SHAREHOLDERS’ AGREEMENTS

A PRACTICAL ANALYSIS

© EMMET SCULLY

LK Shields Solicitors
39/40 Upper Mount Street
Dublin 2
Tel +353 1 661 0866
Fax +353 1 661 0883
Email email@lkshields.ie
Web www.lkshields.ie

,

SHAREHOLDERS' AGREEMENTS – A PRACTICAL ANALYSIS

TEXT OF A PAPER DELIVERED AT A MEETING OF THE GALWAY ENTERPRISE PLATFORM PROGRAMME.

INTRODUCTION

Today I will focus on shareholders' agreements as they apply to early stage companies and I am confining my comments to the type of company which is known as a private company limited by shares which is by far the most common type of company in Ireland.

WHAT IS A SHAREHOLDERS' AGREEMENT?

Put simply a shareholders' agreement is essentially a contract between some or all of the shareholders in a company and frequently the company itself. The basic purpose of a shareholders' agreement is to provide how the company is to be managed and, as far as possible, to prospectively address issues that might otherwise become divisive in the future if not agreed in advance. Certain important points flow from the basic fact that a shareholders' agreement is a contract which I will deal with a little later on.

WHAT ARE ARTICLES OF ASSOCIATION?

Business people who operate a business through an incorporated company (often obtained at a relatively low cost at a company formation agency) frequently do not fully understand the purpose or implications of the articles of association or indeed the differences between the articles of association and a shareholders' agreement. The articles of association are a basic constitutional document of every company. When forming a company if no articles of association are submitted to the Companies Registration Office then one of the model forms of articles of association specified in Part I or II of Table A of the First Schedule to the Companies Act, 1963 will automatically constitute the articles of association of the newly incorporated company. In the case of a private company limited by shares, the relevant model articles of association are those set out in Part II of Table A. These provide that with certain exceptions the articles of association contained in Part I of Table A (which apply to public companies) shall apply to private companies. I refer to these model form articles as "**Table A Articles**" in this paper. You will very commonly find in practice that the articles of association of company are made up of a document drafted by a company formation agency, accountants or solicitors which adopt the one or other of the versions of the Table A Articles with certain modification/exclusions.

The articles of association are registered with the Companies Registration Office on incorporation of a company and any changes thereto must also be submitted to the Companies Registration Office within a prescribed period. Accordingly the articles of association of a company are public documents and are open to inspection by the public.

In legal terms, articles of association automatically bind the company and its members (Section 25 Companies Act, 1963) though the members are only bound by the terms of the articles of association in their capacity as shareholders of the company and not in any other capacity. Articles of association can be amended by way of a special resolution which is a resolution passed by 75% or more of the shareholders present and voting at a general meeting.

Among the provisions contained in most standard articles of association are the following:

- Description of share capital;

- Where there are more than one class of shares, a description of the rights attaching to the different classes of shares;
- Pre-emption rights regarding new issue of shares;
- Provisions concerning the convening and conduct of meetings of shareholders;
- Provisions concerning the convening and conduct of directors' meetings;
- Powers and duties of directors:
    - Article 80 Part I Table A (management powers)
    - Article 79 Part I Table A (borrowing powers);
- Rotation of directors;
- Payment of dividends; and
- Winding up.

As you can see articles of association contain various important provisions concerning the internal regulation of a company.

However the Table A Articles and most standard articles of association prepared by company formation agencies, accountancy firms or solicitors' firms do not deal with many of the issues of internal regulation that shareholders might on a fuller consideration of the matter consider necessary for the smooth running of a company. It is of course possible to "customise" the articles of association for a company so that they deal with such matters in a more comprehensive manner. It is sometimes said that one could draft articles of association to deal with all matters which one would typically see in a shareholders' agreement. Whilst this is arguably true there are certain important reasons why shareholders more often choose to regulate their relationship between one another as shareholders by means of a shareholders' agreement rather than by means solely of the articles of association.

ADVANTAGES OF A SHAREHOLDERS' AGREEMENT

Privacy

The predominant reason for using a shareholders' agreement is that it is a private document between the parties thereto which can be made subject to express confidentiality restrictions. By contrast the articles of association are a public document available for inspection by members of the public in the Companies Registration Office. This makes the articles of association an unsuitable means for dealing with matters such as, for example, the remuneration of directors or other sensitive internal management matters.

Greater Binding Effect

As explained above articles of association can only bind a shareholder in his capacity as shareholder. By contrast shareholders' agreements may be used to give rights and impose obligations on shareholders e.g. binding a person in his capacity as director or as a creditor or agent. However one needs to be very careful in imposing obligations on a party in his capacity as a director. I will return to this point later on.

