Shareholder Agreements and Constitutions: why have both?

By Sean Lynch

***Nutshell**: The importance of both Shareholder Agreements and Constitutions → key aspects of each → some common issues.*

It's reasonably common for business people operating under a company structure to ask the above question or be confused as to why both are recommended when they "seem to do the same thing".

For companies with two or more shareholders, there are a number of reasons why having both of these documents is usually (but not always) a prudent step.

Constitutions

Constitutions are registered and publicly viewable documents which generally address issues raised by the Companies Act 1993 ("Act") and possibly other legislation. The Act contains a range of provisions, some of which are 'mandatory' and cannot be negated or contracted out of - such as directors' duties and the application of the solvency test when making a "distribution". Other provisions of the Act are 'permissive' in nature in that they are only intended to apply if the shareholders agree to 'opt in' and adopt the provision as part of their Constitution, such as the right to issue redeemable shares (which may be a useful funding mechanism).

There are other 'permissive' provisions of the Act which for example allow meeting procedures to be altered from the default position as provided in the Act, or allow the Company to buy back its own shares – but only if permitted by its Constitution.

Furthermore, on issues where the Act is silent, then a Constitution can address potentially a broad range of other issues (for example pre-emptive rights on the transfer of shares) provided that those provisions do not conflict with the 'mandatory' provisions of the Act, which must not be negated or amended. However, it is important to remember that the Constitution is a publicly viewable document, and the shareholders and the company itself may wish to keep certain matters private – which is what a Shareholders Agreement does. Shareholder Agreements are not required to be registered anywhere and can (and should) remain confidential to the parties that sign it.

Companies are not required to have a Constitution and instead simply rely on the default provisions under the Act - but a well drafted Constitution is prudent because it will provide the company with a clear legal platform to potentially exercise a broader range of rights, which could be for the benefit of the company or the shareholders at any time. It is also prudent for the company founders to adopt the right Constitution from the beginning so that it legally binds any future shareholders without those shareholders having to "sign up" to the Constitution terms - as they are required to do for a Shareholders Agreement. Furthermore, the Constitution can be amended or replaced by special resolution (75% shareholder vote) whereas a Shareholders Agreement is usually amended only by the agreement of all parties (unless its provisions state otherwise).

Shareholder Agreements

As touched on, Shareholder Agreements are private, confidential documents which are intended to address matters which the parties deem beneficial to be 'out of the public eye'. The contents may address issues such as:

- The nature of the company's business and its strategic direction.
- What the various roles and responsibilities of the parties are (e.g. some shareholders may simply be investing money whilst others may be investing a combination of money, know-how or other intellectual property which needs to be specifically addressed, possibly by separate agreement(s) too).
- Decision making at board level and decision-making at a shareholder level.
- The future funding requirements for the company and how those will be met.
- The provision of any guarantees or other securities by shareholders and how that will be managed if that occurs.
- Sale or exit provisions which may require the minority shareholders to sell if the majority shareholders resolve to sell (i.e. drag along rights) or entitle the minority shareholders to also sell where the majority shareholders have resolved to sell (i.e. tag along rights).
- The Shareholders Agreement may also address 'forced' share sale or other share purchase options, for example if a shareholder that has agreed to fulfil an active role in the running of the company no longer fulfils that role for whatever reason (i.e. employment termination, health issues or otherwise). Such provisions may also address circumstances where a shareholder defaults on their obligations under the agreement or the Constitution and which may cause them to offer their shares for sale to the other shareholders (without limiting other remedies). It is important to remember that in the absence of pre-agreement between the parties, it may be extremely difficult to 'remove' a shareholder once they have received their shares.
- Restraint of trade and other non-competition provisions.
- If the company is likely to be seeking to raise additional capital in the future, the Shareholders Agreement should address the rules framework within which this will occur and the extent to which existing shareholders will be diluted.
- Finally, if nothing else, a Shareholders Agreement should have an effective dispute resolution clause, without which the parties may become embroiled in costly litigation should a dispute arise.

The scope and content of a Shareholders Agreement is potentially limitless and should be tailored for the specifics of the business in question and the type and number of shareholders and their differing interests and requirements. A short agreement may be sufficient – and brevity is always a worthy goal if achievable.

One drawback of having a Shareholders Agreement is that if there are likely to be a large number of shareholders going forward, then gaining agreement between all (including new) shareholders may be difficult, and a burden administratively. This issue, along with the special resolution threshold change requirement for Constitutions, is often a reason why start-up, fast growth companies which envisage having a large number of shareholders will often elect to simply have a Constitution which addresses all the key provisions they believe are required - in the short term at least.

Some common problems

Lastly, it is worth noting a few common problems that arise:

- *No Shareholders Agreement or Constitution*: like driving without a seatbelt – it's OK until you crash. Primary issues are likely to be that there is no mechanism for 'removing' a problem shareholder, or otherwise resolving a dispute that arises without the expensive step of going to Court. These problems can be compounded when the shareholder concerned is replaced by their 'next of kin'.

- *Conflict & overlap*: We often see situations where a company has both a Constitution and a shareholders agreement but the shareholders agreement has been drafted too extensively, containing provisions which duplicate or otherwise overlap with the provisions in the Constitution. Apart from being poor drafting, it creates uncertainty which could give rise to legal problems later on even if a "conflicts priority clause" is inserted. It is better to ensure that the documents do not overlap
- *Template driven without specialist input*: both documents can sometimes be purely driven by a "template structure" with little or no thought given to the actual real issues the parties will face going forward.
- *Poor drafting*: this can flow from the wrong lawyer or person being selected to prepare the documents.
- *Upkeep*: failure to upkeep and maintain accession execution documents and other documentation required from time to time flowing from both documents. It is not uncommon to see a situation where only three quarters of the shareholders have actually signed up to the shareholders agreement, leaving its application in some doubt and creating shareholder uncertainty issues.

There is no substitute for considering all the issues upfront and deciding which are important and which need to be addressed in one or both documents so as to best affirm and safeguard the governance of the business going forward, best protect and enhance the interests of the shareholders as well as the company, and to avoid costly disputes.

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