SHAREHOLDERS’ AGREEMENTS (SHA)

Christos Chrissanthis

WHEN IS A SHA NECESSARY ?

- Ideally, the parties usually wish to have all their arrangements relating to the Company included in the Memorandum of Association (by laws). This is because contractual arrangements outside the by laws may be unenforceable, particularly if they conflict with the by laws.
- However, under certain circumstances the parties may opt for a SHA. This is likely to be the case in cases like the following:
- (a) the parties do not wish some arrangements to be **public**; the by laws are public, while a SHA is not;
- (b) **company law may not be flexible** enough to accommodate certain arrangements, so it may not be possible to include such arrangements in the by laws; in such cases a SHA is the only solution available, although its enforceability may be doubtful, because company law is usually mandatory and cannot be derogated by contract.

How do parties deal with the enforceability problem ?

- In this case, the enforceability problem arises because company law is of a mandatory nature and cannot be derogated by contract. So, contractual clauses in a SHA which are contrary to provisions of company law will in principle be void and unenforceable. However, there are some ways to deal with this problem:
- **Choice of a convenient applicable law for the SHA.** The SHA may be governed by a law different than the law of the jurisdiction where the company has its registered office, that is, the parties may choose a convenient law to apply to the SHA.
- **Arbitration/Jurisdiction clause.** The parties may provide that disputes will be exclusively referred to the courts of the country whose law is chosen to govern the SHA or to arbitration, hoping that such courts/arbitration will not give prevalence to the company law of the country where the registered office of the company is registered.

- **Prevalence of the SHA clause.** The parties may include in the SHA a clause providing that the terms of the SHA shall prevail against the terms of the by laws and that they agree that in case of conflict between the SHA and the by laws the parties shall act according to the clauses of the SHA. Such a clause may also provide that the parties waive their rights under the by laws and that they will not attempt to enforce the clauses of the by laws against the terms of the SHA. One of the purposes of such a clause is to make it contrary to good faith to invoke the terms of the by laws against the terms of the SHA.
- Penalty clause. In theory the parties may provide for a penalty clause in case the prevalence clause is breached, but in business reality penalty clauses are unusual and not customary.

OTHER PROBLEMS OF ENFORCEMENT OF SHAREHOLDERS' AGREEMENTS

Breach of contract gives an action for damages for any loss caused, provided causation among the breach and the loss is established.

Shareholders' agreements are contracts and the general law rules on contractual breach apply.

However, it is impossible to establish an action for damages, because it is impossible to quantify loss and / or establish causation.

A civil penalty clause is unlikely to be agreed upon.

Specific performance would be required. So, there will be a clause expressly providing that in case of breach, specific performance shall be available. Still, the court process is usually slower than what is required to deal with shareholders' conflicts. Court protection can be inefficient.

Is it legally possible that the Company itself is also party to the Shareholders Agreement? Can the Company undertake a binding legal obligation not to carry on certain acts, unless both shareholders agree? The answer is debatable and it also depends on the particular act.

Usually, the clauses of shareholder agreements are contrary to provisions of company law; i.e. a clause not to increase share capital unless both parties agree, so an not to dilute the participation of each shareholder to the company. This is contrary to a basic provision of company law that voting rights depend on the number of shares, that each share carries one vote and that an increase of capital can be resoluted by way of a certain majority decision. – So, are shareholders agreements enforceable, or are they invalid as contrary to company law provisions? The matter is highly controversial and debatable.

- In some (but not all) jurisdictions the law provides that in case of a dispute among shareholders every party may apply to a court and that such court is authorized to issue under summary proceedings court orders of specific performance, that is, that the court is entitled to oblige shareholders as to which resolutions to pass and which not. In jurisdictions where it is not possible to apply to a court to issue this type of judgment disputes among shareholders may be endless.

WHAT A SHA USUALLY DEAL WITH ?

- The main clauses of a SHA usually deal with the following:
- **(a) MANAGEMENT CLAUSES**

That is, how corporate decisions will be passed and hoe the company will be managed.

The purpose is to make it possible for minorities to participate actively in the management of the company and be on an equal basis with the majority shareholders

- **(b) SHARE TRANSFER RESTRICTIONS**

That is, restrictions relating to transfer of shares to parties outside the company. The ultimate purpose of such restrictions is to secure equality for all shareholders in case of exit, i.e., if it is possible to make profit from selling the shares of the company to an outsider new investor, all shareholders must enjoy the chance to sell their shares on the same terms and participate to the profits.