Variation

As explained above articles of association can be amended by way of a special resolution. By contrast, unless a shareholders' agreement expressly provides for a specific variation mechanism, it can only be varied by unanimous agreement of the parties thereto.

DISADVANTAGES OF A SHAREHOLDERS' AGREEMENT

Binding Effect

Because of its nature as a contract a shareholders' agreement only binds the parties thereto and does not automatically bind all shareholders. Therefore if a party transfers his shares the transferee will not automatically be bound by the terms of the shareholders' agreement. To circumvent this it is normal to provide in a shareholders' agreement that an existing shareholder who is party to a shareholders' agreement can only transfer his shares if he procures that the transferee enters into what is known as a deed of adherence which joins the transferee as a party to the shareholders' agreement.

Interpretation

Again as shareholders' agreements are contracts they are subject to the ordinary rules of contract law, in the event a dispute arising as to the meaning of a provision in the shareholders' agreement, a court would, as a primary means of interpretation, seek to establish what was the intent of the parties based on the wording of the contract. By contrast the language in articles of association has become in many respects fairly standardised and many of the provisions used in articles of association have been judicially considered over the years and there may therefore be available judicial precedent to assist in the interpretation of those provisions.

I have discussed articles of association at some length because in my experience there is frequently a lack of understanding of the role and importance of articles of association. Even where a shareholders' agreement is put in place the articles of association continue to play an important role in governing the internal regulation of a company. In practice you will find that where a shareholders' agreement is put in place it is commonplace to modify the articles of association which were adopted on incorporation or frequently replace those articles so that they conform with the provisions in the shareholders' agreement which relate to the internal management of a company. It is important that the shareholders' agreement and the articles of association are drafted in a manner to avoid inconsistencies arising between the two documents. I deal with later on the question of where inconsistencies arise between a shareholders' agreement and the articles of association.

TYPES OF SHAREHOLDERS' AGREEMENTS

- Pre-incorporation/formation agreement an agreement put in place between the parties who intend to form a company and to be its initial shareholders;

- Subscription and shareholders' agreement - a shareholders' agreement entered into between parties who are subscribing for shares contemporaneously with the entry into the shareholders' agreements;

- Shareholders' agreement governing a 50:50 shareholding position (or where there are other equal minority shareholdings);

- Shareholders' agreement governing a majority/minority situation;

- Shareholders' agreement governing a joint venture situation.

I have set out above the most common categories of situations where shareholders' agreements are used though of course there are numerous variants on these. For the purpose of this paper I am proposing to concentrate on the most common issues that would arise where two or more persons wish to put in place a shareholders' agreement in an early stage business. The other situation which some of you are likely to face in the future is where an investor (whether a venture capital investor or otherwise) wishes to invest in your company. The considerations in such a situation are somewhat different and unfortunately are outside the scope of this paper.

COMMON PROVISIONS IN A SHAREHOLDERS' AGREEMENT

You will of course appreciate that ultimately the contents of any shareholders' agreement will be dictated by specific facts of each situation and the relative negotiating strengths of the various parties. However most shareholders' agreements will deal with the following areas:

Business and Management

Most shareholders' agreements will specify what business(es) the company is carrying out or proposes to carry out and will contain provisions determining in what circumstances the company can alter the manner, nature or location of its business operations. In addition, most shareholders' agreements provide that the business of the company is controlled by its board of directors. In doing so this affirms Article 80 of Part I of the Table A Articles which is one of the more important provisions of the articles of association. Its effect is to delegate to the board of directors of a company all powers of the company which are not specifically reserved by the articles of association or the Companies Acts to the shareholders in general meeting. The effect of this is to vest a broad range of management functions in the board of directors.

Composition of Board of Directors

Whilst it is common for a shareholder holding a material shareholding interest to occupy a position on the board of directors of a company, the Companies Acts do not afford a right to a shareholder holding a minority interest to a position on the board of directors of a company. Furthermore standard articles of association do not afford such a right. Accordingly it is important for a minority shareholder who wishes to have a board seat to provide for same in a shareholders' agreement. Frequently you will find that such an entitlement to a board seat is made conditional upon the shareholder continuing to hold a specified minimum level of shareholding in the company and/or continuing to be an employee of the company (or an associated company). Furthermore it should be considered whether the right to appoint a director is personal to the shareholder (i.e. that the shareholder can only appoint himself) or whether he can appoint another party in his stead. In addition, it should also be considered whether the right to appoint a director can be enjoyed by a person who acquires the shares from the initial shareholder. The answers to these questions will ultimately be dictated by the facts of each particular situation.

