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SALIENT AND CONSEQUENTIAL FEATURES OF A SHAREHOLDER AGREEMENT

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FOREWORD BY THE MANAGING PARTNER

As visionary founders, you have a passion for your business, a dream to realize, and a commitment to bring your innovative ideas to life. In the fervor of establishing a new company, it is easy to get swept away by the excitement and overlook certain crucial aspects that lay the foundation for long-term success. One such indispensable element is the Shareholders' Agreement.

In the dynamic landscape of business, where uncertainties and challenges are inevitable, a well-crafted Shareholders' Agreement serves as the cornerstone of a company's stability and growth. Shareholders agreement is more than a legal formality; it is a strategic roadmap that guides the company through the complexities of corporate governance, decision-making, and dispute resolution.

Its essence, a Shareholders' Agreement outlines the rights, responsibilities, and expectations of each shareholder, fostering a sense of unity and purpose among the stakeholders. This agreement is not merely a contingency plan for potential conflicts; rather, it is a proactive measure designed to prevent misunderstandings and ensure alignment from the outset. By clearly defining the roles and contributions of each shareholder, the agreement minimizes the likelihood of disputes that could potentially hinder the company's progress.

In this guide, we delve into the intricacies of crafting a comprehensive Shareholders' Agreement, exploring its various components and emphasizing its importance in safeguarding the interests of shareholders and the overall health of the company. Whether you are a startup founder, an investor, or a seasoned entrepreneur, this guide serves as a compass, helping you navigate the complexities of shareholder relationships and providing the tools to build a strong and resilient foundation for your company's success.

1. MEANING OF SHAREHOLDERS AGREEMENT

A shareholders' agreement is a contract that regulates the relationship between the shareholders and the corporation. The agreement will detail what models or forms which the corporation should run and outline and the basic rights and obligations of the shareholders. In practice, the shareholders' agreement plays an important role in a close corporation but not public companies. Commonly the shareholders' agreement regulates issues like voting during shareholders' meetings, buying or selling company's shares, the corporation's articles of incorporation and bylaws, as well as the selection procedure for the board members of the corporation.

2. SALIENT CLAUSES AND THEIR LEGAL SIGNIFICANCE.

Shareholders agreements can be crafted in so many forms with different terms and conditions thereon, however, to our practical understanding, this article intends to add value on paramount clauses without which parties may find themselves in a arduous position should the challenge arise. These clauses do not override other legal requirements of a valid contract.

2.1 COME ALONG CLAUSE

A come-along clause, also known as a drag-along clause, is a common provision included in shareholder agreements, particularly in the agreements of growing companies seeking venture capital. While they have advantages and disadvantages, these clauses primarily benefit majority shareholders at the expense of minority shareholders.

2.2 CONTRACTUAL SIGNIFICANCE OF THE CLAUSE

A come-along clause gives certain shareholders, usually majority shareholders, and the right to force other shareholders to sell their shares when those certain shareholders decide to sell theirs . For this reason, the clause is also called a drag-along clause, because when the specified shareholder decides to sell, he can drag along all of the others into the sale.

2.3 REQUIREMENTS OF A COME ALONG CLAUSE

A minority shareholder has little recourse. Essentially, the dragging shareholder must only ensure that the other shareholder's interests are purchased at the same price and under the same terms and conditions as the dragging shareholder’s.

2.4 PURPOSES OF THE CLAUSE IN A SHAREHOLDERS AGREEMENT

Come-along clauses are inserted in shareholder's agreements in two situations. The first is in the shareholder's agreement of a company which will be seeking venture capital. In this case, the clause assures the venture capitalist that he will have an easily executable exit strategy. These clauses are also used in situations where it is unlikely that an investor would want to purchase anything less than 100 percent of the company. Here, the clause helps make the company marketable.

2.5 CHALLENGES OF THE CLAUSE

Often, holding up a potential sale is the only power a minority shareholder possesses to have any say in the operation of the company. A come-along clause basically gives the majority shareholder the right to negotiate a sale on terms acceptable to himself, leaving other shareholders with no voice at all.

3. TAG ALONG CLAUSE

3.1 MEANING OF A TAG ALONG CLAUSE.

A tag along or take along clause / provision gives a minority shareholder the right (but not the obligation) to have his shares bought on the same terms including the price as majority shareholders.
The primary aim of the clause is to protect minority shareholders with minimal control over the company from new controlling investor who might change the business to the detriment of the minority.

When is it customary to use a tag along Clause?

