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:: Understanding Shareholders Agreements

A shareholders agreement is a contract between some or all of the shareholders in a private limited company. The company itself is generally a party to the shareholders agreement. The basic purpose of a shareholders agreement is to provide how the company is to be managed and, as far as possible, to pre-empt and agree resolution of issues that might arise in the future.

What Type of Businesses are they for?

If a business is operated through a private company with a number of shareholders from outside your immediate family, it is advisable that the shareholders and the company enter into a shareholders agreement to regulate their relationship as shareholders in the company. In some private companies, the only shareholders are the promoter and his or her immediate family members (only in a nominal capacity) in which case an agreement relating to the ownership of shares may not be as necessary. However, in cases where the private company is owned by a number of business partners, a shareholders agreement is often essential to ensure that disputes do not arise at a later date.

Where a number of companies come together to in a joint venture for a specific project, it is commonplace for the parties to negotiate and enter into either a shareholders or a more composite joint venture agreement.

A shareholders agreement could apply to private companies limited by shares across any industry. The legal structure of each private company is the same, and the same set of rules apply. It is the amount and diversity of the company's shareholder base that defines what type of shareholders agreement should be put in place, rather than the particular industry in which the company operate.

What about a Company's "Articles of Association"?

The shareholders agreement will be in addition to and compliment a company's articles of association. The articles of association are the basic constitutional document which every company must have by law. Oftentimes, where the company does not adopt articles of association, then the model forms of articles of association specified the Companies Act, 1963 will automatically apply to that company.

Most standard articles of association will contain a description of the rights attaching to the different classes of shares, pre-emption rights regarding new issue of shares, provisions concerning the convening and conduct of director/ shareholder meetings, and provisions covering the payment of dividends.

A shareholders agreement would usually provide that the agreement will override a company's articles of association.

Would detailed Articles of Association Not be Sufficient?

It is not normal for articles of association to contain details of director's remuneration, ownership of important intellectual property rights used by the business, provisions preventing shareholders being involved in competing businesses, or details of what happens when one of the promoters leaves the company on bad terms.

It is possible for the shareholders to include more expansive provisions governing these matters in a company's articles of association, however the significant disadvantage of this approach is that any member of the public could by doing a simple search at the companies office find out all these details. In most businesses, the matters contained in a shareholders agreement will be commercially sensitive and their exposure may be detrimental to the business.

What would a Shareholders Agreement Contain?

As a shareholders agreement is a private contract between a company and its shareholders, it could contain just about anything which the parties want to provide for. However, a typical shareholders agreement will contain some of the following provisions:

Rights and Protections for Minority Shareholders

Minority shareholders can be given detailed rights and protections in the shareholders agreement which they would not otherwise have, as company law affords minority shareholders with little protection. One way of providing for extra rights and protections in favour of minority shareholders is to provide in the shareholders agreement that the company cannot do certain things without first getting the consent or approval of a certain percentage of shareholders to include the minority shareholder. The shareholder consent matters are generally geared towards ensuring that the company's value is not reduced. Consent could be required for the company to:

- dispose of its assets above a certain value;
- issue shares or loan capital;
- create charges over assets; or

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• incur large amounts of capital expenditure.

The minority shareholders could also be given a right to receive specific information (e.g. monthly/quarterly management accounts; cash flow projections; annual budgets etc) or a general right to information concerning the conduct of the business on request. These protections are commonplace where an outside individual or organization (e.g. a venture capitalist) invests in a private company.

Preventing Key Individuals Competing

Certain shareholders or promoters could be prevented from competing with the company. This restriction would generally contain a prohibition on the shareholder or promoter competing generally with the company, as well a prohibition on soliciting employees or customers from the company. Such a restriction could operate during the period in which the shareholder or promoter owns shares in the company, but could also operate to prevent the shareholder or promoter competing with the company in the period following that promoter or shareholder ceasing to hold shares in the company. Advice should be taken in all circumstances, however, as these restrictions which are known as "non-compete" clauses raise complicated enforceability issues.

Transfer and Issue of Shares

A shareholders agreement will typically contain detailed and comprehensive provisions which regulate the future issue and transfer of shares in the company. It is usual to provide for the shares to be offered first amongst the existing shareholders before being sold to a third party. A shareholders agreement can set out time periods in which such "offer rounds" take place, and also a framework for agreeing a valuation on any new shares being issued.

This gives existing shareholders the first refusal on the issue or transfer of shares, ensuring that the shareholders can keep ownership of the company amongst themselves if one shareholder decides to sell his or her shareholding or where the company needs to raise fresh capital.

Ownership of Intellectual Property

Where a company uses important intellectual property, such as a trademark to its name or a patented production process, the shareholders agreement could set out that all shareholders agree that any intellectual property developed by any of the shareholders (either outside business in their personal capacity or before the company was incorporated) belongs to the company. This is vital to safeguard against the situation where the promoter or shareholder that owns such intellectual property in his or her personal capacity leaves the company on bad terms. If the company does not have ownership to the intellectual property essential to the operation of the business, it could be forced to pay the former shareholder or promoter in order to use it.

Deadlock Resolution

A deadlock is a form of exit clause which is commonly used in a 50/50 situation. It enables one or other shareholder to invoke a procedure when there is a deadlock - a fundamental disagreement between the parties that cannot be resolved.

A deadlock process involves one party specifying a price for his shares and saying either that he will sell his shares to the other party at that price, or will buy the other party's shares at that price.

This provision generally results in a realistic market value being placed on the shares and can save on negotiation and valuation fees at a later stage. An alternative usually provided in a deadlock clause is that, if the parties cannot agree to resolve their differences satisfactorily, a liquidator will be appointed with a view to winding up the company voluntarily.

Shareholders can deal with possible future disputes amongst themselves by taking steps to put in place a shareholders agreement. It is much easier to put in place an agreement now while business is running smoothly or before a specific project commences and relations are good, than to have a dispute arise down the line when this may not be the case.

This article provides and outline of the various options and proper legal advice should besought in all circumstances.

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