On a related point, it is also important to consider the extent to which the parties wish to allow a director to appoint an alternate to stand in during his absence. Table A Articles provide for the ability for a director to appoint another person (who may be a director or another person) who is approved by a majority of the board to stand in as the director's alternate. This may be convenient if attendance at board meetings would be rendered difficult by a director's travelling commitments or the location of a director's residence. However such matters can normally be dealt with making provision for directors' meetings to be capable of being held by telephonic communications in the articles of association.

Convening/Conduct of Board Proceedings

It is common in shareholders' agreements to provide that certain number of scheduled board meetings will be held at regular intervals and will be convened on a specified period of notice and is to be accompanied by an agenda and board papers. The shareholders' agreement may also provide for the calling of urgent meetings by a shorter period of notice. It is also common to provide that a certain number of, or certain specified, directors must be present at any board meeting in order for it to be quorate. Where such a quorum requirement is included I normally suggest that an additional provision be included to the effect that if the necessary quorum is not present that the meeting be adjourned for a specified period (e.g. a week or a fortnight) to the same place at the same time and that the reconvened meeting would proceed with the directors then actually present to consider the business on the agenda for the earlier meeting. In the absence of such a provision one or more directors might seek to use the requirement for a quorum in a mischievous manner by refusing to attend board meetings and thereby prevent the company from acting through its board of directors.

Information Rights

Whilst a director will by virtue of his office of director be entitled to all information concerning the company's business he will hold such information subject to his fiduciary duties which include a duty not to use such information to the detriment of the company. Furthermore a shareholder who is not a director has very limited rights under the Companies Acts to receive information which, put simply, is not much more than a right to receive the accounts which are to be laid before the annual general meeting for approval. Accordingly it is important, particularly for minority shareholders, to include a right to receive information concerning the conduct of the business. This may either be drafted as a right to receive specific information (e.g. monthly/quarterly management accounts; cash flow projections; annual budgets etc) and/or a broader right to receive any information concerning the conduct of the business which such shareholder may reasonably request. In some cases, particularly where the minority shareholder is an investor, if a shareholder is not provided with the relevant information, he may have a right to enter the business premises of the company, access and copy records, interview employees and indeed appoint consultants on his behalf to investigate and report on the conduct of the business of the company.

Dividends

Under Table A Articles, and indeed most standard articles of association, dividends are recommended by the directors and approved by the shareholders in general meeting. Interim dividends are recommended and paid by the directors and are ratified by the shareholders in general meeting. The important point here is that in either case no dividends will be paid unless the board of directors firstly recommends the payment of a dividend. Absent lack of evidence of mala fides on the part of the board of directors it is extremely difficult, if not impossible, for a minority shareholder to insist on the payment of dividends to him. Accordingly it is quite common to include in a shareholders' agreement a provision whereby a certain amount of the profits of a company must be declared and paid out in each year by way of dividend. Frequently in early stage companies the operation of this Clause is suspended for a specified period to allow the company to reach a position where it is making a certain level of profits or to use retained profits for development/expansion.

Finance

Frequently early stage companies will not be sufficiently cash generative to meet the working capital requirements of the company and adequate finance may not be available from banks, outside investors or other third party sources. In these circumstances the shareholders may

finance the company's initial working capital requirement themselves by contributing funds to the company by way of share capital or loan capital to meet the company's initial working capital requirements. If this initial capitalisation together with available cash flow is not sufficient, and to the extent that third party sources of finance do not become available, the parties may foresee that they will need to provide additional working capital to the company themselves. Frequently parties will deal with this on an "**as needed**" basis though in some cases parties provide in shareholders' agreements that in such circumstances they will provide the necessary finance by way of an investment for further shares, loan capital and/or the provision of personal guarantees to support bank facilities. A shareholders' agreement may also provide for what is to happen in the event that a party defaults on its obligations. A note of caution is required if such a provision is being considered. This is because a shareholders' agreement does not necessarily terminate if a receiver or a liquidator is appointed to the company and a receiver or a liquidator may seek to enforce such a covenant on behalf of the company against the shareholders who gave such a covenant. Accordingly it is prudent to place a monetary limit and/or a time limit on such covenants or at the very least to stipulate that any such covenant terminates if the company enters into liquidation or is otherwise insolvent.

