



CCW BUSINESS LAWYERS



Articles of Association & Shareholders' Agreements



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introduction

As many companies survive quite happily without a Shareholders' Agreement - and with what we would call "standard" or "off the shelf" Articles of Association – we are often asked to explain why we frequently recommend both changing existing Articles of Association and introducing a Shareholders' Agreement. This note attempts to explain why.

All businesses are different

Before considering some of the "technical" reasoning behind why tailored Articles of Association and Shareholders' Agreements are important it is worth stating a very simple but important fact. All businesses are different and a set of rules that applies to one business might not necessarily apply so well to others. Drafting new Articles of Association and a Shareholders' Agreement is primarily about attempting to devise a set of rules for your company that best protects both the interests of the company itself and the individual shareholders personally.

Majority rules

In order to appreciate the importance of your Articles of Association some background to the statutory and contractual position of shareholders in private limited companies is needed.

Generally, the key powers and the corresponding rights that attach to shareholdings in private limited companies in the United Kingdom are determined by the percentage of shares held and critically whether somebody holds a simple majority (more than 50%) or a super majority (more than 75%).

These fairly basic "majority rules" principles mean that, in circumstances where a "majority" shareholding is not held, the other shareholders in private (and public) limited companies can, to an extent, be disenfranchised as the "majority" will control (amongst other matters):

- the ability to appoint or remove directors to the board;
- the ability to determine when shareholdings in the company may be bought, sold or transferred;
- dividend policy;
- strategic commercial decisions; and
- day-to-day management of the company.



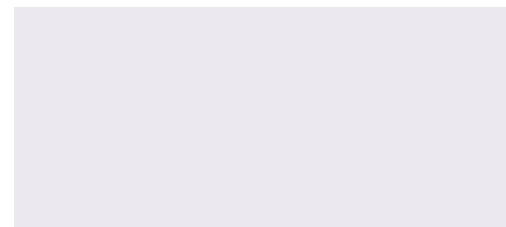
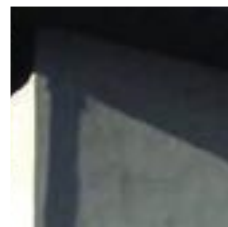
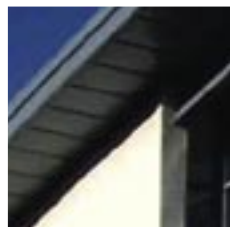
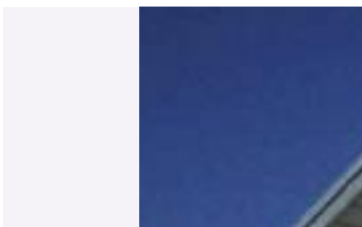
These issues may not be so difficult if there are many shareholders who can influence these types of decisions or if the shareholders have invested in the company for purely financial reasons.

However, in the vast majority of small or medium sized private companies it is likely that all shareholders will also be closely tied to the management of the company and are likely to be more than purely “passive” shareholders. Therefore, these shareholders, quite rightly, should have expectations over and above what their pro rata shareholding rights would bring.

It is also important to note that the “majority” parties are also at some risk. In the event of a dispute with a minority shareholder (who more often than not will be a key employee) the minority shareholder, irrespective of his or her conduct, will probably be able to retain their shareholding in the company. If such a shareholder has committed a serious fraud against the company or has been guilty of gross misconduct, it is unlikely

that the other shareholders will have any expectation that this shareholder should continue in their association with the company or remain a shareholder. However, unless your Articles of Association or Shareholders’ Agreement specifically cater otherwise, then this is likely to be the outcome.

Therefore, “standard” Articles of Association without any Shareholders’ Agreement will be unlikely to accurately reflect the reality and expectations of the shareholders involved or accurately reflect the needs of the business. It is for these reasons that more complex, specifically tailored Articles of Association and/or Shareholders’ Agreements are often suggested.



articles of association

Perhaps surprisingly to many business owners, the Articles of Association are actually very flexible and as a consequence there are an infinite number of types of Articles of Association and clauses that can be drafted. However, generally speaking, the key areas for change are:

- When certain shares are to be given any rights that are proportionately better than their pro rata entitlement, and if so what those rights should be (common variations include rights to income, to capital, general voting rights and the right to appoint directors);
- Any predetermined formulas for valuations of shares that become available and whether the valuation depends on the circumstances of transfer (most common distinction being between valuation of shares for “good leavers” and “bad leavers”); and
- In which circumstances shares may be transferred. It is frequently the case that the Articles of Association will provide that in certain circumstances (for example, on the death of a shareholder) those shares “come in to play”, giving the remaining shareholders the right to purchase;
- In which circumstances transfers of shares are mandatory as opposed to optional and who has the right to acquire shares.



shareholders' agreements

If one goes to all of the detail mentioned opposite in relation to the Articles, why is a Shareholders' Agreement necessary? That's a good question. The answer is dependent on history, practice and publicity.

