

# Why have tailored articles of association and even a Shareholders Agreement?



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If you are setting up a company with your business partner, you may be tempted to rely solely on the statutory default articles of association for private companies limited by shares (the Model Articles) to govern the internal procedures of the company, and the corporate relationship between you.

These notes show why you really should consider having articles that are tailored to your circumstances, and even a shareholders' agreement, between you and your partner - even if you wouldn't dream of falling out with him or her.

## Introduction

Suppose you are operating a business through a company of which you are the sole owner and manager. But now you want to introduce a partner so that you own and hold 60% of the shares in the company and your partner 40%, and he is the other director of the company. Perhaps he is already working in the business as an employee.

## Model (default) Articles could result in early deadlock

Under the Model Articles, the quorum for board meetings is two. One of you, for example your partner, could block any board decision by just not turning up to the meetings.

To prevent this happening, tailored articles could provide that you form the quorum and have control over board decisions. As majority shareholder you could even give yourself the right in tailored articles (or in a shareholders' agreement) to appoint or remove directors by notice to the company.

Another feature of the Model Articles is that any director who has a personal interest in a matter to be considered at a board meeting cannot form the quorum and cannot vote on that resolution (unless the matter comes within some narrow exceptions).

Tailored articles could provide that any conflicted director can be included in board meetings for quorum and voting purposes as long as he has fully disclosed his interest.

Under the default position, there would also be potential deadlock at shareholders' meetings since the Companies Act 2006 provides that the quorum at those meetings is two, unless the articles provide otherwise.

Tailored articles could prevent your partner from blocking shareholder decisions as well.

## How to get rid of a shareholder

In general you cannot force another shareholder to give up their shares, but tailored articles (or a shareholders' agreement) could enable you to do so in certain circumstances.

One example is that if a shareholder is also an employee or director and ceases to be one of those, articles (or a shareholders' agreement) could provide that shareholder must offer his or her shares for sale to you, as the other shareholder, or to the company. The provisions might make a distinction in the price of the shares being offered, between whether the departing shareholder is a "good leaver" or "bad leaver".

Another example is that if you wish to sell your shares and your buyer wants 100% of the company, you can have "drag-along rights" under which you would have the right to require your partner to sell to the buyer, generally on the same terms as you are receiving.

## How to prevent your co-shareholder from selling his shares without first offering them to you

The Model Articles give the directors the power to refuse to register the transfer of a share. So if you have gained control of the board by tailored articles, you could prevent your partner from transferring his shares to someone of whom you disapprove. However that would not stop your partner from selling the beneficial interest in his shares and remaining as the registered holder.

Tailored articles could extend the meaning of "transfer" to any transfer of the beneficial interest or the creation of any security over the shares and require that the shareholder proposing to transfer any interest in his shares must first offer them for sale to you as the other shareholder or to the company.



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## Minority protections in shareholders' agreement

As a 40% shareholder, your partner could block a shareholders' special resolution, and he has other shareholders' rights such as the ability to requisition a meeting of shareholders. But if you gain control of board and shareholders meetings by tailored articles, he doesn't have much legal protection other than the ability to bring proceedings for wrongdoings, which would be costly and risky. (Such legal proceedings include a petition for unfair prejudice in relation to the affairs of the company (section 994 Companies Act 2006) and/or a derivative claim against a director (section 260).)

Shareholders' agreements often include provisions, under which the shareholders agree that they will use their powers to ensure that the company will not do certain listed reserved matters without the prior approval of a certain percentage of shareholders. For example, if 70% were used in this case, none of those reserved matters could be done without all shareholders' consent.

You may prefer not to offer this veto right and simply to require your partner to leave things to the wishes of the majority – you.

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## Restrictive covenants in shareholders' agreement

After leaving the company, your partner would still owe some of his fiduciary duties as a director, and any restrictive covenants in his service agreement would apply. However any restrictive covenants which he enters into as a shareholder and which could be included in a shareholders' agreement, are allowed to be wider than those he is subject to as an employee.

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## Employees and tax

If your new partner is already, or is to become, an employee in the business, issuing shares to him creates tax consequences for both him and the company. Specialist tax advice should be sought at the outset and we'd be pleased to help.

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## Conclusions

Entering into a corporate relationship with another person does have its implications and some of them may not be what you would expect.

However much you are best mates, it is much better that, before you and your partner enter into the relationship, you understand the legal implications and agree between yourselves how to adjust them to your circumstances. If you don't, and things get tricky down the line, it will be much harder and more costly to renegotiate, and you may not even obtain agreement on what you would have been able to obtain consensus at the outset.

### For further information on this subject please contact:

**Nicola Mallett**  
Practice Development Lawyer

T + 44 (0) 20 7074 8082  
[nicola.mallett@lewissilkin.com](mailto:nicola.mallett@lewissilkin.com)