Minority Protection

As I have explained above most standard articles of association vest extensive powers of management in the board of directors and ultimately the board of directors will be controlled by one or more shareholders. Because the Companies Acts provide for quite limited rights for minority shareholders it is quite common in a shareholders' agreement where there is a majority/minority situation or where there are a number of minorities to provide for certain restrictions on the powers of the directors to act without the consent of either specified shareholders or a specified percentage of shareholders. Matters that would commonly be so restricted include:

- The issue of shares or securities convertible into shares (e.g. options/warrants);
- The redemption or repurchase of shares or other return of share capital to shareholders;
- The amendment of the share capital structure;
- The disposal of the business of the company or a material part thereof or the disposal of trading assets above a certain level;
- Incurring borrowings above a certain level and the giving of security for such borrowings;
- The payment of dividends otherwise than in accordance with the specified distribution policy;
- Making a material change in the business;
- Incurring capital expenditure above certain limits, making loans or giving guarantees/indemnities;
- Paying employees or directors in excess of specified limits;
- Entering into onerous contracts/arrangements or arrangements not on an arm's length basis or with related parties.

Keyman Insurance

It is particularly common in early stage companies to find that the death or incapacity of certain members of the management team may have a detrimental effect on the company's prospects. Accordingly it is increasingly common for companies to take out keyman insurance on its more important management team members the proceeds of which would be received and used by the company to source and hire replacement personnel. It is very common for an investor to require a company to take out this type of insurance prior to the investor completing the investment.

Intellectual Property

It is a commonplace to find that individual promoters of a company may hold in their personal names certain valuable rights which are used by the company (e.g. rights to source code or other IP, domain names, trademarks etc). It is frequently the case that a significant amount of preparatory work has been carried out by the promoters prior to a company being incorporated or commencing to trade and the promoters may with the best of intentions have acquired such valuable rights in their own name with the intention of transferring them to the company but did not get around to it. Ultimately this can have unfortunate consequences for a company if relations break down with a promoter who holds such rights and such promoter then claims ownership of such rights for himself. It is sometimes the case that the transfer of such rights are dealt with in a service agreement between the company and the promoter or in a separate stand alone intellectual property rights undertaking. However these need to be treated with some caution as frequently one will find that significant work has been carried out by a promoter prior to the incorporation of the company or the commencement of his employment with the company and the provisions in a service agreement may not be sufficient to cover the ownership of intellectual property rights which were developed prior to commencement of employment. Accordingly for these reasons it is prudent (even at the risk of some level of duplication) to provide in a shareholders' agreement that all such rights which relate to the business of the company (whether developed before or after the date of the shareholders' agreement) belong to and are to be transferred to the company. In many cases these rights will form an essential part of the value of the company and it may be difficult to attract future outside investment if there is uncertainty over the ownership of such rights. Where a shareholders' agreement is being entered into in connection with an investment by an outside party such outside investor will almost invariably seek such covenants from the promoters.

Issue of New Shares – pre-emption rights

Most standard articles of association vest the power to issue shares in the board of directors. Whilst this power to issue shares may be restricted by contractual provisions in the shareholders' agreement as described above it should also be considered whether to impose an obligation on the directors to firstly offer the shares to the existing shareholders pro-rata to their shareholdings before issuing shares to an outside party. These are known as "**pre-emption rights**". These pre-emption rights are contained in Section 23 of the Companies (Amendment) Act 1983 but, as I have said above, are commonly disapplied in standard articles of association leaving the issue of shares and indemnity of the recipients of those shares fully at the discretion of the board of directors. It is however also frequently the case that the parties decide to adopt a more customised version of these "**pre-emption rights**" in the articles of association which provides that the directors must offer existing shareholders the opportunity to purchase such new share pro-rata to their existing shareholdings and allow those shareholders a specified period in which to indicate whether they wish to take up such entitlement. It can in addition be provided that where there is not a full take up by the shareholders that the directors may go back to those shareholder(s) who may have expressed an interest in taking up more than their individual entitlement and offer the

remaining shares to them or the directors may at this stage issue the shares to outside parties. Such customised "**pre-emption rights**" also commonly provide that they can be waived or disapplied with the consent of all or a specified proportion of the shareholders. This ability to waive or disapply the pre-emption rights is useful where there is a consensus that the company requires investment in excess of what can be provided by the existing shareholders and thereby avoid the delay involved in complying with the pre-emption process.

Transfer of Shares – pre-emption rights

In private companies it is common to impose an obligation on a shareholder who wishes to sell his shares to give some or all of this co-shareholders an opportunity to purchase them. These are also known as "**pre-emption rights**" and they are most usually found in the articles of association for reasons I will explain later on.

