Planning a Shareholders' Agreement

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A shareholders' agreement should be the bespoke product of the commercial goals of the parties, and the form of agreement will vary depending upon the type of company involved.

Shareholders may be individuals, corporate entities, trusts, or partnerships.

The following planning checklist is derived from the MOU for a shareholders' agreement I drafted for the formation of a commercial joint-venture company to exploit knowhow. This required the design of a novel share-capital structure involving different classes of share. In addition to reserved matters, entrenched provisions were set out in the Articles.

'Several devices can be used within the articles to bolster, secure or entrench the rights, predominance, power or position of certain shareholders or a particular shareholder, or alternatively to provide a safe means of escape from the company. These devices mirror the objectives of a separately negotiated shareholders' agreement. Devices within the articles include:

- *designating certain matters as reserved matters requiring unanimous decision or a higher than normal percentage of votes;*

- *providing veto votes to particular shareholders in relation to certain transactions;*
- *the incorporation of weighted voting rights;*
- *the use of class rights; and*
- *the provision of golden shares (usually only found in privatisation issues)…*

If the reserved items are contained within the articles then CA 2006, s.22 (Entrenchment provisions of the articles) states that a company's articles may provide that specific provisions may only be amended or repealed if conditions are met, or procedures are complied with, that are more restrictive than those applicable in the case of a special resolution. These provisions for entrenchment may only be made in the company's articles on formation, or by an entrenchment of the articles agreed to by all the members: s.22(2)(a). Entrenchment provisions, of course, do not prevent amendment of the company's articles by agreement of all the shareholders or by order of the court or other authority having power to alter the company's articles: s.22(3)(a), (b).' The Law and Practice of Shareholders' Agreements, 4th edition, by Katherine Reece Thomas and Christopher Ryan (2014).

Covering e-mail

Dear [ ]

SUBJECT TO CONTRACT

After overall consensus has been achieved on the underlying key commercial principles our legal advisor, Mr Carl Islam of 1 Essex Court, Temple, London (carl@ihtbar.com) can prepare a draft joint venture agreement for circulation and amendment by e-mail. The following is our summary of what we consider to be the key commercial principles to be discussed and agreed between us for inclusion in the draft joint-venture agreement ('JVA').

If there are other issues you wish to add, please include your comments in this draft and e-mail it to Mr Islam for consolidation into an overall working check-list of points to be re-issued for discussion and approval.

Yours sincerely,

PLANNING CHECK-LIST /MOU

1. **CAPITAL AND FUNDING:**

1.1 The authorised share capital is to be discussed and agreed taking into account any potential lenders requirements and credit status.

1.2 The proportions in which equity is to be held respectively by the parties. It is proposed that:

- ['**X**'] have a 60 % share carrying 75 % of the votes on all resolutions; and that
- ['**Y**'] has a 40% share carrying a pro-rata number of the votes.

1.3 Classes of shares. It is proposed that there will be two classes of share: "A" ordinary shares, and one special "B" share conferring on **X** [ ] votes in addition to the [ ] conferred by its holding of 60% of the ordinary "A" shares.

1.4 The number of share to be issued and whether they are to be fully or partly paid.

1.5 The amount of initial investment (equity and loans) by each party.

1.6 Any non-cash contribution is to be valued in accordance with an agreed methodology.

1.7 Obligations on the parties to make additional finance available to the JVC and the authority and procedure for making cash calls, and the application of default and dilution provisions if finance commitments are not met.

1.8 The desired ratio of equity to debt for the balance sheet.

1.9 Loan finance: shareholder / outside loans. A commercial decision will be necessary in the case of debt finance as to how much should be raised by outside loans and how much if practical from the

2. shareholders themselves. Where the rate of interest on an outside loan is less than the return which the JVC can generate on those funds, there is an attraction in allowing the JVC to gear up with outside loans. Where shareholder loan finance is chosen a variety of issues will need to be addressed as to the form and terms of the loans. The effect of thin capitalisation rules should also be considered (which may not be applicable in our circumstances).

1.10 The obligations of the parties to give parent company guarantees to support JVA borrowings with provision for liability to be shared in proportion to.

