COMMERCIAL LAW

Shareholder Agreements and Voting Deadlocks: Legal mechanisms for resolving disagreements

A newly formed company should consider putting in place a Shareholders Agreement as soon as the investors have been established and shares issued. This type of contract remains confidential to the business as it is not required to be filed with Companies House. The rights and obligations of the shareholders are governed by the agreement, including rights of minority shareholders, parameters for new share issuances, anti-dilution measures, procedures for share buy-backs, rights of first refusal and exit requirements for departing shareholders. In addition management and decision-making is customarily specified in the agreement as well as issues involving company administration, specific purposes and operations of the business, duties of officers, and restrictions on the powers of controlling shareholders, key stakeholders and managers. The Shareholders Agreement can be critical in determining a legal structure for the business at the outset so that all parties have agreed expectations and can protect the value of their respective investments in the company.

The Shareholders Agreement may be formed among all of the shareholders individually and/or the company itself. A well drafted agreement provides stability and continuity so that all new investors in the business will know up-front what their rights and obligations will be in respect of the company and the other shareholders. This also provides a means of resolving issues in order to minimise the negative effects of conflict including in the case of a shareholder deadlock.

In certain instances a deadlock may arise where the shareholders disagree and the votes among them are split equally. The effect of unresolved disagreements in this context is that mistrust among shareholders will grow especially when they believe their legitimate expectations have not been met; they may consequently use their voting rights in the company to block progress and extract higher value for their equity in order to quickly sell and exit the company. This can also lead to a dispute in court or mediation which can become protracted and expensive.

At the outset of negotiations a Shareholders Agreement that takes into account the possibility of such disagreements and deadlocks is critical. Terms can be drafted into a Shareholders Agreement which provide for resolution procedures, whether by arbitration or mediation. Additionally, technical provisions such as claw-backs, reverse vesting, put and call options, forced sales or so-called “shotgun” escape routes are means to resolve conflicts. Penalty clauses may also divest a shareholder of voting rights upon the occurrence of certain events. Absent appropriate contract wording no shareholder has the right to compel a co-investor to buy them out at what they may perceive to be a fair price. Particularly in new companies and start-up ventures the complexity of asset valuation can make it difficult to complete a forced exit for resolution of a deadlock. In a buy-out of shares the valuation needs to account for skills of certain individuals, business methodologies and pre-monetised intellectual property which may not yet have any determined value. The Shareholders Agreement can minimise the impact of such risks with carefully drafted buy-sell clauses to facilitate exits or sales by hiving out specific assets. Additionally in such circumstances a start-up founder may have generated valuable ideas and substantial goodwill or intellectual property. These intangibles can be leveraged to make deadlock resolution provisions mandatory to new investors in order to ensure that disputes are resolved efficiently and cost effectively.

A Shareholders Agreement is part of the critical framework for a new company in establishing the groundwork for investors to launch the venture with appropriate legal protections. Should your business require expert advice in this area please contact 3HR Head of Commercial carol.kilgore@3hrcs.com who can advise you accordingly.

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