Pre-emption rights take various forms but most commonly include the following elements:

- A shareholder who wishes to sell his shares notifies the company of his intention to sell shares by way of a notice to the company (a "**Transfer Notice**"). A Transfer Notice authorises the Company to seek a purchaser for the shares and ultimately to effect a sale of the shares to the purchaser (if the selling shareholder refuses to complete the sale). A Transfer Notice is normally irrevocable except in limited circumstances;

- The Transfer Notice specifies the number of shares which a selling shareholder wishes to sell and will either specify the price at which he wishes to sell those shares or authorises the company to instruct a third party to value the shares in which case the third party's valuation will constitute the price;

- Once the price is set or determined the company will then notify the other shareholders in the company of the shares that are available for purchase and the price thereof and invite those other shareholders to apply to purchase such shares;

- It may be provided that those other shareholders are entitled to apply to buy all the shares available for sale with the proviso that they will be scaled back in proportion to their existing shareholdings if the demand from the shareholders as a whole exceeds the available supply;

- An alternative approach is to invite the other shareholders to apply for a specified number of shares and, if the full amount of shares is not taken up on the first round, to offer the shares left over by way of a second round to those shareholders who indicated that they would be willing to buy shares in excess of their initial allocation;

- If having so offered these shares to the other shareholders some or all of the shares not taken up then the selling shareholder is normally allowed a specified period in which to sell to outside parties at the same price and on the same terms at which the shares were offered to the existing shareholders;

- Sometimes instead of allowing the selling shareholder to sell to an outside party the pre-emption regime authorises the directors to find another purchaser for the shares which might be an outside party or might indeed be employees of the company who do not already hold shares.

It is common also to find that certain categories of transfer of shares are exempted from the obligation to offer them to other shareholders. This sometimes includes the transfer of shares to family members or to a family trust or the transfer of shares by a corporate

shareholder to another member of its group or the transfer of shares on the death of a shareholder to his personal representatives or his successors. In addition it is also common to find a provision allowing for the waiver/disapplication of these pre-emption rights with the consent of all or a specified proportion of the shareholders. This waiver/disapplication facility enables a company to avoid the time that would otherwise be expended in complying with the pre-emption procedures where a consensus exists amongst the existing shareholders that the shares can be transferred to a particular person or persons without going through the formality of the pre-emption regime.

It is also common to provide for certain situations where a shareholder can be compulsorily forced to transfer his shares. These situations include:

- where an individual shareholder becomes bankrupt;
- where a corporate shareholder becomes insolvent or has a receiver or an examiner appointed;
- where a corporate shareholder transfers shares to another member of its group and that transferee ceases to be a member of the group;
- sometimes but less frequently, where an individual shareholder dies; and
- where an individual shareholder is an employee of the company (or an associated company) and he ceases to be employed by that company.

In these circumstances the board of directors is given a power to require such shareholder (or his personal representatives) to issue a Transfer Notice and, in default of doing so, to deem a Transfer Notice to have been issued. The sale price of the shares is fixed by an independent party (e.g. the company's auditors or another third party valuer) and then the pre-emption regime as described above is implemented.

I will deal in more detail later on with the issue of compulsory transfer of shares by departing employees/shareholders.

I mentioned above that it is more common to have the pre-emption regime relating to transfer of shares contained in the articles of association rather than in a shareholders' agreement. The reason for this is that the articles of association are a public document and a prospective purchaser of shares in a company would be deemed to be on notice of the contents of the articles of association of that company as filed in the Companies Registration Office whether or not he has in fact inspected them. Accordingly if a person is purchasing shares in a company whose articles of association contain pre-emption rights then such purchaser should seek evidence that the procedures contained in the articles of association concerning pre-emption rights have been complied with or alternatively that the pre-emption rights have been waived with the approval of the necessary majority. If such a prospective purchaser purchases shares in such circumstances without obtaining such evidence, and if the pre-emption procedures had not been complied with, the purchaser may not acquire title to the shares in question, as he would not be a "bona fide purchaser for value". If however the pre-emption procedures are set out in a shareholders' agreement a third party purchaser would not be on notice of such pre-emption rights as they, in that case, are not contained in a public document and would not be affected by non compliance with those pre-emption procedures.

Non Competition Provisions

It is common to find in many shareholders' agreements, and particularly in shareholders' agreements entered into in connection with a venture capital investment, various restrictions

on promoters which restrict them for the period whilst they hold shares in the company and for a period of up to two years thereafter from:

- competing with the business(es) carried on by the company;
- soliciting customers of the company;
- soliciting employees of the company.