1.11 The accounting treatment of the JVC.

1.12 New shares are to be offered to the parties in proportion to their existing shareholding.

1.13 Tax considerations affecting the form of financing of the JVA are to be identified and options explained.

1.14 Any authorisations and consents required to be obtained for any of the parties to invest in the JVC are to be identified and listed as conditions precedent to the effectiveness of the JVA.

2. CONSTITUTION OF THE JVC

A standard Memorandum and Articles of Association are to be prepared by Mr Islam. Specific amendments will be proposed for discussion and approval by our respective legal advisors once the key commercial principles have been discussed and agreed.

3. THE BOARD OF DIRECTORS OF THE JVC AND DIRECTORS' MEETINGS

The key commercial principles relating to the board and management structure to be discussed agreed and provided for in the JVA include:

- number of directors;
- number of directors to be appointed by each party;
- whether the board itself can appoint additional directors;
- voting: e.g. whether by a simple majority / special majority, one man, one vote, or by weighted voting rights;
- Chairman to be [**X**] and to have a casting vote;
- names of the first directors;
- frequency of meetings and location;
- quorum and length of notice of meetings;
- authority of board representatives to bind their parent organizations;
- mechanisms for resolution of deadlock;
- appointment of chief executive, executive directors or officers, and any rights of appointment of particular

executives or management positions to attach to particular shareholders;

- autonomy of the board and specific matters to be reserved for the shareholders
- terms of reference required for chief executive and other executives.

4. SHAREHOLDER MEETINGS

The procedural details will be contained in the Articles of Association. Basic principles to be recorded in the JVA include:

- quorum to require a representative of each party;
- notice of meetings, short notice, and written resolutions
- location of meetings;
- Chairman's casting vote;
- separate class rights; and
- proxies.

5. MATTERS REQUIRING UNANIMITY OR SPECIAL MAJORITY

The JVA should set out matters that require unanimity (or a special majority vote) before they can be undertaken by the JVC. Issues to consider are as follows:

- what specified matters require unanimity (or special majority) at board level;

- what specified matters are to be reserved for unanimous (or special majority) decision by the parties at shareholder level;

  e.g. - issue of new shares;
  - admission of new shareholder;
  - alteration of constitutional documents;
  - change of JVC name;
  - formation of subsidiaries;
  - loans / borrowings / mortgages / guarantees in excess of specified limits;
  - strategic business plan;
  - approval of annual budgets;
  - capital expenditure commitments by the JVC above specified limits;
  - declaration of dividends;
  - new types of business / geographical expansion;
  - any merger, joint venture or material co-operation arrangement with third parties;
  - acquisition / disposal of material assets or securities;
  - entry into or termination of other material contracts;
  - pricing/trading terms;
  - employment / removal of chief executive or other senior management;
  - appointment / removal of auditors;
  - alteration of accounting policies;
  - commencing/settling substantial litigation;
  - establishment of a JVC pension scheme;
  - licensing of intellectual property rights by the JVC;
  - liquidation of the JVC; and

- dealings between the JVC and any shareholder (other than trading on arms length in the ordinary course of the JVC's business).

- Whether provision is needed to deal with deadlock.

6. <u>ADMINISTRATIVE OR CORPORATE MATTERS</u>

These include:

- registered Office;
- Secretary;
- form and timing of management information or other financial reporting from JVC to shareholders;
- obligation to maintain proper accounting records
- each party's rights of inspection of the JVC's accounts and records; and
- insurance.

7. <u>PROFIT DISTRIBUTION</u>

Principles to be agreed include:

- dividend policy – the maximum level of profits to be distributed or retained each year;
- how profit distribution policy can be changed;
- provision for interim dividends; and
- any authorizations required from regulatory authorities for payment of dividends.

8. INTELLECTUAL PROPERTY

The JVA will specify the broad principles. The detailed terms of each IPR licence will be set out in individual agreements entered into between the JVC and the licensor.

9. CONTRACTS

In the same manner as for IPR above the JVA will specify the broad principles governing the entering into of contracts by the JVC as contemplated in an attached and agreed Business Plan that will describe how the parties are to collaborate to operate the venture of [ ].

