Shareholders' agreement – do you need one and who will it benefit?

Introduction

If you are establishing a company with other shareholders or investing in an existing company, the conventional wisdom is that you should have a shareholders' agreement. But is that always advisable and do the benefits justify the costs?

While a shareholders' agreement can offer generic benefits to all shareholders by providing more certainty and formalising underlying agreements and understandings between shareholders, the benefits to minority shareholders, or to joint venturers who have equal shareholdings, are more obvious. Any benefits to majority shareholders are more finely balanced (assuming the positives of having an agreement outweigh the negatives).

This article investigates the benefits of a shareholders' agreement from the different perspectives and the key provisions which should be included in such an agreement to achieve those benefits.

Minority protection

Where a company has minority shareholders the shareholders' agreement primarily protects that minority.

Without a shareholders' agreement (or special provisions in the company's constitution):

- the majority will have voting control to decide all decisions except for a limited number of decisions which the Companies Act specifies must be passed by a special resolution of shareholders (being a 75% majority or any higher majority specified in the constitution);
- the minority will have no right to board representation;
- the minority will only have limited rights to company information and will not be privy to board information;
- the minority may not have recourse if any intended business plan or objectives are not followed;
- the majority could sell their shares and leave the minority behind in the company;
- the minority will only generally have recourse if the majority exercises its control in a manner which is "oppressive" to the minority.

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A shareholders' agreement will typically address each of these issues, providing the minority with contractual rights in each area. These rights will supplement the more limited statutory rights and minority protections under the Companies Act.

Accordingly for a minority investor paying cash for shares in a company the advantages of a shareholders' agreement are normally clear (for further discussion of key investment terms typically sought by minority financial investors please also see my related article **"It's no time to be shy when negotiating investment terms"**). A cash investor should also have the leverage to get a suitable agreement, as it can make it a condition of investment.

For a non-financial investor, such as an employee receiving shares, the benefits of a shareholders' agreement and the leverage to get one may be more marginal. Any additional rights may be very limited. In fact, it may well be the majority which pushes for, and benefits most from, such an agreement (or special provisions in the company's constitution) to the extent that it may restrict rather than add to any minority rights.

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Majority shareholder perspective

For the majority shareholder the benefit (or otherwise) of having a shareholders' agreement is more finely balanced. Largely the agreement will reduce the power and control of the majority. If the majority has a choice (which it may not have, if the minority insists on a shareholders' agreement as a pre-condition to investing), it may prefer to avoid entering into a shareholders' agreement.

However a shareholders' agreement may still benefit the majority by providing greater clarity around the agreed future direction of the company, perhaps reducing any risk of an oppression claim or a claim by the minority that it invested based on different understandings or promises (the shareholders' agreement will usually say that it represents the entire agreement between the shareholders and supersedes any other written or oral agreements or representations).

A shareholders' agreement may also benefit the majority if it contains collateral covenants from the minority shareholder(s) (such as subscription or other financial obligations or non-compete or restraint of trade provisions) or a right for the majority to "drag" the minority in any share sale (enabling the majority to deliver 100% share ownership of the company where required by the buyer).

Without a drag right the majority might still be able to effect a sale of all of the company's assets, however it will need 75% shareholder support to do so and, even if it can achieve that majority, a share sale is generally the preferred sale mechanism for the seller (see related article **"The company or the assets?"**).

Of course, there is no guarantee the minority will agree to give the majority a drag right in any shareholders' agreement. Even if the minority is agreeable to a drag right, it may be preferable for the majority shareholder to include such a right in the constitution rather than create a shareholders' agreement. This might avoid the inevitable discussion with any shareholders' agreement of what else should go in it to protect shareholders.

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Joint venture/ no majority

Where no shareholder (or shareholder group) has a majority (eg. there are two shareholders with 50% each or more than two shareholders where no aligned shareholders hold more than 50%), there are mutual benefits for all shareholders in having a shareholders' agreement.

As no individual shareholder will be able to control any decision a shareholders' agreement should provide greater certainty for all shareholders (by setting out an agreed direction and business plan, board representation rights, mechanisms to determine annual budgets, agreements relating to funding, etc) and thereby minimise the issues which may have to be horse traded on an issue by issue basis. Importantly the agreement will also usually provide a mechanism to deal with a voting deadlock on any important issue to mitigate the risk of a deadlock strangling the company's progress.

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Relationship with constitutional documents

It should be noted that many of the additional rights and protections typically included in a shareholders' agreement could alternatively be included in the company's constitutional documents (in whole or part).

One benefit of this approach is that the constitutional documents are automatically binding on future shareholders without the need for a deed of accession. The process to vary special provisions in a constitution when the shareholding structure of the company changes or such provisions otherwise become redundant is also more straightforward, whereas a shareholders' agreement can become a straightjacket if an individual shareholder holding less than 25% of the shares withholds agreement to amendments required to take the company forward (perhaps as leverage for other demands).

Where there is a large number of shareholders, a shareholders' agreement may be unwieldy (particularly if it is likely that the identity of shareholders will change over time) and a bespoke constitution is likely to be more suitable. If a bespoke constitution is not adequate for any reason in these circumstances, consideration should be given to including provisions in the shareholders' agreement which will allow the agreement to be amended by a special majority (so unanimity is not required).

It depends on the proposed substance of the shareholders' agreement whether including all of this substance in the constitution is a practical alternative. Some provisions, particularly transitory provisions and private agreements, may not be appropriate to include in a constitution (which is an enduring public document).

