litigation about their valuation.

It is interesting to note a few things about this case:

- the length and complexity of the proceedings; one look at this very long judgment would demonstrate to the reader what enormous cost must have been involved in the preparation and presentation of this case
- the fact that Patricia's husband had not made any practical plans for his early and unexpected demise in terms of working out what the best way ahead would be for the ownership of the business. He left his shares to her and the children, and no arrangements were made that took into account that Patricia had no experience of the specialist insurance work that they did, and could not take any part in the business
- that there was no way by which the parties were likely to come to any agreement about the buyout; Ian had made an offer to Patricia, but it was unacceptable to her and the sale price for her shares was ultimately decided by the court.

The other really useful provision that can be agreed between the shareholders is an ability to eject or remove a director who is behaving inappropriately and/or breaching their duties, even if they do not have a majority shareholding. Re Sevenoaks Stationers (Retail) Ltd is a good example of a situation in which the shareholders had to go to court to get a misbehaving director removed; he was eventually removed and disqualified as a director. He had been a director of five insolvent companies and had failed to keep proper accounting records, file annual returns or ensure annual accounts were prepared, as well as trading while insolvent.

- **Other protection for minority shareholders**

  In addition to the above, it is normal to provide a so-called 'tag-along' clause in the agreement. These provisions apply in the event of a sale of the business, with the minority shareholder being entitled to sell their shares to the buyer at the same price as the majority have obtained. This is to prevent the majority selling their stake to a willing buyer, leaving the minority shareholders stranded with a new owner.

- **Protection for majority shareholders**
  The 'drag-along' clause is commonly included in order to prevent the minority from scuppering the sale of a business by refusing to sell their stake. It will provide that once a certain threshold of agreement is reached, the minority must sell their shares to the buyer, provided they are offered the same terms as the majority shareholders.

- **Controlling the transfer of shares**
  One of the main issues to consider is what should happen if one shareholder wants to leave the company. Without any such clause in a shareholders' agreement, a shareholder who leaves may be unable to sell their shares because the directors refuse to register the transfer. (This can be challenged, but it is difficult and expensive.) With no real market for the shares, the minority will usually be forced to sell their holding to existing shareholders at a discount. Alternatively, the majority shareholder might seek to sell shares to any outsider they choose, leaving the remaining shareholder(s) running a company with someone of whom they disapprove or whom they do not know.

  It is therefore important to have a set route in terms of how shares are to be sold. Firstly, you should decide on whether shares must be offered to the remaining shareholders first. This is common and the most practical option in most cases. This way, if one of the shareholders wishes to leave the company, then the other(s) will have the option to purchase the shares from them.

  Most agreements provide for the outgoing shareholder to place a value on the shares, which, failing agreement on the price, would then be referred to an independent expert (usually independent accountants or auditors) to determine a reasonable value. The next decision would be whether the remaining shareholder(s) would be bound to buy the shares of the outgoing shareholder. They may not want to, or be able to afford to, in which case you need to decide if they would have a choice or not. Problems may arise in terms of funding the purchase if they are bound to buy and this may not be ideal. If the shareholder refuses to buy the shares, there can always be a provision that the shares are then offered to the company, who must buy them back if there is sufficient cash/bank facilities. You may also wish to consider whether the shares could be sold to a third party, though this could bring about its own problems. However, this may not be as onerous as having an unhappy shareholder ‘locked in’ to the company. The shareholders’ agreement helps iron out such issues before they arise by setting out a clear structure to the sale or transfer of shares.

Having provisions such as this is particularly important where shareholders are related or in close personal relationships. Many shareholders erroneously believe that standard company law prevents shares being transferred out of the immediate circle of existing shareholders, but this is not the case. The directors may refuse to register a transfer but, as explained above, this does not help minority shareholders who disapprove of the person to whom the transfer is to be made, if the directors hold the majority of the shares.

The other circumstances where transfer of shares becomes important is where a shareholder dies, and the agreement may provide for what happens in this situation. It is common for cross-option provisions to be included. Shareholders grant each other options that will only come into effect when one of them dies. It is normally provided that:

- Each shareholder agrees that, upon their death, their fellow shareholders have the option to buy their shares at market value.
- In addition, the shareholders agree that their personal representatives have the option on their death to sell the deceased’s shares to the surviving shareholders.

At the same time as this agreement is put in place, each shareholder would take out a term assurance life policy under which proceeds are held in trust by the surviving shareholders to pay for the deceased’s shares.

This means that a shareholder can ensure that the value of their shareholding will be received by their family, without the need to leave the shares themselves to relatives who may not actually want them, or who may cause difficulties for the other shareholders.

- **Linking shareholding to employment**
  Often, directors or key employees hold shareholdings in the business. If they were to resign or leave the business for any other reason, there needs to be provision to ensure that they must sell their shares back to the company, or to other shareholders. A mechanism will be in place to set out the procedure for this.
  It is normal for such provisions to include different methods of reaching the valuation depending on the circumstances of the exit. These are so-called 'good' and 'bad' leaver clauses. Where a director or employee has left the business in amicable circumstances, they will be likely to benefit from a fair valuation clause, where the price is determined by reference to the value of the business in accordance with normal principles. However, where the individual has been dismissed for gross misconduct, or has resigned because of some dispute about their conduct or performance, this may well trigger a bad leaver clause, which means that they will receive only a nominal sum for their shares.