These restrictions are frequently given for the benefit of the investing party or in other types of shareholders' agreements for the benefit of the company itself. In early stage businesses which are heavily dependent on the promoters involved and their knowledge and contacts these types of restrictions play an important part in demonstrating a promoter's commitment to the company and, as I said, will frequently be insisted upon by venture capital and other third party investors. These provisions are also important apart from venture capital situations as many businesses are particularly vulnerable to a promoter departing and "**setting up shop**" elsewhere and possibly also hiring some of the employees of the existing company and then competing with the existing company. These type of restrictive covenants are only part of a package of measures designed to ensure that the promoters are committed to the business of the existing company and another important part of this package of measures are provisions whereby a departing promoter may be required to sell his shares which I deal with a little later on.

It is important to remember that these type of restrictive covenants must be very carefully drafted and, in simple terms, where they continue in effect after a promoter ceases to be employed they should be restricted:

- to a period of no more than two years after the date the promoter ceases to be employed;
- in territorial application to those territories where the business was carried on at the date the departing promoter ceases to be employed;
- to the business(es) carried on by the company at the date the promoter ceases to be employed;

If the application of the restrictive covenants are too broad in terms of their geographic, sectoral or temporal application they may be subject to challenge by the affected party on grounds that they are in breach of the common law doctrine of restraint of trade or in breach of the provisions of the Competition Act 2002.

Considerations relating to departing employee shareholders

Where a number of parties come together and establish a company in which they are employed it is frequently based on the understanding that the parties are effectively earning their shareholding through their efforts as an employee in developing the business of the company. Very frequently situations arise where a number of people come together establish a company with equal shareholdings and spend time in developing a promising business and at some time down the line differences arise leading to one of the promoters ceasing to be employed by the company. In those circumstances, whether or not the departure was on good or bad terms, the remaining promoters may then realise that their former colleague holds a significant proportion of the shares in the company and that if they want to attract replacements for the departing promoter they may well have to issue new shares thereby significantly diluting their own position. There is no provision in the

Companies Acts or in standard articles of association which provide for the compulsory transfer of shares by a shareholder who ceases to be employed.

Accordingly it is prudent to consider whether to impose a requirement on a shareholder who ceases to be employed by a company to dispose of his shares. This is a matter which many promoters experience genuine difficulties in arriving at a solution which is fair and reasonable. It is frequently felt that after a promoter has spent a certain amount of time in building up the company that he had earned the right to keep his shares and if this is the prevailing consideration then one has to decide when the appropriate milestone is reached to allow such a shareholder to keep his shares.

On the other hand other parties may consider that the most important consideration is the ability to require a person who acquired shares as a promoter or an employee or in connection with his employment to dispose of those shares on ceasing to be employed. As explained above this can be achieved by giving the board of directors an ability to require such persons to issue a Transfer Notice (as described above) in respect of their shares and, in default of such person issuing a Transfer Notice, to authorise the board of directors to deem a Transfer Notice to be issued. This approach also has the advantage of allowing the board of directors to deal with "**hard cases**" such as where a person is forced to leave employment by virtue of illness or redundancy. In my own experience it is better to take this approach rather than having a provision whereby shares are automatically transferred on cessation of employment. From the perspective of an investor he or she may not want this decision left to the board of directors and may insist on having the power to direct the company to force an ex-employee to issue a transfer notice.

Frequently in such circumstances the pre-emption procedure is modified to give the directors the ability to find purchasers for shares which become available in this manner whether such purchasers are existing or new employees or indeed the directors may elect for the company to repurchase the shares itself which it may then hold as treasury shares which are available for future reissue or the Company may cancel the shares so repurchased. A common misunderstanding that exists is that the company will be readily able to repurchase shares from its shareholders. Whilst the Companies Act 1990 has made it legally possible for a company to purchase its own shares it also specified a number of important pre-requisites before a company can do so. Of these probably the most important is the requirement that the company have "**profits available for distribution**" equivalent to the purchase price of the shares to be repurchased. In technical terms "**profits available for distribution**" are the excess of accumulated realised profits over accumulated realised losses and, in terms which may be more familiar to you, they effectively equate to retained profits or retained reserves. In practice, most early stage companies will not have built up the necessary reserves to enable the company to purchase its own shares. Accordingly, it is unwise simply to provide that a departing employee shareholder must sell his shares to the company. It is preferable, as I have said above, to give the board of directors the power to specify who will purchase the shares of a departing employee shareholder.

