**IBA Guide on Shareholders’ Agreements**

**England and Wales**

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1. **Are shareholders’ agreements frequent in England and Wales?**

Shareholders’ agreements are usual especially where there are complicated shareholder structures, where there is a differential in the treatment of different shareholders or where the shareholder arrangements amount to a quasi-partnership (i.e., small partnerships of a limited number of individuals which, although operate as a limited company, are in practical terms run as if they were a partnership between those individuals in control).

They are also sometimes used where the shareholders wish to keep private certain information regarding the terms of their relationship as shareholders in the company. The fact of their existence as shareholders will, however, be public information.

However, it is not uncommon for companies to solely rely on their articles of association to regulate the affairs of the company and its shareholders especially if they are small owner-managed private companies.

1. **What formalities must shareholders’ agreements comply with in England and Wales?**

Shareholders’ agreements, in the vast majority of cases, do not have to be filed at Companies House (the public register of companies in England and Wales) and therefore are private documents as between the shareholders. The exception to this is where the shareholders’ agreement is specifically mentioned in the articles of association or if the shareholders’ agreement contain terms which would otherwise affect the company’s constitution.

This contrasts with the terms of the articles of association of a company which are made available for public inspection.

1. **Can shareholders’ agreements be brought to bear against third parties such as purchasers of shares or successors?**

The common law doctrine of privity of contract (also known as the third party rule) states that only the parties to a contract acquire directly enforceable rights under it. Therefore, as a general rule, only the parties to a shareholders’ agreement can sue or be sued under that agreement.

There are a number of statutory exceptions to the third party rule, of which the most important is that created by the Contract (Rights of Third Parties) Act 1999 under which a third party may enforce a contract term against the parties to the agreement where:

* The contract expressly gives the third party the right to do so; or
* The term purports to confer a benefit on the third party, and the contract shows the parties' intention to make that term enforceable by the third party. This is a question of contract interpretation.

It is worth noting that shareholders’ agreements will often include provisions that require new shareholders to execute a deed of adherence to ensure that that the new third party shareholder adheres to the terms of the shareholders’ agreement.

1. **Can a shareholders’ agreement regulate non-company contents?**

Shareholders’ agreements can deal with all aspects of the relationship between the parties if required, including non-company matters and personal rights and obligations of shareholders. However, it would be usual to restrict shareholders’ agreements to matters relating to the company and shareholding relationships. If the parties wish to deal with non-company matters, these will usually be contained in a separate agreement.

1. **Are there limits on the term of shareholders’ agreements under the law of England and Wales?**

No, there are no restrictions on the term of a shareholders’ agreement in England and Wales. It is not unusual for shareholders’ agreements to be in existence for relatively short periods (particularly in the case of high-growth companies, where there is an expectation of further rounds of funding).

Shareholders’ agreements will often have express termination provisions which provide for the agreement to terminate once all the parties to it cease to hold shares in the company.

1. **Are shareholders’ agreements related to actions by directors valid in England and Wales?**

Under current legislation, directors must exercise independent judgment and have a duty to promote the success of the company for the benefit of its members as a whole. There is, therefore, a general principle that directors cannot fetter their future discretion and therefore should not contract, undertake or otherwise agree in advance, to exercise their discretionary powers in a particular way.

For example, in the context of a shareholders’ agreement, the duty to exercise independent judgment would prima facie mean that a director cannot simply agree with his appointing shareholders to vote at board meetings in any particular way (even if voting in that way would not otherwise be a breach of his duties to the company) as he would not be exercising his independent judgment.

This is a general rule and, in particular circumstances, directors may bind themselves as to the future exercise of their powers. Case law would indicate that the exceptions fall within two broad headings as follows:

* A company acting through its members may release the directors from the strict application of the general rule; and
* Directors may agree to act as directors in a particular way if, at the time when they enter a contract, undertaking or other agreement agreeing to do so they consider, acting in good faith, that to do so is in the best interests of their company.

Therefore, in certain circumstances, the duty to exercise independent judgment may not be infringed by a director acting in accordance with an agreement properly entered into by the company that restricts the future exercise of the director's discretion or acting in a way authorised by the company's constitution.

1. **Does the law of England and Wales permit restrictions on transfer of shares?**

Yes. Current legislation provides that the shares or other interest of any member in a company are transferable in accordance with the company's articles of association. Therefore, it will usually be the articles of association and/or a shareholders’ agreement that will regulate the restrictions on share transfers.

1. **What mechanisms does the law of England and Wales permit for regulating share transfers?**

It is open to shareholders to agree amongst themselves how the transfer of shares is to be regulated. Since the shareholders may well have chosen to enter into the shareholding venture together, it is likely that they will require some restrictions on transferability of shares. The purpose of these restrictions may be to lock the shareholders into the company for a specific period or may be to prevent the transfer of shares to a competitor of the business or to someone with whom the other shareholders have no connection.

