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The Bigger Picture

we need to talk about...

Shareholder relationships and how to minimise risks

Anyone who owns a company is likely at some point to consider whether to invite others to join. James Worrall, a solicitor in the corporate law team at Withy King in Bath, helps business owners navigate the risks of bringing a new shareholder into their company and looks at the issues which might arise if they take shares in someone else's.

An individual who is the only director and shareholder of a company has total discretion as to the direction of the company and what happens to profits. Successful companies grow and more often than not, bring in people to help them, sometimes giving them shares in the company so that they have a stake in its future success.

What is often an afterthought (or not thought of at all until it is too late) is how the relationships of the shareholders or directors may change over time. Disputes are commonplace, often where the goodwill between the parties at the start of a business relationship and the understanding of how things will work out if anything goes wrong, have eroded and the shareholders no longer want to continue in business with each other.

It is for this reason that shareholders should consider the future implications of shares being issued or transferred to third parties so that worst-case scenarios can be looked at and procedures put in place to deal with them in a way that limits the potential damage to the business. Also, potential shareholders should consider what protections they want to safeguard against majority shareholders abusing their position. These points can all generally be dealt with in the company's articles of association and, if required, a shareholders' agreement.

The first issue to consider is what happens if the new shareholder later wants to sell their shares. Articles often give directors the power to refuse to register a transfer of shares and prevent an unknown third party becoming a shareholder. But this is hardly satisfactory for the shareholder who may be in a position where he needs to sell or for the company if the directors refuse a transfer and a disaffected shareholder remains involved. The answer is a mechanism by which a shareholder may sell his shares, with the process itself considered in detail. Should the shares be offered first to the other shareholders? How is the price for the shares calculated? What if the seller can't agree a fair price? A binding process means that disputes can be avoided as all parties know where they stand and how the situation will be dealt with.

Linked to the sale of shares is what happens if a shareholder's continued interest in the company is detrimental to the company itself, for example if the shareholder was a director who has left the company to join a rival. The remaining shareholders may wish for this to act as a trigger for the sale of the departing shareholder's shares, what is often called a "deemed transfer event".

The articles can control the procedure for the sale of the shareholder's shares without the shareholder's consent, as they are "deemed" to have offered their shares for sale. The articles can also dictate a different price to be paid where the shareholder is leaving in certain circumstances, for example if in breach of a shareholders' agreement or due to gross misconduct. "Poison value" can be attributed to the shares meaning the other shareholders can acquire them for a nominal sum.

The death of a shareholder is another point to consider. Generally, in the absence of agreement, shares held by the deceased will pass under the terms of the Will to the beneficiaries even if they do not have a role in the running of the business. If the death of a shareholder is a "deemed transfer event" however, the other shareholders can acquire the shares from the deceased's estate and the estate receives cash value for the shares.

And what if a third party comes along and wants to purchase the company? A founder who has given a small percentage of shares away is likely to want to be able to compel the other shareholders to sell or be "dragged" into the sale. The disaster scenario is that a good deal falls through as a minority shareholder refuses to sell.

These are just a few of the issues to consider when bringing a new shareholder on board. The points are as relevant to an established company as a start-up.

James Worrall specialises in corporate structuring and company law. For advice, please contact James on 01225 730100 or email james.worrall@withyking.co.uk

THE FIRST FOUR THINGS YOU SHOULD THINK ABOUT IF...

...you're giving away shares in your company or taking shares in a company

What proportion of the company's shares are you going to hold?

There are certain key percentages for shareholders, 26% means that you can block special resolutions, for example to amend the articles of association or change the company's name; 50% means you can block ordinary resolutions, for example, to remove a director. If you are the sole shareholder of a company think carefully about the limits on your power that will result from a new shareholder joining.

What about the company's constitution?

The company's articles of association set out the rights that shares and shareholders have. Are there multiple classes of shares? Do they have voting and dividend rights? Be cautious if you are being offered shares of a different class to the other shareholders, such as "B" shares. Different classes of shares may have different rights, meaning you may not get a dividend when other shareholders do. It is essential to read and understand the articles of association, taking advice if you need it.

What about the relationship between the shareholders?

Consider whether there should be a shareholders' agreement in place covering the obligations of the shareholders to each other. Shareholders' agreements can dictate matters which require the consent of all or a certain proportion of the shareholders before the company can proceed, for example borrowing significant sums of money.

What is the end goal or exit strategy?

Consider how an ultimate sale of the company should be dealt with. Should a certain proportion of the shareholders be able to compel the others to sell? What if you are taking a minority shareholding and the majority shareholders want to sell? Should you be able to force them to include your shares in the sale?