



CORPORATE GUIDE: SHAREHOLDERS' AGREEMENTS AND ARTICLES OF ASSOCIATION FOR FOUNDER SHAREHOLDERS

Many privately-owned companies with a small number of founder or other significant shareholders put in place a shareholders' agreement and dovetailed articles of association. This guide considers the main reasons for this and provides a checklist of the main issues to address.

If you would like to know more, including discussing our fixed prices for advising in this area and creating bespoke shareholders' agreements and articles of association for your company, please speak with your usual contact at Stevens & Bolton or a contact listed at the end of this guide.

While many of the same issues require consideration in all shareholders' agreement projects, it is important to consider each particular case individually and to ensure that the provisions are tailored to the particular circumstances.

WHY CONSIDER PUTTING THESE ARRANGEMENTS IN PLACE?

All private companies are required to have constitutional documents which set out rules for the governance and administration of the company. Company law rules also provide a general framework for operating companies, allocating responsibility to the directors (usually by majority vote) for day to day management and strategic decisions – only a few matters (such as share capital changes and altering the name or articles of association of the company) have to be decided by the shareholders.

In many cases, the main shareholders of a company wish to vary or supplement those usual rules. For example:

- The main shareholders may have agreed that the company will be run as a quasi-partnership, with each shareholder having equal power irrespective of actual shareholdings.
- The commercial position of a significant minority shareholder may put him or her in a position to require stronger protection (for example to veto certain decisions) than the basic legal rules would allow.
- Controlling shareholders may wish to impose controls on the actions of the company.
- The main shareholders may simply wish to record their agreement in relation to certain aspects of running the company as described below, to provide clarity and focus for the company and its shareholders.

The answer usually lies in a shareholders' agreement and dovetailed articles of association, which can be used to override those usual rules. Whether the agreed provisions are put into the shareholders' agreement or the articles of association will depend on a number of factors including:

- Confidentiality/public disclosure – generally, the contents of a shareholders' agreement are a private matter between the contracting parties, whereas the articles of association are open to public inspection at the companies registry.
- Number of shareholders/parties – if there are a large number of shareholders, a shareholders agreement will often be impractical, whereas articles of association have the benefit of automatically binding all shareholders once they acquire their shares.
- Changes of shareholders/parties – articles of association may be preferable if it is likely that there will be regular shareholder changes, as again any new shareholders will automatically be bound, whereas a new shareholder will only be bound by a shareholders' agreement if he specifically agrees to that by entering into an adherence agreement.
- Alterability – where the intention is to provide individual shareholder protections (e.g. the right to veto certain decisions), this may be best achieved in a shareholders' agreement which can only be varied by agreement of all parties. Achieving the same result in relation to provisions included in articles of association is more complex.

AREAS TO CONSIDER

The relative shareholdings of the main shareholders and the overall commercial context will be important factors in the drafting of these documents. Set out below is a checklist of the main areas to consider – if the company has any subsidiaries some of them are also likely to be relevant to each subsidiary.

Management and decision making at director level

- Who will be on the board?
- Will there be a chairman and will he or she have a casting vote in the case of deadlock caused by equality on the board in relation to any decision?
- How are directors appointed and removed?
- Will any shareholder have a right to be and remain a director or to appoint a director while a shareholder or holding at least a certain qualifying level of shareholding?
- What will the quorum for meetings of the board be?
- Will any decisions also require shareholder approval (i.e. shareholder veto rights) - and if so, what level of shareholder approval will be required?

Shareholder decision making

- Is it sufficient to rely on general law as to when an ordinary resolution (one share above 50%) or a special resolution (75%) is required, or will additional decisions require shareholder approval - and if so, what level of shareholder approval will be required?
- Will there be a chairman?
- What will the quorum for meetings of the shareholders be?

Provisions of information and business planning

- Is a framework required for preparation and annual approval of a business plan, and if so, what happens if the required level of shareholder approval cannot be reached?
- Will all or some shareholders have the right to receive information, such as monthly management accounts?
- Will all or some shareholders have further rights of access to corporate records?

Dividend policy

- Will regular dividends be expected or will this be left to the discretion of the directors?
- Will it be helpful to be able to pay different levels of dividends to different shareholders, in which case should separate share classes be considered?

Issues of shares

- Will further issues of new shares (diluting existing shareholders) be allowed if the directors think fit, or only with shareholder consent and/or if pre-emption procedures are followed requiring new shares to be offered to existing shareholders first?
- Does provision need to be made for an agreed pool of shares to be available for the grant of share incentives to new employees in the future?

Transfers of shares

- Will shares be freely transferable?
- Will directors have an absolute discretion to refuse to register any share transfer (subject to acting in good faith in the interest of the company and its shareholders)?
- Will approval of all or any shareholders be required to any share transfers or will shareholder consent not be required if pre-emption rights are followed requiring shares to be offered to existing shareholders/the company/any employee trust first?
- If there are to be pre-emption rights in relation to voluntary transfers, at what price should the shares be offered for sale?
- If there are share transfer restrictions, will there be any exceptional automatically permitted transfers - e.g. for companies transferring to group members, for individuals transferring to a spouse or other family member/family trust or for transfers between members?
- Will there be circumstances in which a shareholder is required to offer his or her shares for sale - e.g., employee shareholders ceasing to be employed or death? If so, at what price should the shares be offered for sale?

Drag and tag rights

- If a stated majority wish to sell their shares, must they procure a like offer for the shares held by the other shareholders?
- If a stated majority wish to sell their shares, must the other shareholders accept a like offer for their shares so that a sale of the entire issued share capital of the company can be delivered?

Deadlock and dispute resolution

- What if the affairs of the company are deadlocked due to a lack of required shareholder agreement on a proposed course of action - is it best simply to drop the proposal, or should an independent party be appointed to decide, or should the deadlock be a sign that the relationship has broken down resulting in buy-out procedures for the sale or purchase of some or all shares of some shareholders?
- Should any other dispute resolution mechanism be provided for to facilitate swift and practical resolution of disputes to avoid the business of the company being damaged?

Restrictive covenants and other protections of goodwill

- In addition to any restrictions in service agreements, will all or any shareholders be bound by restrictions (e.g. preventing completion or poaching of customers or staff of the company) while they are shareholders and for a period after they cease to be shareholders and/or employees?
- Should shareholders agree to confidentiality obligations relating to the affairs of the company?
- Should the shareholders' agreement include provisions protecting the intellectual property rights of the company?

KEY CONTACTS

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