Reducing The Inherent Risks Of Shareholder Relationships

Anyone who owns a company is likely at some point to consider whether to invite others to join. This is often an inevitable consequence of growth and a positive move for the business.

HOWEVER, introducing new shareholders is not without its challenges. Professional advisers from Wiltshire-based firms, Withy King and Morris Owen, discuss the issues and advise on how to minimise the risks.

"Successful companies more often than not bring in people to help them grow the business, sometimes giving them a stake in its future success," said Rishi Ladwa, a solicitor in the corporate team at Withy King in Swindon. "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 as the business evolves. Disputes are commonplace, often where the goodwill between the parties, that exists at the start of a business relationship along with an apparent understanding of how things will work out if anything goes wrong, has eroded and the shareholders no longer want to continue in business with each other."

Rishi Ladwa, solicitor from the corporate team at Withy King

Mr Ladwa continued: "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. Potential shareholders should also consider what protections they want to safeguard against majority shareholders abusing their position. Most of these points can generally be dealt with in the company's Articles of Association if they are specifically drafted to address such issues but usually a shareholders' agreement is also required."

Rob Beale, a partner at Morris Owen in Swindon, agreed. He said: "A company's Articles of Association and shareholders' agreement set out the terms of the relationship between the company and its shareholders, providing clarity and peace of mind for all parties. Unfortunately many companies, particularly those run by family members, decide not to draw up a formal agreement beyond standard Articles, relying instead on personal relationships, goodwill and trust to see them through any challenges. This is fine when things are going well but all too often sadly, we see what happens when there is disagreement and we are called in to advise on how best to pick up the pieces. There will always be a temptation to avoid professional fees but in some cases, the risks outweigh the relatively small cost of getting it right up front."

Rob Beale, a partner at Morris Owen

Mr Beale added: "The other advantage of having a shareholders' agreement is for valuation purposes, especially in relation to tax and when resolving shareholder disputes. Banks also like to see formal agreements in place and it can assist in the lending process when businesses appear to be properly run and can show that they have taken steps to minimise potential risks."

Points to consider in a shareholders' agreement

Richard Baxter, a partner in Withy King's corporate team, suggests that the first issue to consider is what happens if a new or founder shareholder later wants to sell their shares.

Richard Baxter, a partner from Withy King's corporate team

He said: "Articles of Association 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 or discounted sum," Mr Baxter explained.

"The death of a shareholder is another key point to consider. Generally, in the absence of agreement, shares held by the deceased will pass under the terms of their 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. There are, however, tax traps for the unwary in this area.

"And what if a third party comes along and wants to purchase the company? Such a purchaser will invariably want to acquire 100% of the shares in issue. 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 setting up a new multi-shareholder enterprise or bringing a new shareholder on board but should provide a starting point for further discussion, whether you are a start-up business or an established company," said Mr Baxter.

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BOARDROOM DEBATE

Withy King has compiled a few questions for businesses to consider if they are planning to issue shares in their company or take shares in another 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 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 many of the rights that shares and shareholders have but can vary widely. Are there multiple classes of shares? Do they having 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, for example meaning you don't 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?

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