A tag along clause is usually negotiated into a shareholders' agreement when majority shareholders sell significant stakes to a new investor. For example, two founders of a company, each with 50% shareholding may agree to sell 75% of their holding to an Institutional Investor such as a venture capital and in so doing change from almost having majority control to minority with much less say in how the business is run.
Institutional investors usually take a significant stake in a company when they invest, and usually want to be in a position to sell at a profit within two or six years. Although the additional equity is valuable in the sense that it allows the company to grow much more rapidly (increasing the value of the minority shareholder investment), it comes with the downside/disadvantage that the investor is in for the shareholders are unlikely to have.

3.2 SHOULD SHAREHOLDER AGREEMENTS INCLUDE A TAG ALONG CLAUSE?

We would argue that it should, regardless of whether you are the minority or majority. As well as protecting the minority's investment value, it allows the minority to piggy back on the major investors' ability to find a buyer at an attractive price. Institutional investors usually have excellent networks of potential buyers and the time and people to find the most suitable buyer, sell him the proposition that he should buy, negotiate the best terms and have the paperwork signed up. Minority shareholders, particularly if they are involved in the running of the business, don't have these resources.

Two majority shareholders can benefit from a take along clause because it gives the minority investors (again, who are likely to be more involved in running the company) a sense of fairness in treatment that makes them likely to contribute more or at least be less resistant to the possibility of outright sale. Some would argue that a take long clause may put off potential buyers, but in most cases, a new buyer buys in order to change the business direction of the acquisition (for example merging departments with an existing business to create synergies), and the direction is much more difficult to change when there are minority shareholders involved.

3.3 PRE-EMPTION CLAUSES

Pre-emption rights give existing shareholders first refusal to buy another shareholder's shares or first offer on an issue of new shares by a company, in each case, before they may be offered elsewhere.

In terms of the pre-emption rights on the transfer of shares, their primary function is to help maintain the existing shareholder base and limit the ability for an unknown third-party shareholder to become involved in the company. It is therefore important for a shareholder wishing to sell or gift their shares to another person (or a company looking to approve the registration of such a transfer) to understand what pre-emption rights exist and what process must be followed before the shares can be sold.

Pre-emption rights on the issue of new shares, their primary function is to help protect a shareholders' proportion of voting and other rights in a company from being diluted without their consent. This is because the new shares cannot be offered to other potential buyers without first being offered to the existing shareholders in proportion to their existing shareholding. It is therefore important for a company intending to raise funds by allotting new shares to be aware of any pre-emption rights which may exist and where they may arise.

It is important to note that pre-emption rights do not allow existing shareholders to acquire additional shares for free; a shareholder's ability to accept a pre-emptive offer for shares will depend on them having the funds to accept the offer and pay for the shares at the proposed or agreed price.

3.4 PRE-EMPTION RIGHTS CAN ARISE IN THREE WAYS

1. Statutory pre-emption rights under the Companies Act, or
2. The provisions of a company's articles of association (in respect of either an issue of new shares or a transfer of shares), and
3. The provisions of a shareholders' agreement (in respect of either an issue of new shares or a transfer of shares).

3.5 INALIENABILITY CLAUSES

These clauses like approval and pre-emption clauses are used to prevent the free transferability of shares . An inalienability clause is inserted into a shareholder agreement to ensure that all strategic investors retain their interests in the share capital. It has the effect of prohibiting the sale of shares of the company for specified period of time.

The approval clause allows a beneficiary to deny the entry of a third party into the share capital of the company without the consent of some or all the existing shareholders. Its main purpose is to control or regulate the entry of undesirable persons into the shareholding structure of the company.

It is important to note at this point that there will normally be no clause to prevent the transfer of shares between existing shareholders in the company to preserve an established balanced sheet between the existing shareholders.

4. STAND STILL CLAUSES

4.1 WHAT IS A STANDSTILL AGREEMENT?

A standstill agreement is a contract that contains provisions that govern how a bidder of a company can purchase, dispose of, or vote stock of the target company. A standstill agreement can effectively stall or stop the process of a hostile takeover if the parties cannot negotiate a friendly deal. The agreement is particularly important because the bidder will have had access to the target company's confidential financial information.

4.2 SIGNIFICANCE OF THE CLAUSE

i. A standstill agreement is a contract that contains provisions that govern how a bidder of a company can purchase, dispose of, or vote stock of the target company.
ii. A standstill agreement can effectively stall or stop the process of a hostile takeover if the parties cannot negotiate a friendly deal.
iii. A company that comes under pressure from an aggressive bidder or activist investor finds a standstill agreement helpful in blunting the unsolicited approach.

4.3 UNDERSTANDING STANDSTILL AGREEMENTS

A company that comes under pressure from an aggressive bidder or activist investor finds a standstill agreement helpful in blunting the unsolicited approach. The agreement gives the target company more control over the deal process by prescribing the bidder or investor's capacity to buy or sell the stock of the company or launch proxy contests.