The next question to consider in connection with this issue is the price at which the shares should be repurchased in such a compulsory disposal situation. There are quite a number of approaches to this. If it has been decided that a departing employee shareholder must dispose of all his shares then the question will be whether those shares are to be purchased at market value or at some discount to market value or on some other basis. In these circumstances the market value is most commonly determined by a valuer e.g. the auditors or other independent valuer. Typically discounts are applied either with reference to the period of time the employee shareholder has been with the company and the longer the period of service then the lesser the discount factor is and after a certain period of time no discount factor to market value will apply and the shares will be purchased at their market value. Typically periods of three to five years are specified for this purpose. Another

approach is to apply a discount by reference to whether the employee shareholder has been a "**good leaver**" or a "**bad leaver**". In good leaver situations the departing employee shareholder typically receives market value and in bad leaver situations he typically receives the lower of the price he paid for his shares and the market value of the shares. Although there are different approaches to defining good leaver and bad leaver situations some of the more common good leaver situations are where the employment relationship ceases by:

- death;
- permanent incapacity;
- termination by the company in cases where the termination is subsequently found to be an unfair or wrongful dismissal and the following cases are typically treated as "**bad leaver**" situations:
- voluntary resignation by the employee within a specified time period;
- dismissal by the company where the dismissal is not an unfair or wrongful dismissal.

These types of provisions require careful consideration as they obviously build in a serious penalty for departing employee shareholders who may have expended significant time and energy in developing a business and who may have foregone better salary terms and other benefits that he could have enjoyed elsewhere.

Enforcement/Remedies

Bearing in mind that the essential purpose of a shareholders' agreement in the first place is to set down a set of rules for the internal management of the company and, as far as possible, to prospectively address how potentially divisive issues will be dealt with, one also commonly finds that shareholders' agreements will sometimes contain mechanisms for resolving disputes. Such mechanisms may include an escalation procedure where disputes between shareholders are escalated to a non-executive chairman (if he is independent of the matter in dispute) or another third party and the parties may agree that that third party's decision on the matter is final and binding on them. Another variant to this is to give the chairman of the company a casting vote on matters in which there is a tied vote but frequently this is not commercially acceptable if the chairman is not truly independent because such a casting vote arrangement could otherwise vest control in one or other factions within the company.

Another alternative is to provide for binding arbitration. An arbitration clause in a shareholders' agreement may provide that some or indeed all the disputes arising under in connection with the shareholders' agreement may be referred to an outside arbitrator. The principal advantage of arbitration as a means of dispute resolution is not one of cost or speed but rather one of confidentiality. Arbitration proceedings are held in private whereas most proceedings that go to court will as a matter of public policy be heard in open court and indeed may well become public a long time before the hearing of the matter by a court.

However arbitration also has its disadvantages. A party to a dispute under a shareholders' agreement may feel that the dispute might be more speedily or efficiently resolved by a court but the other party may insist on the matter being presented to an arbitrator and would be able to obtain a court order staying the legal proceedings until the arbitration had been carried out. A further disadvantage of the arbitration route (depending, of course, on one's perspective) is that the decision of the arbitrator will normally be expressed to be binding and, with very limited exceptions, is not open to appeal whereas a decision of the circuit court or the high court is normally open to appeal to a higher court.

It is often the case that certain matters of an operational nature lend themselves to a more efficient resolution by arbitration rather than by a court. It may be more appropriate that an arbitration clause provides that certain (but not all) matters are to be resolved by arbitration that other matters may be referred to a court of law. A particular situation giving rise to a dispute may be so urgent to necessitate the obtaining of an injunction from the High Court to restrain the matters subject to the dispute. An arbitration clause, if sufficiently well drafted, can authorise an arbitrator to make provisional awards such as an injunction. However assuming the arbitrator had the power to grant an injunction and if the arbitrator were to grant an injunctive award it would probably still need a High Court order to enforce the arbitrator's award. The same is also true of an arbitrator's final award. In summary therefore on this point you should not simply assume that dispute resolution by means of an arbitration is automatically better than resolution by way of court proceedings. The appropriateness of including an arbitration clause should be carefully considered in each particular fact situation.

Sometimes a shareholders' agreement provides for other dispute resolution procedures including the granting of an option in certain deadlock situations for one party to buy out the other party or parties either at a stated price or at a price fixed by a third party valuer. This situation might arise where the negotiation power of one party is clearly superior to the other party or parties. In other cases where the parties are of similar negotiating power a procedure is sometimes used whereby after a deadlock has arisen one party can serve a notice on another party stating the price at which he wishes to sell his shares or by the other party's shares. The consequences of serving such a notice are that the other party will sell his shares at that price or alternatively buy the shares of the party serving the notice. It is usual to precede the serving of such notice with a form of escalation procedure before the procedure can be invoked or allow for a "**cooling off**" period.

