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Do I need a shareholders' agreement?

Myths and rumours and minority protection

Whenever a private company has two or more independent shareholders, they will often be told that they should have a shareholders' agreement. In the broadest sense that's true: the relationship between the shareholders should always be agreed in some form. But a formal written agreement, in addition to the company's articles, is not always needed.

The default position is majority rule. A majority of the directors and a majority of the shareholders can do almost anything, especially if they hold 75% of the voting shares. The exception is that they can't force a shareholder to transfer his shares, except in very limited circumstances. A minority shareholder who does not like the way the company is run has very little comeback. Unless there is misconduct involved, his only hope is the "unfair prejudice" remedy, which is notoriously difficult and expensive to enforce. At best, it gets your shares bought out at a fair market value; it does not stop the unfair conduct, nor is it much good if your shares are worth very little but have excellent prospects for growth.

From the perspective of a majority shareholder, there's not much wrong with democracy. The one key thing all shareholders should want is the ability to buy back the shares of a shareholder who stops being involved in the business, whether because he leaves, dies or gets pushed out. That is usually put in the company's articles, and obliges a departing shareholder to offer his shares for sale at a fair price, either to the other shareholders or to the company itself. The exact means of valuation is up for discussion, but more often than not it is a straight proportion of the value of the company, without discount for the fact that it's a minority shareholding, or the fact that there is no prospect of a sale. The majority probably also wants drag-along rights, forcing a minority to join in any sale of the company approved by the majority.

If those two things are in the articles, and the directors have good, strong employment contracts, the majority shareholder probably doesn't want a shareholders' agreement: it will only take away rights he has through his majority control.

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A minority shareholder, on the other hand, has lots to gain. A shareholders' agreement will typically give the minority shareholder a veto over a long list of actions, as well as rights to participate in management and is to be consulted. It may give him a right to be a director, or to appoint one, and entrench his position so he cannot be sacked. It may impose obligations on the majority to act fairly, and to commit to a particular business plan. The agreement or the articles will give the minority tag-along rights, giving them the right to be offered the same terms as the majority if the company is sold. The majority shareholder may even be obliged to provide funding, or restricted from withdrawing funding he has provided.

What if there are equal shareholdings, or there is no overall control? In my view there is considerable danger in giving minority shareholders a veto, especially over routine business decisions. The company can become deadlocked and the business grinds to a halt, which is in no one's interests. I generally say that democracy should rule, and the minority should take their chances. What's sauce for the goose is sauce for the gander: any shareholder could find himself on either side of the argument, and it's best if the company is allowed to continue to function and make profits while the shareholders argue. How far take this approach depends on the circumstances and the shareholdings: three equal partners putting a lot of money into a joint venture might want more protection than 20 5% shareholders who are passive investors.

What else would you find in a shareholders' agreement? Restrictive covenants may be important, restricting the ability of a shareholder to compete with the business after he leaves. For a director, those can be in an employment contract, although restrictions relating to a shareholding are less likely to be struck down as unreasonable.

There is often a dispute resolution process. We often see "Texas shootout" or "Russian Roulette" clauses requiring a shareholder to state a price per share at which he will either buy or sell. They rarely work in practice and I advise against them, unless the parties have equal bargaining power, equal ability to run the company and the financial resources to buy out the other shareholders at short notice. There may even be "bad leaver" clauses, obliging shareholders to sell their shares cheap if they do not perform their obligations in the venture.

Do you need a shareholders' agreement? It's foolhardy to go into a jointly owned company without thinking through the issues, but I sometimes conclude that a formal written agreement is an unnecessary expense. The company needs appropriate articles with transfer restrictions, obligations to sell shares on leaving the company, and possibly "drag and tag". Directors should have employment contracts with appropriate restrictive covenants. After that, if you have two or three equal shareholders, or a large majority against small minority holders, I might well dispense with a shareholders' agreement and let the majority rule.

On the other hand, where an investor is putting in a significant sum of money, or the minority shareholdings are large, an agreement can be essential to protect the value of their investment. Not all shareholders' agreements are the same, but the wrong approach can lead either to shareholders walking away with much of the value from the business, or the business grinding to a halt under the dead hand management of shareholder vetoes.

I have been drafting shareholders' agreements for 30 years; if I can help with yours, do give me a call.

Chris Robinson

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