Shareholders' Agreements …are they necessary?

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Shareholders' agreements are optional. They're not regulated by law. Most companies don't have them, and yet they're a vital part of many transactions. In the companies that have them, no person or entity can become a shareholder without agreeing to conditions set out in the shareholders' agreement. These agreements set parameters of conduct, and they seek to align the different interests of disparate shareholders. In short, they provide a framework for shareholders to work together.

What is it?

The simplest description is that it is a commercial agreement among shareholders who set out rules to govern themselves. Like any commercial agreement there are conditions to follow and legal consequences if one does not follow them.

Firstly, a shareholders' agreement can be signed by the shareholders/owners of both a joint stock company and a limited liability company. The term "shareholders' agreement" is just a convenience.

If a company has a charter, does it need a shareholders' agreement? The charter is more rigid and there is less scope to stray from the basic rules to more particularized commitments. Generally, the charter is considered the "law" of the company. The charter is prepared in accordance with the Enterprise Law. It is signed by all founding shareholders. The company operates within the rules set out in its charter.

While the rights and obligations of the shareholders, which are provided by the Enterprise Law, are repeated in the charter, most commercial matters among the shareholders are not regulated by the charter (eg, right to nominate key personnel, reserved matters, deadlock resolution, etc.)

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Indeed, if commercial terms are provided in the charter, the licensing authorities will sometimes challenge them saying they go beyond what the law specifies. But in a shareholders' agreement, the shareholders can freely set out a framework by which they agree how to regulate certain specific commercial matters not provided for in the charter. A shareholders' agreement also deals with special rights and obligations beyond the statutory ones already provided in the charter. For example, it can provide a shareholder with certain special rights (such as tag-along, drag-along rights, call options, put options, etc.), among other rights permitted under law.

In principle, a shareholders' agreement is entered into by the shareholders to protect both the company and its shareholders. It is private. It need not be filed with the licensing authority. It is a simple commercial agreement governed by contract law.

Do we really need it?

A shareholders' agreement is optional. But the founding shareholders or owners should consider entering into such an agreement before the company is established in order to create a contractual basis to govern the relationship among themselves and between the shareholders and the company. An agreement ensures that the founding shareholders understand their rights and obligations in connection with both the establishment of the company and its operation. An agreement provides clarity.

Like any contract, a shareholders' agreement is negotiated. It is agreed by the founding shareholders and is adhered to by subsequent shareholders. In practice, the details of each agreement vary, depending on the type of the company, the class of shares, shareholding ratio of each founding shareholder and other factors.

What's in it?

There are some basic contents commonly included in a shareholder's agreement, for example: agreement to form the company, charter capital, capital contribution and shareholding ratio of each shareholder, management and governance structure, etc. A shareholders' agreement can also contain special agreed provisions. For example, matters that relate to issuance of new shares, restrictions on share transfer, special shareholders' rights (eg, right to nominate key managerial personnel or directors, right of first refusal, pre-emptive rights, tag-along and drag-along rights), distribution of dividends, deadlocks and mechanisms for dispute resolution, etc. A shareholders' agreement can be governed by foreign law as long as any party is a foreign individual/entity[2].

In some issues a "deadlock" may result. A mechanism to resolve a "deadlock" should be clearly stated in the shareholders' agreement.

A shareholders' agreement can protect minority shareholders by identifying certain "reserved matters" which need unanimous shareholder's approval or which require more than a simple

[2] Some topics covered by a shareholders' agreement are: definitions and interpretation; incorporation and business of the company; business plan and project; capitalization; corporate governance; operational issues; dividends and financial matters; representations and warranties; share transfer restrictions; put and call options; non-competition; indemnification; deadlock; term and termination; governing law, dispute resolution and more.

majority. Obviously, the value of a large majority approval must be balanced against the need not to impede the decision-making process and diminish efficiency of the company’s operation. Compromises are vital.

A shareholders’ agreement may detail the distribution of dividends, such as timing, conditions for dividend distribution and more.

Are new shareholders bound by the agreement?

In principle, a shareholders’ agreement governs the relationship among shareholders, including founders’ successors and/or beneficiaries and the company. The shareholders' agreement should benefit and be binding upon any successor and/or beneficiary of a shareholder. In this connection, a party to a shareholders’ agreement must commit to procure any transfee, successor or heir to agree in writing to adhere to the shareholders’ agreement before becoming a shareholder of the company. Indeed, execution of an adherence agreement can be a condition to being registered as a new shareholder.

There can be a mechanism to provide broad protection under the shareholders’ agreement. A shareholder can be bound by specific terms of the shareholders’ agreement even after he leaves the company, eg, a shareholders’ agreement can restrict former shareholders from using the company’s trade secrets for one’s own business both while a shareholder and after leaving the company. Restrictive covenants can help to prevent a shareholder from competing with the company by taking advantage of special information it receives.

Charter vs shareholders’ agreement

Back to the charter. A shareholders’ agreement exists alongside the charter. In case of a conflict, the shareholders’ agreement does not prevail over the charter. But the shareholders may agree that the shareholders’ agreement takes precedence. A common mechanism to assure this is to provide in the shareholders’ agreement that in the event of an inconsistency or conflict between the agreement and the charter, the agreement will prevail, and the shareholders must cause the necessary amendments to the charter to ensure that the terms are consistent with the shareholders’ agreement. Obviously, it is more difficult to achieve an amendment during a period of conflict. This underlines the necessity of reviewing the shareholders’ agreement and charter for inconsistencies and to be inclusive in the drafting.

In brief, a shareholders’ agreement is critical and important. It covers matters which are not governed by the company’s charter. An agreement can provide a path to clear governance with that path well understood at the outset. Even the actual negotiation of a shareholders’ agreement is a mechanism to promote understanding of individual shareholder goals.

During the company’s operation, the shareholders can amend the shareholders’ agreement to be sure it remains consistent with the shareholders’ goals.

A shareholders’ agreement has great value in the smooth operation of both a large and a small company.