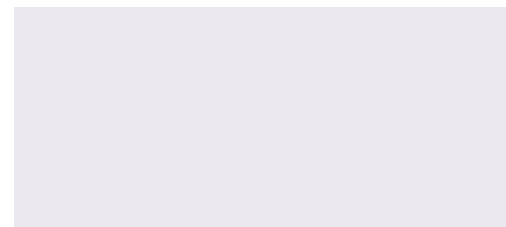
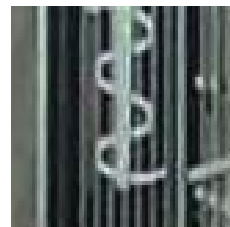
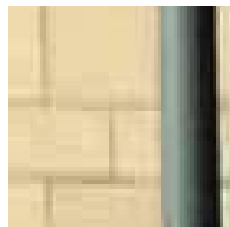
Historically the Articles of Association of a company, being one of its founding documents, have been seen as sacrosanct. Therefore, often it is only "constitutional" matters that are dealt with in the Articles. More practically, the Articles of Association are a very formal and legalistic document - and a document that has to be registered in a public register. Practice, therefore, has it that private matters, particularly relating to the commercial interests of the company (for example mechanisms for board and shareholder decision making) are dealt with in the Shareholders' Agreement.

So, what is in a typical Shareholders' Agreement? The first point, and perhaps most important point of all, to make in relation to Shareholders' Agreements is that there is an almost absolute right of freedom of contract. This simply means that there are virtually no limits to matters that can be dealt with in a Shareholders'

Agreement. Indeed, Shareholders' Agreements can be used to cover a huge variety of different situations - from simply allocating decision making powers within a company, to dealing with complicated divisions of proceeds in joint ventures or indeed controlling decision making rights between different sections of shareholders in large public listed companies.

The most common use of Shareholders' Agreements is nearly always when a company has a number of different shareholders, and/or there is a need to rebalance power within the company. It is therefore likely that amongst the provisions of a Shareholders' Agreement will be those which change the balance of power in a company from that which would apply as of "right". This is likely to mean some of the parties giving up some of the rights which they might have had as a result of their percentage holding in the company and/or agreeing to do or not to do a variety of things only with the approval of the other shareholders.

The next most common set of provisions to be found in Shareholders' Agreements are those dealing with disputes between



shareholders' agreements

shareholders. Our experience is that shareholder disputes can and frequently are time consuming, expensive and, worst of all, severely disruptive to the business concerned. Predetermined mechanisms for resolving disputes and dealing with circumstances in which shares can be purchased and at what value can provide a very important role in protecting against protracted and disruptive inter-shareholder disputes. It is therefore worthwhile giving consideration to and implementing these provisions at the outset as (stating the obvious) there is not much prospect of getting them in place once a dispute has arisen.

Although a topic that is obviously not particularly easy to discuss, Shareholders' Agreements should also contain mechanisms to deal with death or serious ill health of shareholders. This question ought to be tackled both from the perspective of what is in the best interests of the shareholder's estate and beneficiaries and also what is in the best interests of the company.

Insurance policies can be put in place in order to protect the company on a shareholder's death and to ensure there is sufficient liquidity to allow the shares to be "bought out" and transferred into cash for beneficiaries (if of course that is what is required). Serious ill health is perhaps a more difficult issue to tackle as it is unlikely to be insurable. However, again, consideration should be given to the appropriate mechanisms to deal with serious ill health and again this should be from the point of view of the company and the shareholder personally.



summary

The key point to remember is that all businesses are different and one glove certainly does not fit all. Your Articles of Association and your Shareholders' Agreement must be tailored to suit your circumstances. Taken together, a well drafted and tailored set of Articles of Association and Shareholders' Agreement offer a dynamic way of allowing a group of people to work together within the ambit of one company in such a way as to safely promote the growth of that business with both the interests of the individual shareholders and the company protected in the best way possible.



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