10. RESTRICTIONS ON PARTIES

The extent of any non-competition and other restrictions on the independent business freedom of the parties is to be discussed and agreed. Key principles include:

- restriction not to compete with the JVC's business (duration and territorial scope) – exceptions (i.e. existing activities of the parties not contributed to the JVC) and an undertaking by the JVC not to compete with each party's own non-contributed businesses;
- whether there should be an obligation on the parties to refer to the JVC any business within the field of the JVC;

- confidentiality by the parties in respect of affairs and technology relating to the JVC, and in respect of the affairs of each other;
- restriction on a party poaching employees of the JVC;
- how long the restrictions are to apply for i.e. for the life of the JVC or limited period, for a period after a party ceases to be a shareholder in the JVC and/or the termination of the JVA; and
- parent company guarantees of performance (if not a party) by affiliates.

11. CHANGE OF CONTROL OF A SHAREHOLDER

Whether any rights are to be triggered by a change of control of a party. Issues to discuss and agree include:

- definition of change in control; and
- whether an obligation should be imposed on a party affected by a change in control to offer to sell its shareholding interest to the other parties, and the valuation procedure and criteria.

12. TRANSFER OF SHARES

The agreement should set out clearly the rules to apply if a party wishes to exit by transferring its shares in the JVC. The issues to discuss and agree include:

- the pre-emption provisions in favour of the other parties to be included - either a right or first offer or a right of first refusal;
- whether a party can sell some (or only all) of its shares;
- any minimum period during which no sales to third parties are permitted;
- the valuation procedure and formula if a party wishes to exercise pre-emption rights and guidelines as to price: pro-rata market value; fair value; discount / premium for size of shareholding;
- whether a party is free to sell shares in the JVC to a third party if pre-emption rights are not taken up. Alternatively should a party have a right to call for liquidation of the JVC if the pre-emption rights are not exercised;
- whether continuing JVC parties should have a second right to pre-empt the sale if and when a third party purchaser is identified;
- whether a "shoot-out" provision should be included i.e. which requires the continuing parties on receipt of notification to either elect to purchase the shares of the selling party or to sell their shares to that party;
- "Piggy back" rights in the event of a public offering; and
- any specific put/call options to be included at the outset and the price formula and times at which the options can be exercised.

13. <u>TERMINATION</u>

Issues to address in relation to exit strategies and options include:

- any circumstances in which termination will automatically occur;
- the rights of an innocent party to call for transfer of shares upon material breach by a defaulting party, and the effects of insolvency by another party or their parent;
- the right of a party to give notice of termination (leading to liquidation unless otherwise agreed) after a minimum period – or to exit solely by transfer of shares;
- arrangements upon termination / liquidation: distribution of assets; return of confidential material; disposal of outstanding orders and inventory; payment of outstanding loans; non-compete obligations; and outstanding contracts at termination;
- rights of each party to use the JVC's intellectual property / know-how after termination; and
- division of any other assets and liabilities of the joint-venture.

14. DEADLOCK

Issues to discuss and agree in considering whether it is necessary or desirable to develop procedures for resolving any major deadlock or breakdown include:

- definition of deadlock or breakdown;
- reference to the chairmen / chief executives of the parties for agreed resolution;
- Chairman's casting vote;
- reference to an expert or panel;
- any mediation or other alternative dispute resolution procedure to be developed;
- exit by transfer of shares to a new joint venturer;
- specific right to serve notice to trigger the shoot-out formula; and
- specific right (after minimum period) for either party to call for liquidation of the JVC.

15. BOILER-PLATE PROVISIONS

Standard provisions included in joint venture agreements usually include:

- confidentiality;
- costs of preparation to be borne equally (including an equal contribution toward to costs of preparing this document);
- force majeure;
- notices;
- amendments;
- assignment of rights / obligations;
- exclusion of Third Party Rights (Contracts) Act;

- conflict between the JVA and its constitutional documents (i.e. supremacy of the JVA as between the parties);
- no partnership;
- severability;
- entire agreement;
- provisions relating to public announcements;
- governing law; and
- dispute resolution.