  There have been a couple of interesting cases on these clauses recently, which are useful to bear in mind in practice. The case of *Richards v IP Solutions* involved a High Court decision as to whether the company had been right to summarily dismiss the claimant, and if so whether the bad leaver clause in the company's articles could be enforced. The clause in question stipulated that a bad leaver would get £1 for all the shares that he was required to transfer. The argument was that this was such a draconian clause that it amounted to an unenforceable. (Such clauses are a form of agreed damages, which the courts are well used to striking out if they feel they are unreasonably high in the circumstances.)

  The court decided that the leaver provisions in the articles were agreed between parties for commercial reasons to do with a shareholder leaving the company, and there was nothing unconscionable in an arrangement arrived at between parties dealing at arm's length with the benefit of extensive expert advice. If the company had lawfully dismissed Mr Richards (which it had not), the court would have found that transfer provisions in the bad leaver clause were enforceable. Other cases have tended to back up the principle that such clauses are included for a good reason, and that the courts will generally enforce them, however unhappy the director/employee might be with the price they have obtained for their shares.

In *Ideal Standard v Herbert 2019*, a clause had been included in a shareholders' agreement (SHA) affecting a director/shareholder. The employment had been terminated and a settlement agreement finalised that was "intended to settle outstanding differences" between the employee and the company. The director said that the effect was to waive a restriction in the SHA. (These are common: see below.) The judge said it did not; there was no reference in the compromise agreement to the SHA. In addition, the SHA provided that any waiver had to be in writing and signed by the person granting the waiver; the settlement did not do this. Always remember that, with such directors, you need to think of their different roles as 'employee', 'owner' and 'director', and deal with the termination of each status as a separate consideration from a legal standpoint.

- **Regulating shareholder/directors**
  A shareholders' agreement will often impose restrictions on an exiting shareholder – for example, preventing them from setting up a competing business within a certain area of operations for a particular time. It may also impose confidentiality requirements on the shareholder not to disclose certain information about the business to others. These are very valuable provisions, since they are often stricter than might be permitted in an employment contract, and will generally be enforceable.

- **Dividend policy**
  The agreement can set out a dividend policy which provides a binding agreement as to, for example, a minimum percentage of dividend to be paid or considered if profits allow, or different dividend levels to be paid to each shareholder for different classes of shares, and also for situations where a divided is not to be paid.

- **Administrative and regulatory matters**
  It is usual for the agreement to provide the identity of the auditors and bankers, location of the registered office and the accounting reference date, and that these will not be changed without the unanimous consent of the shareholders.

- **Other matters**
  There is no particular limitation on the matters that can be covered in a shareholders' agreement, and it may also include details of the financing of the

company, including an obligation on the shareholders to provide further funding to the company if the company requires it, and specifying what form this funding might take. Clauses may cover the constitution of the board and directors' voting, and the parties' intentions as to the future direction of the business.

Valuation clauses

Shareholders' agreements will usually contain a valuation clause which will be triggered where there is to be a buyout of shares. This may be where a shareholder elects to sell because they wish to exit the business, or has died, and the remaining shareholders have the right or obligation to buy the shares out. Valuation clauses need to be carefully worded and, although they are really useful, they are not foolproof, and there have been a number of cases where they have been disputed. General advice is that:

- As far as possible, they should 'stand alone', leaving no further decisions to be taken by the parties about, for example, the identity of the valuer or the basis of valuation. If the parties have fallen out and are 'at war', it is dangerous to assume that they will be able to come to any kind of agreement about anything, and this will allow one party to hold up the sale by refusing to reach agreement.
- The valuer should be as independent from the parties as possible. It will only make the situation worse if one party believes the valuer is really on the other party's side.
- The clause needs to be carefully worded. An interesting case was Cosmetic Warriors Limited & Lush Cosmetics Limited v Andrew Gerrie 2017. Lush's articles of association included a right of first refusal process in the event that a shareholder sought to sell the shares. The shares would first be offered pro rata to the existing Lush members at a price equal to 'fair value', and then, if that was not accepted, the selling shareholder was entitled to sell the shares on to the third party for no less than the fair value. The issue was the meaning of 'fair value'. The shareholder who was selling held a minority shareholding but the provisions of the valuation clause did not provide specifically that the valuer could apply a discount on the basis that a shareholding was a minority. It seems likely that this was a mistake, but the court refused to imply additional wording into the clause to allow it, and the minority shareholder received a high price for their shares!

SHAREHOLDERS' AGREEMENT CHECKLIST

This checklist lays out the broad categories of matters that are recommended to be covered in a shareholders' agreement. It is not exhaustive and is only in summary form. It is essential to get legal advice to ensure that any agreement contains the most relevant matters for individual businesses and circumstances.