It is however not absolutely essential to, and indeed many shareholders' agreements do not, provide for a dispute resolution procedure. In such cases the parties may have recourse to remedies provided at law and under the Companies Acts.

Bearing in mind that ultimately a shareholders' agreement is a contract one party can sue another party for damages of breach of contract or, in appropriate cases, for injunctive relief restraining certain actions that would be a breach of the shareholders' agreement or, less commonly, an injunction seeking a mandatory injunction requiring certain things to be done. Courts generally only grant injunctions in certain fairly limited circumstances and the most important consideration is that the court must be satisfied that damages would not be an adequate remedy for the plaintiff.

The Companies Acts also afford shareholders certain remedies which are frequently combined with a claim damages for breach of contract or other relief. Under Section 205 of the Companies Act 1963 the High Court is given very wide powers to resolve shareholders' disputes where the court if of the opinion that the affairs of the company are being conducted or that the powers of the directors of the company are being exercised in a manner oppressive to a shareholder or in disregard of a shareholder's interests as a member of the Company. Under Section 205 the High Court can make such order as it thinks fit, including, directing or prohibiting any act or cancelling or varying any transaction or for regulating the conduct of the affairs of the company in future or for the purchase of the shares of any shareholder. Frequently in cases such as this the High Court will order one shareholder to purchase the shares of another shareholder and can order the company to repurchase the shares of one or more of the shareholders. In addition a disaffected shareholder may also seek an order under Section 213 of the Companies Act 1963 for the winding up of the company. Again the High Court may make such an order if it is of the opinion that it is just and equitable to do so.

ALTERATIONS OF SHAREHOLDERS' AGREEMENTS

As explained above a shareholders' agreement will generally speaking only be capable of alternation with the consent of all the parties to the agreement. It is open for the shareholders' agreement to specify a variation procedure involving less than unanimous consent and this would be most common where one party (such as a venture capital investor) has superior negotiating power. In addition as mentioned above the High Court has power under Section 205 of the Companies Act 1963 to vary or indeed terminate a shareholders' agreement.

I also mentioned previously that the shareholders' agreement and articles of association should be drafted with a view to avoiding inconsistencies. In order to deal with the possibility that inconsistencies may arise between the two documents it is normal to include in the shareholders' agreement a "**supremacy clause**" which provides that in the event of conflict the provisions of the shareholders' agreement would prevail to decide the conflict. It is extremely important that such a "**supremacy clause**" is drafted very carefully. Without going into technical detail, if articles of association are amended such amendment must be filed in the Companies Registration Office within a prescribed period and if the supremacy clause in a shareholders' agreement operates as a de facto variation of the articles of association then there is an argument to the effect that the shareholders' agreement should be filed in the Companies Registration Office along with the articles of association. Obviously as the shareholders' agreement may contain sensitive details that the parties to the shareholders' agreement may not wish to be made public it would be most undesirable to be forced to file the shareholders' agreement in the Companies Registration Office. To avoid this it is generally advised that the supremacy clause be drafted to provide that the parties to the shareholders' agreement agree between themselves as parties to the shareholders' agreement and that in the event of a conflict between the shareholders' agreement and the articles of association that they will agree to be bound by the interpretation in the shareholders' agreement and that they will use their voting powers as shareholders to amend the articles of association to remove the inconsistency.

DIRECTORS' DUTIES

As I mentioned above a shareholders' agreement may be used to bind parties to the agreement in a capacity other than that as a shareholder. One will commonly find that a party to a shareholders' agreement is a director as well as being a shareholder. In these circumstances it must be borne in mind that a director has an overriding duty to act in the best interests of the company and he cannot fetter his duties in this regard. This point needs to be borne in mind where a party to a shareholders' agreement is a shareholder and also is or will become a director.

CONCLUSION

I hope that the foregoing discussion assists in giving you a better understanding of the purpose and nature of shareholders' agreements and of the issues which more commonly arise in connection with shareholders' agreements. Obviously specific considerations would arise in the context of particular types of shareholders' agreements such as a joint venture situation or a venture capital investment which are outside the scope of this paper. I should also mention that in my view it is prudent when putting in place a shareholders' agreement one also consider putting in place appropriate service agreements with key members of the management team to the extent that they are not already in place.

© Emmet Scully, LK Shields Solicitors
Phone: 353 1 6610866
Fax: 353 1 6610883
Email: escully@lkshields.ie

This memorandum is a summary for general information only. It is not a full analysis of the matters presented and may not be relied upon as legal advice.