- **(c) ANTI-DILUTION PROTECTION**

Majority shareholders may resolute in favor of huge and consecutive capital increases, so as to cause the reduction of the participation and the voting rights of the minorities who may not be able to follow on with additional contributions to the company in order to retain the volume of their participation. Anti-dilution clauses are clauses destined to provide protection to minorities against such a likelihood.

MANAGEMENT CLAUSES

- The most important management clauses are:
- (a) **Appointment of Directors.** A clause enabling certain shareholders to appoint one or more directors directly to the Board of Directors (BoD) without any voting. Usually it provides that each shareholder shall appoint one director to the BoD.

In many jurisdictions company law is not flexible enough to accommodate such a contractual arrangement.

In other jurisdictions such an arrangement is better accommodated by providing for different “classes of shares”. There is a different class of shares for each shareholder and each class is entitled to appoint one director to the BoD.

- **(b) Reserved Matters (Veto rights).** Such a clause provides that certain corporate resolutions (which are called “Reserved Matters”) must be unanimous, or consented by all or particular shareholders. So, this clause results to something like a veto right. One may provide for Reserved Matters at the level of General Meetings or BoD or both.

- Other management clauses that often appear in SHA include the following:
- **(d) Increased quorum / majority clauses.** Such clauses provide for an increased quorum to convene a General Meeting or a BoD, and/or increased majority to pass a corporate resolution.
- **(e) Annual Business Plan and Budget.** This clause provides that at the beginning of each year the shareholders shall approve (often unanimously) a detailed Business Plan and Budget for the company and that the BoD shall be bound to take action according to such business plan and budget only. So, if directors incur liabilities or make expenses beyond what is provided for in the approved business plan they incur liability towards shareholders for mismanagement. A business plan may be very detailed to include all possible expenses, investments, etc. that the company may need to make throughout the year.

How to achieve equal management control ?

Equal voting rights

Employing non voting shares

Avoiding President’s casting vote

Appointing equal number of directors to the BoD

Each party being able to replace the directors he appointed

BoD meetings upon reasonable notice

No quorum unless each party has an equal number of directors present in a meeting

Directors that are present being able to represent absent directors

Directors to the Company may have conflicts if they are at the same time directors to the shareholders; if directors are under a conflict situation, they may be unable to vote.

Vetoes rights; Reserved matters where a resolution can be passed only on the basis of a joint decision (consent) or on the basis of increased majority. Vetoes rights can be incorporated into shares in the form of “class rights”.

A detailed Annual Business Plan and Budget which is agreed at the beginning of each year and can be amended with a joint decision only.

TYPICAL RESERVED MATTERS

Changes to:

- Memorandum of Association
- Share Capital
- Nature of Business

Liquidation

Sale of business or material assets

Acquisitions

Loans and guarantees

Related parties' transactions

Management agreements

Loans

Major capital expenditure and investments

Dividends

Major agreements, particularly any exclusive agreements

Licenses of intellectual property

Appointing auditors

Annual Business Plan

Approving financial statements

Appointing major employees

SHARE TRANSFER RESTRICTIONS

- To understand share transfer restrictions we need to bear in mind the following:
- Shareholders who invest money in a company usually do not intend to hold the shares for their entire life. In most cases their purpose is to sell the shares after a while when their value will have substantially increased (because of successful management and accomplishment of a profitable investment project). So their purpose is to sell the shares and make a profit out of this sale, after let us say 3-5 years.
- A new investor who might be interested to purchase shares in a company will wish to obtain at least a majority participation. Shares representing only a minority participation are not really tradeable; no one would be willing to purchase a minority.

- So, for minorities the risk is that they may be unable to sell their shares. They may have invested money to the company by making contributions to it, they may wait until the company becomes profitable and the shares acquire a substantial value, but at the end only the majority shareholder will be able to sell his shares and minorities will remain stuck inside the company.
- Share transfer restrictions are destined to ensure that all shareholders shall be able to sell their shares together and shall be able to participate equally to the profit out of such a sale.

- The typical share transfer restrictions in a SHA are:
- (a) a **Lock Up Period**
- (b) the **First Option Right**
- (c) the **Tag Along Right**
- (d) the **Drag Along Right**
- Usually a SHA has all of these clauses, but the parties may decide to accept only some of them

LOCK UP PERIOD

- Under this clause that shareholders agree that for a certain period of time transfers of shares are prohibited.