Shareholders’ agreements may contain a number of the following mechanisms for regulating share transfers.

*Board consent*

The most flexible way of dealing with restrictions on share transfers would be to include a general restriction on any share transfers without the consent of the board of directors.

*Pre-emption rights*

This provides a right of first refusal requiring any shareholder who wishes to sell their shares, to first offer their shares to the other shareholders pro rata to their existing shareholding, allowing them to preserve their percentage shareholding in the company (provided that they have sufficient funds available to acquire the shares). Pre-emption rights can take a number of forms, some of which are identified below.

*Deemed or compulsory transfer provisions*

Shareholders’ agreements and/or the articles of association will sometimes impose provisions under which certain shareholders may, upon the occurrence of certain events, be required to transfer their shares to existing shareholders or to the company at a specified price. These provisions are called ‘deemed transfer provisions’. Events such as the termination of employment, the bankruptcy or insolvency of one party, death, becoming of unsound mind and/or the material breach of certain provisions of the shareholders’ agreement may be the trigger for the application of this provision.

As a further sophistication, the company can sometimes penalise a shareholder by requiring the transfer of shares at a discounted price. For these purposes, a distinction is then made between a ‘good leaver’, who is normally entitled to obtain a fair value for his shares and a ‘bad leaver’, who normally obtains a heavily discounted price for his shareholding. For example, a ‘bad leaver’ may include a shareholder who terminates his employment with the company within a specified period or who commits a serious breach of the shareholders’ agreement.

*Buy-out provisions*

The general concept is to give certain shareholders the opportunity of buying out the shareholding of some or all of the other parties either at a pre-agreed or formula price or by way of a market value formula determined by a third party (usually an independent accountant). Several colourfully-named procedures have been created to manage the buy-out process. Examples include Russian roulette and Texas shoot-out (explained below):

* Russian roulette. Under the Russian roulette procedure a shareholder serves notice on the other shareholder offering either to buy the shares of the other party, or to sell its own shares to the other party (but not both), at a specified price. The other party can either accept the offer or reverse it at the same price.
* Texas shootout. Under the Texas shoot-out procedure if a shareholder serves a notice of termination, each of the shareholders has the right within a specified period to deposit a sealed bid in writing to the company under which that party unconditionally offers to purchase all (but not some only) of the shares in the company held by the other party or parties at the cash price

per share stated in the bid. The party depositing the bid with the highest price per share (or depositing the only bid) shall become bound to purchase and the other party or parties shall become bound to sell its/their shares at the price stated in such bid.

*Tag along/drag along*

So-called tag-along and drag-along rights are commonly found in shareholders’ agreements. Tag-along rights require a selling shareholder to procure that a third party purchaser who obtains control of the business offers to buy the shares of the remaining shareholders on the same terms. This is a way of guaranteeing exit for minority shareholders. Drag-along rights, on the other hand, give the selling shareholder the right to force the remaining shareholders to be bought out by a third party purchaser on the same terms. This is a way of guaranteeing that a minority cannot prevent the sale of the company.

*Permitted transfers*

As an exception to restrictions on share transfers, shareholders are sometimes given the ability to transfer some or all of their shares to a close family member or a corporate affiliate. The purpose of this provision is usually either for tax planning purposes or to enable intra-group transfers of investments. These share transfers are normally called ‘permitted transfers’.

1. **In England and Wales do bylaws tend to be tailor-drafted, or do they tend to use standard formats?**

Articles of association are usually drafted in a reasonably standard format. A standard set of articles is contained in the Model Articles for private companies, which is a set of articles prescribed by company legislation. Companies can ‘adopt’ the Model Articles in their entirety or can amend them to suit their requirements. Alternatively, companies may choose to draft a bespoke set of articles. In that respect, there is no ‘one size fits all’.

Shareholders’ agreements in England and Wales are tailor made to the specific needs of the parties to them.

1. **What are the motives in England and Wales for executing shareholders’ agreements?**

The key motives for executing shareholders’ agreements are to manage the expectations of shareholders by preventing misunderstandings between the parties in relation to such issues as corporate governance, rights on transfer of shares and shareholders’ obligations etc.

In addition, there are often good commercial reasons to insert key provisions in a private contractual document.

1. **What contents tend to be included in shareholders’ agreements in England and Wales?**

Whilst the content of shareholders agreements will vary from company to company, they will usually contain provisions relating to: (i) regulating the proceedings of directors; (ii) determining the quorum or veto rights over certain key decisions of the Company; (iii) regulating the activities to be undertaken by the company; (iv) regulating shareholders’ obligations; (v) providing minority shareholder protections; (vi) establishing specific restrictions on shareholders, for example in relation the sale or transfer of shares; and/or (vii) establishing restrictive covenants (including non-solicitation and/or non-compete provisions for example); (viii) the dividend policy; (ix) resolving deadlock; and (x) the exit strategy.