The business

- Obligation on shareholders to use reasonable endeavours to promote and develop the business (or the joint venture company as appropriate)
- Setting out vision for the business. Where do the shareholders see it as going – for example, spreading geographically, pursuing particular markets, to be developed to be sold within a certain timeframe?[1]

Running of the business

- Such shareholder and board meetings are held as may be necessary for initial set up of the company, including to:
    - adopt the articles in the agreed form
    - change the company's name to [NAME]
    - appoint the directors, with agreed titles as appropriate, eg [NAME(S)] as X director[s] and [NAME(S)] as Y director[s] and [NAME] as chairman. [NAME] shall be managing director and [NAME] shall be finance director
    - appoint [NAME] as the secretary of the company[2]
    - resolve that the registered office of the company shall be at [ADDRESS]
    - appoint [NAME] as the accountants for the company
    - resolve that the company's financial year shall end on [DATE] in each year
    - open a bank account on behalf of the company as agreed

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[1] It's useful to look at this as it can often expose differences between the shareholders as to their medium- and long-term objectives or vision for the company.

[2] There is no need for a company secretary, but some companies may wish to allocate the responsibilities for company administration by appointing one.

- The adoption of a business plan in whatever format is agreed, eg detailed plan for first year and outline five-year plan etc
- Identification of what work/roles are being performed by whom within the business, and the expectations of the parties in relation to work provided
- Reserved matters, ie things that require the consent of all the shareholders – for example, to
    - change (by whatever means) the nature of the business from the type of business planned at the outset or from time to time during the life of the company
    - amend the articles of association, or any particular clauses
    - change the name of the company
    - sell or otherwise dispose of the whole or any part of the company's undertaking, property, assets, or any interest in them or contract to do so whether or not for valuable consideration
    - increase, reduce, sub-divide, consolidate, redenominate, cancel, purchase or redeem any of the capital of, or allot or issue any shares in the capital of, the company
    - alter any rights attaching to any class of share in the capital of the company, or create any option, warrant or any other right to acquire or subscribe for any shares in the capital of the company
    - do, permit or allow to be done any act or thing whereby the company may be wound-up, or enter into any compromise or arrangement under the Insolvency Act 1986
    - merge or amalgamate with any other company or undertaking, or acquire directly or indirectly any interest in any shares or other security convertible into shares of any other company, or form or acquire any subsidiary
    - purchase, lease or otherwise acquire assets, or any interests in assets, which [in aggregate] exceed the value of £[AMOUNT] [or for consideration which exceeds £[AMOUNT]]

- enter into any other contract, transaction or arrangement of a value exceeding £[AMOUNT]
- borrow any money in excess of [£[AMOUNT] OR any limits agreed in writing from time to time between the shareholders], or create any mortgage, debenture, pledge, lien or other encumbrances over the undertaking or assets of the company, or factor, assign, discount or otherwise dispose of any book debts or other debts of the company
- give any guarantee, make any payment or incur any obligation or act as surety otherwise than in connection with the company's ordinary business for the time being
- lend or agree to lend, grant any credit or make any advance to any person otherwise than in the ordinary course of the business of the company
- set directors' remuneration from time to time
- appoint a director, or remove any director (subject to provisions below on removal of a director who is in breach of their duty to the company etc)
- hold any meeting of the shareholders or purport to transact any business at such meeting, unless all shareholders are present, whether in person or by proxy
- instruct lawyers, with a view to establishing the company's legal position and/or launch legal proceedings against any person with or without legal representation

Procedure for issue of new shares

- Identification of a mediator, arbitrator or expert to resolve issues arising in relation to the agreement

Directors and management

- Rules for directors' and shareholders' meetings, eg
    - minimum periods of notice, and provisions allowing short notice
    - who is entitled to call a meeting

    - quorum
    - proxy rules
    - casting votes if applicable
    - number/frequency of meetings to be held.
- Provisions permitting removal of director(s) by shareholders where the director is eg in breach of duty or bringing the company into disrepute (may require votes of all shareholders excluding those held by the director in question)
- Right of all/certain shareholders to be involved in the management of the business, and not to be excluded from this, as applicable
- Financing of company, and provision of further financing (When does the obligation arise, and who is obliged to provide it in what proportions?)
- Restrictions on shareholders in the form of restrictive covenants including non-competition, non-solicitation and non-deal clauses, non-poaching undertakings and confidentiality clauses
- Obligation to maintain proper accounts, to provide full relevant financial information and to grant access to the books and records to all shareholders
- Dividend policy – any minimum dividend payable, normal level of dividends, provision for changing this agreement
- Arrangements for resolution of a deadlock[3]
- Events giving rise to obligation to transfer shares eg breach of agreement, death of shareholder, removal as director and appropriate valuation clause, including good and bad leaver clauses for shareholder/directors as appropriate
- Arrangements for transfer of shares where shareholder wishing to sell, valuation clause, procedure
- Tag-along clause protecting minority shareholder(s)
- Drag-along clause protecting majority shareholder(s)
- Arrangements for liquidation of company

September 2021

[3] Key in a 50:50 company