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Key provisions of a shareholders' agreement

A shareholders' agreement should typically cover the following key areas:

- *Establishment and Structure* - the initial share capital, constitution (normally in annexed agreed form), directors, registered office, bankers, auditors etc.;
- *Objects and Business* – the primary objects of the company and the scope of its business activities, preferably including adoption of an agreed initial business plan and budget;
- *Subscription/ Investment Obligations* – if not separately agreed the agreement may encompass each shareholders' investment obligations (equity and any shareholder loans) and any other agreements relating to financial support (including whether any shareholder guarantees will be provided for external funding or whether that funding will be non-recourse);
- *Board* – the board structure and each shareholder's rights to appoint and replace board members, whether there will be independent directors, quorum requirements, voting and whether chairman has a casting vote, meeting frequency and whether the will be board remunerated;
- *Key Management* - any agreements relating to the key management personnel and management structure;
- *Financial and Reporting* – whether accounts will be audited, the financial and other information which must be provided to shareholders and the board respectively, the financial year end;
- *Reserved Matters/ Special Majority Decisions* – decisions which will require special majority approval (eg. typically unanimous or 75%) at board and shareholder level respectively;

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- *Deadlock* – mechanisms which will apply if the requisite majority for a key decision cannot be achieved (see further discussion below);
- *Transfers of Shares* – to extent not covered by the constitution, any 'lock-in' obligations or other restrictions on transfer, pre-emptive rights, tag and drag rights;
- *Default/ Compulsory Transfer* – consequences of a shareholder defaulting or becoming insolvent, including any compulsory transfer provisions and associated pricing mechanism;
- *Shareholder Support* – any agreements relating to other support individual shareholders will provide the company and the terms of that support;
- *Non-competition and restraints* –restrictions on the shareholders competing with the company;
- *Termination* – default and other termination events;
- *Other provisions* – mutual or one way warranties (possibly company warranties if the agreement encompasses subscription obligations), confidentiality, dispute relation mechanism, costs and other usual template provisions.

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Deadlock mechanisms

One of the more contentious areas of any shareholders' agreement is what should happen when a deadlock arises.

A deadlock will arise when the requisite voting majority for a key decision is not achieved. For a joint venture (where no shareholder has a majority or casting vote) that could occur for any decision, whereas for a company with a majority shareholder it may arise for those decisions which require some minority support (typically called "reserved matters" or "special majority" decisions).

Usually the agreement will include internal escalation (eg. to each party's CEO) or mediation provisions in the first instance to exhaust the possibility of the parties reaching a voluntary resolution. If that is unsuccessful, then there are four broad options:

- *No binding resolution mechanism* – leave it to the parties to find a resolution eventually on the basis that they all lose value if the company doesn't do what is in its best interests (ie. they are similarly incentivised to find a solution). This is fine in theory, but one cannot assume rationality will prevail when shareholders fall out and there is always scope for brinksmanship (a "*it will hurt you more than me, so eventually you will give me what I want*" type attitude).
- *Binding arbitration or expert determination* - this will allow an independent third party to resolve the impasse. One difficulty with this is that a third party, with no financial stake in the business, may be asked to make a business decision for the company and its shareholders. It also leaves open how the next key decision will be resolved where the shareholders continue to co-exist in the company but are fundamentally misaligned regarding the future direction of the company (it is not practical or cost effective to arbitrate every key decision).
- *Forced buy-sell mechanism* – typically this will allow the shareholder who is prepared to pay the most to buy the other shareholder out to do so, or, in the situation where the minority is blocking the majority will on reserved matter, the majority can buy out the minority at 'fair market value'. This effects a once and for all solution (divorce) and is generally favoured when all avenues for a voluntary resolution have been exhausted. Potential disadvantages (or advantages, depending on what side of the fence you sit) are that these mechanisms tend to favour the more financial party (who might be able to buy out the other party at an undervalue, knowing the other party can't pay market value the other way) and can be manipulated (ie. a deadlock is manufactured to provide the opportunity to buy out the other party).

- *Liquidation of assets*– like a forced buy-sell mechanism this provides a final solution. It also has similarities to a forced buy-sell mechanism where the shareholder who values the company's assets and business highest might buy them in the liquidation. The liquidation need not be a formal Companies Act 'liquidation', but rather a controlled sale of the company's assets pursuant to an agreed mechanism (usually through an independent third party).

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Conclusions

The requirement for a shareholders' agreement, or at least bespoke provisions in the company's constitution, should be evaluated for any company where there are two or more shareholders. If there are a large number of shareholders it may be more appropriate to include any special provisions in the constitution.

In most cases a shareholders' agreement will primarily benefit the minority shareholders rather than the majority, particularly where the minority is investing cash in the company and has the leverage to attain greater minority rights than conferred by company law and a standard constitution. However a shareholders' agreement may still benefit the majority, particularly if it includes important financial or non-competition covenants by the minority shareholder(s) or drag along rights. If there is no majority shareholder a shareholders' agreement is invariably recommended to reduce the risk of a deadlock stifling the company's progress.

To determine if a shareholders' agreement will be beneficial, a useful exercise is to consider the key provisions typically including in such an agreement (as set out in this article) and evaluate the benefits of those provisions (by comparison with the position which will apply if there is no specific agreement on these matters).

A shareholders' agreement should address an appropriate mechanism to deal with the possibility of a voting deadlock stifling the progress of the company. The most favoured mechanisms usually allow one shareholder (or shareholder group) to buy out the other or to force the liquidation of the company's assets.

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