1. **What determines the content included in shareholders’ agreements in England and Wales?**

The parties to a shareholders’ agreement are free to agree the content and restrictions contained within a shareholders’ agreement.

1. **What are the most common types of clauses in shareholders’ agreements in England and Wales?**

Typical shareholders’ agreements in England and Wales will include provisions in relation to the following: (i) the composition of the board; (ii) representatives and warranties given by the directors/the company and/or the shareholders; (iii) the transfer of shares; (iv) restrictive covenants (including non-solicitation and/or non-compete provisions, for example); (v) confidentiality; (vi) any restrictions on certain actions of the company (which may require the consent of certain shareholders or a certain percentage of shareholders); (vii) rights to receive financial information and agreement on business plan; (viii) dividend policy; and (ix) veto rights in relation to certain matters.

1. **What mechanisms does the law of England and Wales permit to ensure participation of minorities on the board of directors and its control?**

Under current legislation, minority shareholders can take advantage of minority protections in circumstances where the majority shareholders seek to act in a way which is ‘unfairly prejudicial’ to their interests. If this can be established, the court ‘may make such order as it thinks fit’.

In addition and as mentioned above, many small companies are regarded by the law as ‘quasi-partnerships’ – in other words, they are, in effect, small partnerships of a limited number of individuals which, although operating as a limited company, are in practical terms run as if they were a partnership between those individuals in control. The significance of the status of a ‘quasi-partnership’ is that the courts are, generally speaking, more willing to give certain additional rights to minority shareholders in those companies. In particular, a minority shareholder in a ‘quasi-partnership’, has been involved in the running of the business, can often claim protection from being ousted or excluded from the ongoing management of the business (without good reason).

1. **Is it possible in England and Wales to ensure minority shareholder control by means of a shareholders’ agreement?**

It would be unusual for a minority to be granted control of the board of directors. However, this could be achieved by one or more of the following methods: (i) permitting a minority shareholder to appoint and maintain in office the majority of directors to the board; (ii) weighted voting rights; (iii) veto rights in relation to certain decisions of the board; (iv) voting trust arrangements; (v) quorum requirements to ensure the inclusion of the minority shareholder at meetings; and/or (vi) irrevocable powers of attorney.

1. **What are the usual valuation mechanisms in connection with rights of first refusal or share transfer regulations?**

On a voluntary transfer of shares, it is usual for the proposed seller to have a right to specify the price at which he would like to sell those shares. However, the directors are often given the right to approve this price in advance before the shares are offered at that price (to the other shareholders firstly on a pre-emptive basis and then to third parties if all the sale shares are not taken up by the existing shareholders for example). If the directors do not agree the proposed sale price, there usually follows a period of negotiation with the seller, in the hope of reaching a mutually agreed amount for the sale price and failing such agreement, the sale price is usually set by an independent expert. Alternatively, the articles and/or shareholders’ agreement may set a pre-agreed or formula price or by way of a market value formula determined by a third party (usually an independent accountant).

Where there is a compulsory transfer situation, the company may wish to penalise a shareholder by requiring a transfer of shares at a discounted price. For these purposes, a distinction is then made between a ‘good leaver’, who is normally entitled to obtain a fair value for his shares and a ‘bad leaver’, who normally obtains a heavily discounted price for his shareholding. For example, a ‘bad leaver’ may include a shareholder who terminates his employment with the company within a specified period or who commits a serious breach of the shareholders’ agreement.

The maximum price at which a bad leaver will usually be able to sell his shares will be the lower of fair or market value and the nominal value. The principle is that such a shareholder is leaving in circumstances where he should not benefit from any uplift in the value of his shares. Good leavers on the other hand, can benefit from any uplift in value on the shares to be sold.

1. **Is it admissible for a shareholders’ agreement clause to refer dispute resolution to the courts other than those of England and Wales and/or under a law other than that of England and Wales?**

A shareholders’ agreement in England and Wales allows the parties to agree, at the outset of their contractual relationship, which country’s (or countries’) courts are to have jurisdiction to hear disputes arising from the contract.

As a separate determination, the parties are free to include a governing law clause to determine the substantive law applying to the contract and to any disputes that may arise.

If there is no effective jurisdiction clause, the correct forum for the settlement of disputes will be determined by the rules of private international law or, within the EU, by the rules set out in the Recast Brussels Regulation (EU) 1215/2012 of 12 December 2012 (which largely supersedes its predecessor, the Brussels Regulation (EC) 44/2001), the Brussels Convention, the 1988 Lugano Convention and the 2007 Lugano Convention.

1. **Is it admissible for a shareholders’ agreement to include an arbitration clause with seat outside England and Wales and/or under a law other than that of England and Wales?**

The parties to a shareholders’ agreement in England and Wales are free to choose arbitration as the method of dispute resolution. They are also free to specify the seat of the arbitration and the governing law of the contract to be applied at the arbitration proceedings.