In the banking industry,
A standstill agreement can also exist between a lender and borrower when the lender stops demanding a scheduled payment of interest or principal on a loan in order to give the borrower time to restructure its liabilities.
A standstill agreement is a form of anti-takeover measure.
A standstill agreement between a lender and borrower halts the contractual repayment schedule for a distressed borrower and forces certain actions that the borrower must undertake.
A new deal is negotiated during the standstill period that usually alters the loan's original repayment schedule. This is used as an alternative to bankruptcy or foreclosure when the borrower can't repay the loan. The standstill agreement allows the lender to salvage some value from the loan. In a foreclosure, the lender may receive nothing. By working with the borrower, the lender can improve its chances of getting repaid a portion of the outstanding debt.

5. RATCHET AND ANTI-DILUTION CLAUSES

5.1 WHAT IS A FULL RATCHET?

A full ratchet is a contractual provision designed to protect the interests of early investors. Specifically, it is an anti-dilution provision that applies, for any shares of common stock sold by a company after the issuing of an option (or convertible security), the lowest sale price as the adjusted option price or conversion ratio for existing shareholders.

5.2 SIGNIFICANCE OF THE CLAUSES

I. A full ratchet is an anti-dilution provision that applies the lowest sale price as the adjusted option price or conversion ratio for existing shareholders.

II. It protects early investors by ensuring they are compensated for any dilution in their ownership caused by future rounds of fundraising.

III. Full ratchet provisions can be costly for founders and can undermine efforts to raise capital in future rounds of fund-raising.

IV. Weighted average approaches are a popular alternative to the full ratchet provision.

6. DEADLOCK CLAUSE

Shareholders often disagree with each other on how their company should be managed and controlled, and the direction and strategy it is taking. Differing views may be beneficial to a business, but disagreement, potential deadlock and an inability to make important decisions can be severely damaging to the company (and, in the long run, to shareholders).

Deadlock provisions within shareholders' agreements, investment agreements or articles of association provide a means of resolving issues which shareholders cannot agree or otherwise compromise on.

6.1 WHAT IS DEADLOCK?

Usually, shareholders' agreements set out the conditions that must be met for deadlock to occur. However, these are generally situations which go beyond a mere single ineffective vote by shareholders .

Usually, a number of votes on the same issue must be made over a period of time, with the outcome being each time consistently indecisive. Such delay would generally give shareholders time to compromise on or find other ways of resolving the issue.

Deadlocks can also occur when other dispute resolution methods have been tried and failed, for example, when shareholders' agreements provide for shareholders using mediation to find an amicable solution if an issue cannot be resolved after two general meetings.

Deadlock provisions are a way of forcing a decision in such situations, being often so severe for one side that the threat of their use is enough for the issue to be resolved by compromise. The circumstances in which they can be used are usually limited to matters significantly affecting business operations.

6.2 THE MOST COMMON TYPES OF DEADLOCK CLAUSES

Although deadlock clauses can be given all sorts of interesting names, they all boil down to a requirement of one party selling their shares to the others so that there is a change of control and the remaining shareholders can make a decision on the disputed matter.

In effect, these are all types of conditional termination provisions. Common examples of deadlock clauses in shareholders' agreements include:

6.2.1 SHOTGUN / RUSSIAN ROULETTE

Essentially, such clauses allow one shareholder to make an offer to buy out the other shareholder for a certain price and under certain terms and conditions, who is then allowed to either accept such offer or buy the shares of the offeror for the same price and under the same terms and conditions (assuming there are two equal shareholders).

6.2.2 TEXAS SHOOTOUT

In this type of deadlock clause, each shareholder sends a sealed bid for the others' shares to an independent and neutral third party. The third party then opens all bids at the same time and the highest bid wins, with the winning shareholder required to buy the others out at that price.

6.2.3 AUCTION

An auction is similar to a shotgun mechanism as the offering shareholder may have the opportunity to pay a price of their choice, including a premium. However, an auction also differs from a shotgun approach, in that it lacks adverse consequences for shareholders making low bids, as the outcome simply depends on who makes the highest bid.

7. CONCLUSION

The absence of appropriate clauses to resolve disputes, deadlocks or some other aspects of the shareholding before they occur can come with a high cost. With such clauses, if there is severe disagreement, there are various ways of seeking exit from the company or resolving the problem such as using drag along clauses. Given the genuine possibility of a deadlock among shareholders and the existential threat this can pose a challenge to a company's ongoing viability, shareholders should ensure the shareholder agreement contains robust and precise provisions on procedures designed to resolve these matters.

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