- The clause is destined to ensure that the company will be given a period of time to accomplish a project (an investment). Usually, for a new investment it takes some time to generate profits. The purpose of the clause is to secure that the shareholders shall not leave the company during this period and that they will support it.
- The customary Lock Up Period is usually something like 2-5 years.

FIRST OPTION RIGHT

- Under this clause the shareholders agree that, after the lapse of the Lock Up Period, if any of them wishes to transfer his shares, he must first offer them to the other shareholders and only if the other shareholders are not interested to purchase them, he is allowed to sell them to an outsider.
- So, in practice, if the shareholder who wishes to sell his shares has an actual and specific offer from an outsider, that is, an offer referring to a specific price, then he needs to offer his shares to other shareholders first, on the same terms (that is, the same price, etc.).
- The idea behind the clause is that, if the price is generous and appealing, that is, if it exceeds the fair value of the shares, the other shareholders will not be willing to exercise their first option right, but if the price is below the fair value, then the other shareholders are likely to be willing to purchase the shares for themselves, because this will be a business opportunity to them.

TAG ALONG RIGHT

- This clause provides that, if the shareholders who are entitled to exercise the First Option Right are unwilling to exercise it (i.e., they are unwilling to purchase the shares offered to them), then they will be entitled to follow to the shareholder who wishes to sell his shares and sell their shares as well to the outsider. They are entitled to tag themselves along the shareholder who wishes to sell his shares and sell their shares also. So, if the Tag Along Right is exercised, all shareholder will sell their shares together.
- In practice, this means that the shareholder who had the initiative to sell his shares and received an offer towards this end has to oblige the offeror that, if needed, he will purchase the shares of the other shareholders as well.
- So, a new investor is likely to be bound to purchase all the shares of all shareholders, or nothing.
- The idea is that if the price offered is below the fair value of the shares, the other shareholders will exercise the First Option Right, but if the price is appealing, they will exercise the Tag Along Right.

DRAG ALONG RIGHT

- This clause provides that, if one shareholder wishes to sell his shares, but the other shareholders do not wish to exercise either the First Option Right, or the Tag along Right, then the shareholder who wishes to sell his shares shall be entitled to oblige them to sell them to the outsider, if the latter wishes to purchase them. So, the shareholder who wishes to sell his shares may be able to drag with him the other shareholders and oblige them to sell as well.
- Usually, an outsider will not be willing to purchase a minority participation to the company; he will wish to purchase all the shares, or at least a majority participation, which will enable him to actively manage the company. So, unless it is possible to sell a majority participation, one cannot really sell shares in a company.
- This clause is destined to ensure that even a minority shareholder shall be able to enforce a sale of shares representing a majority participation to an outsider.

ENFORCEABILITY OF SHARE TRANSFER RESTRICTIONS

- Share transfer restrictions are enforceable only if they are included in the by laws of the company. Fortunately, most jurisdictions accept share transfer restrictions. So, share transfer restrictions appear both in the SHA and the by laws.
- Shares usually bear a note that transfers of shares are subject to restrictions that are listed in the by laws.
- Transfers of shares in violation of share transfer restrictions that are contained in the by laws are void.

ANTI-DILUTUION PROTECTION

- Anti-dilution is about retaining the same levels of participation among shareholders within the company.
- Shareholders may be diluted because of capital increases. Each time the share capital of the company increases, the level of participation of shareholders may diminish, unless the latter are able to participate in capital increases, make additional contributions to the company and retain the same level of participation. Those shareholders who are unable to follow capital increases will be diluted.
- Anti-dilution protection is achieved basically by making the resolution for a capital increase a reserved matter. So, a capital increase cannot take place unless all shareholders agree.

- However, having such anti-dilution protection may prove detrimental to the company. The company may be in need of new funds. Some shareholders may be willing to make additional contributions to the company by way of a capital increase, while others may not. If increase of capital is a reserved matter, it may not be possible to finance the company to meet its financial needs.
- Therefore, anti-dilution protection clauses are usually followed by clauses counterbalancing this risk. Such clauses usually provide that, in case some shareholders wish to proceed with a capital increase, while others do not agree, then those shareholders wishing to make a capital increase will be entitled to grant the company an interest bearing loan. So, the company will not increase its capital and shareholders will not be diluted, but at the same time the company will be funded by those shareholders who wish to lend it money; these shareholders shall receive interest, in addition to dividends from the profits of the company.