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HOW DO YOU PROTECT YOUR SHAREHOLDING? BENEFITS OF A WELL-DRAFTED SHAREHOLDERS AGREEMENT

Written

By

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Over the previous three months we have looked at the implications of being a shareholder of a company, the importance of protecting yourself if you are a shareholder and the main terms that should be included in a shareholders agreement (SHA). In this issue we are focusing on some of the common areas of dispute that are likely to arise if you do not have a well-drafted signed SHA, writes [Dr Rosanna Cooper](#).

It is important to remember that a majority shareholder owns a fifty-one percent

shareholding (or more) in a company and as a result has the right, amongst other things, to remove a director from the board. If the other shareholders do not wish a majority shareholder to have and/or exercise such rights then this should all be agreed in a SHA. The [articles of association](#) should be amended to reflect the terms of the SHA. For a more detailed discussion of articles of association and shareholdings, please see our previous articles in the [March](#), [April](#) and [May](#) issues of *Inventique*.

If there is a dispute amongst the shareholders of a company, how can this be resolved?

Some minor disputes can be resolved informally, without consuming any resources, and in relation to such disputes there should be no requirement for the intervention of a SHA. However, the more serious disputes, and those involving a number of shareholders will require a structure that forces a conclusive outcome. A common way that this might be dealt with in a SHA is by providing a

mechanism by which shareholders can resolve potential disputes. A SHA can also provide an exit procedure that can be called upon where an amicable agreement cannot be reached, and this has the effect of enabling shareholders to get out of the company with as little disruption as possible. This kind of procedure is only effective if it is well drafted.

Does a shareholder have any rights over the sale of shares in a company?

Perhaps one of the most common disputes amongst shareholders, yet one to which little thought is given, is in relation to the control over the sale of the company's shares. Owning shares in a small private company can often give a shareholder a degree of control over the company, as there are likely to be limited shares and shareholders. It therefore becomes more important as the company grows, to ensure that the right people control its expansion and growth. Although standard Articles of Association (Articles) can deal with the issue of share sale, it is often the case that shareholders in small companies are not necessarily aware of the workings of such Articles. Clear provisions in a SHA would alleviate any uncertainties.

By way of example, an inventor sets up a company (NEWCO) to commercialise an

invention, the inventor forms NEWCO with three other individuals who all bring varying levels of expertise to NEWCO, and all take shares in NEWCO. Over the next 18 months, with their joint efforts, NEWCO becomes very successful and begins to attract interest from investors and competitors.

Meanwhile, one of the shareholders wishes to retire and sell his shares. Given his contributions to the company and its vision, which the company would now be losing, the existing shareholders do not wish him to sell his shares to a third party that has made no contribution to the development of the company, and who might now have a certain degree of influence over the company. A comprehensive SHA will often contain a provision that before shares are offered for

sale to third parties, existing members would have the right to purchase such shares (right of pre-emption). This gives the existing members the option to keep control over the ownership of shares. Although pre-emption will usually be

What if the majority shareholder dies?

In the event of a shareholder's death, unless provisions exist to the contrary, it is usually the position that the deceased shares will go to his or her estate and any surviving spouse would have the option to take his/her position at general meetings of the shareholders. This may seem rather remote, but depending on the shareholding

Protection of Minority Shareholders

If you are a minority shareholder in a company, it is important that your interests are protected as well as ensuring that you have a say in important company affairs. The point is that as a minority shareholder you are most likely to be out voted on important issues if you do not strengthen your position. As explained in this series of articles, it is common in small companies for shareholders to assume the role of director-shareholders. An express term can be included in the SHA to avoid any dispute regarding the removal of minority shareholders or their directorships.

Another aspect of minority protection is ensuring that the issuing of new shares in

Limits on Director-Shareholder's Activity

By virtue of their position, director-shareholders can normally bind the company in contract, as the Articles of the company empower the directors to effect the day-to-day running of the company. This is an extremely important issue, and there is a need for shareholders in small private companies to have a greater degree of control over the way in which the company is committed to perform certain obligations. The SHA should provide for certain limits on contracts so that a director-shareholder or even the majority of the board could not bind the company in contracts where the financial value

dealt with in the Articles, the terms of the SHA prevail against the Articles. However, it is always advisable to modify the Articles in line with the terms of the SHA

of the deceased, a spouse with a certain level of control, and possibly very different ideas from the shareholders, may now wish to make his or her presence felt. Clear express terms in a SHA would ensure that this undesired situation does not materialise.

the company does not cause the value of the shares of the minority shareholder to substantially diminish. It is common for a SHA to include a provision that unanimous voting would be required for the directors to issue new shares in the company, or a right of first refusal to buy a number of shares that will maintain the minority shareholding.

The extent of minority protection that would be included in a SHA would depend on the circumstances of the business and the individual members, and several other protective measures can be adopted. Legal advice should be taken in each particular case.

exceeds a set amount. In this way, if there is any dispute as to whether a director-shareholder can enter into a contract on behalf of the company, the SHA would provide a definite solution.

In conclusion, there are a number of disputes and instances in which one would want the terms of a SHA to provide solutions, a few are mentioned above, but a comprehensive agreement is recommended to ensure that founding members in particular are adequately protected.