Shareholders' agreements—special provisions

A shareholders' agreement is a contract between some or all the shareholders of a company in which they agree to regulate the exercise of some of their rights as shareholders over the life of a business.

A shareholders' agreement should be specifically tailored, having regard to the relevant business and the intentions of the parties.

Often parties to a shareholders' agreement will require the inclusion of special provisions which regulate the occurrence of foreseeable events, such as the shareholders' exit from the business.

This fact sheet provides an overview of some of the special provisions shareholders may wish to include in a shareholders' agreement.

Special provisions

1. Exit mechanisms

   Depending on the nature of the business venture, the parties to a shareholders' agreement may wish to agree on a mechanism of exit from the business prior to a specified date or upon the happening of a particular event.

   An example of an exit mechanism is where the parties endeavour to ensure that an 'exit' occurs within a certain time frame after execution of the shareholders' agreement. At the designated time, the parties agree that the board will appoint a financial adviser (such as a stockbroker or investment bank) to act on behalf of the company and all of its shareholders to do the following:

   (a) Advise on whether the highest valuation of the company and the best return on exit for the shareholders would be obtained through an initial public offering, a sale of the share capital, a trade sale or other alternative (Exit Option).

   (b) Make a recommendation to the company about whether to proceed with an Exit Option or commence preparations to proceed concurrently for more than one of those Exit Options.

   (c) Manage the process of preparing for an Exit Option.

   If the parties wish to pursue an Exit Option, then the shareholders' agreement will contain certain other provisions dealing with the conduct of the company and the shareholders during the exit process. These provisions will usually include the company and each shareholder taking all necessary action to facilitate the Exit Option. At the same time, the shareholders are likely to be restricted from transferring or encumbering their shares during the exit process. The shareholders' agreement will then terminate upon the occurrence of an Exit Option.

2. Tag along / drag along

   Tag along and drag along provisions are measures adopted from time to time by the parties to a shareholders' agreement which come into play when a prospective purchaser wishes to buy the company's shares.

   (a) Tag along provisions

   A tag along provision is a contractual obligation used to protect minority shareholders.

   If a majority shareholder wishes to sell his or her stake in the company, then a minority shareholder has the right to 'tag along' to the transaction and sell his or her shareholding on the same terms of sale as the majority shareholder.

   Tag along rights effectively oblige a majority shareholder to include the holdings of a minority shareholder in any sale negotiations and to ensure any tag along rights are facilitated if a minority shareholder wishes to exercise them.

   Where a tag along right exists, minority shareholders are not usually obliged to sell their shares to the purchaser but may choose to do so at their discretion.

   (b) Drag along provisions

   Drag along provisions, on the other hand, relate to the rights of a majority shareholder, who wishes to sell its shares, to force minority shareholders to sell their shares also.

   The minority shareholders getting 'dragged' into the transaction generally receive the same price, terms and conditions as the majority shareholder.

   Drag along provisions are designed to protect the majority shareholder as they eliminate the ability of minority shareholders to frustrate a sale of the company to a buyer who is only interested in purchasing 100 percent control of the business.

It is at the discretion of the majority shareholder as to whether it exercises its rights to force minority shareholders to sell their shares.

3. Valuation methodologies

   One of the most common difficulties in respect of shareholdings in a company relates to the valuation of shares. The value of a company's shares is directly related to the value of the company itself. Therefore, an important consideration for shareholders is what methodology to adopt to value the company, for example, in circumstances of a proposed share sale of the company.

   Common valuation methodologies include the discounted cash flow method, capitalisation of earnings, and orderly realisation of net assets. The particular methodology adopted will depend on the nature of the company's business, its financial performance and position, the intentions of the parties and the circumstances where the valuation is required.

4. Special funding requirements

   Some companies may have special funding requirements which shareholders will need to take account of when preparing the shareholders' agreement. Some of the considerations regarding funding may include the following:

   (a) Whether ongoing funding will be required over the life of the business or at particular intervals.

   (b) Whether there are any taxation or other advantages to funding some business operations by the shareholders (i.e., funding through debt as opposed to equity).

   (c) What funding arrangement will be in place (if funds are required) for working capital purposes, to meet losses of the company, to finance company growth or for any other matter which may arise.

   One of the most important considerations is whether ongoing shareholder funding is mandatory or optional.

5. Cross border considerations

   If the shareholders of a company are based in different countries, or different jurisdictions within a country, then the shareholders will need to give consideration to any differences in the laws or accounting practices which apply in each location and how any differences may impact upon the shareholders' arrangements and the operation of the company.

   In particular, the treatment of taxation is a key consideration for cross border companies, and shareholders must ensure they are fully apprised of the prevailing laws and practices in each location to ensure the structures and arrangements they adopt provide the best tax treatment for the company as well as each of the shareholders.

No "one size fits all"

The special provisions which the parties to a shareholders' agreement may require can be many and varied. There is no 'one size fits all' approach to drafting shareholders' agreement. This must always be borne in mind when considering and determining the procedures, rights and restrictions to be contained in a shareholders' agreement.

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