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Helping you to help yourself

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PROTECTING SHAREHOLDER INTERESTS

If you are a shareholder/investor in a private company with few shareholders (i.e., no more than 5), you should know how to protect your interests

Each year 2,000-3,000 companies are registered in Jamaica¹. Whilst not the most common business vehicle², private limited companies are often selected as the most appropriate because, as most people know, they limit investors' liability to risk of loss in the event of business failure, to the capital which they have paid up on their shares or have promised to pay up on their shares. Their personal wealth usually remains unaffected.³

Every company must have, as well as a memorandum of association setting out the lawful objects of the company, a set of articles of association setting out the rules for its internal management. Some private companies are incorporated with standard Table A articles (or with Table A amended), which means they follow the draft articles set out in Part II of the First Schedule to the Companies Act. However, there are a number of considerations to which entrepreneurs wanting to set up a private limited liability company ought to address their minds when seeking to have their articles of association drafted.

The following sets out some of the main considerations:

(a) Removal of Directors from Office

Sometimes when there are internal disputes within a company, a partner/shareholder may attempt to remove the 'offending person' from the board of directors, with or without that person's concurrence. Directors may be removed from office by ordinary resolution in spite of anything which the articles of association may say to the contrary or the terms of any directors' service contract (s.175⁴). This statutory right effectively scuppers any opportunity for a minority shareholder who sits on the board or wishes to have her representative on the board, to maintain a decision making presence to protect her interests in the company.

If you are a minority shareholder you should consider weighting your voting rights in this respect in order to prevent your unwanted removal from the board.

(b) Director's Interests in contracts

In many companies, partners will have interests in or with other entities, with which it may prove advantageous for the company to do business. For example, a furniture manufacturing company may obtain its supplies from a lumber company in which one of the partners has shares. This is not unlawful. But if the investor in the lumber company is also a director of the manufacturing company she must

declare her interest in any lumber supply contract to her co-directors (s. 188 & reg. 84~) and she will not be able to vote or be counted in the quorum.

This requirement could effectively hamper the operations of any two member/managed company.

You should consider removing the restriction entirely or amending it so that it applies only to the quorum.

(c) Chairman's Casting Vote

Both the members' meetings and the board are controlled by those who have the majority of votes. Where there is an equality of votes, the chairman will have the casting vote (regs. 60 & 104). This right will be especially significant in the case of two women run companies or joint ventures, because it will give the chairman effective control, allowing her to make binding decisions in spite of the other's dissatisfaction with them.

You should consider removing the casting vote of the chairman at both board and member levels.

(d) Death of a Partner/shareholder

Many small companies have a partnership of two or three persons: individuals who have come together because they worked well together in a company where they were previously employed or perhaps they are friends with redundancy money and a good idea at their disposal. They decide to set up their own business, hoping their special chemistry will work well for them.

A problem may arise when a partner/shareholder dies.

On the death of a shareholder, her shares will be transmitted by operation of law to her personal representatives, who will transfer them to the deceased person's beneficiaries under her will or on intestacy (regs. 29-32). This could mean that the remaining shareholder finds herself in business with the husband of the deceased partner, who may know nothing or next to nothing about the running of a successful business or a business of this type. Moreover, if he cannot be encouraged to sell his shares to the remaining partner, she will be stuck with an unwanted new partner, with possible disastrous consequences to the business.

You should consider extending any restrictions in the articles of association on lifetime transfers (see next item). to those arising upon death or bankruptcy also.

(e) Transfers of Shares and First Rights of Refusal (Pre-Emption Rights)

Probably one of the most important regulations in the Articles is the one which deals with the ability of shareholders to transfer their shares. You will recall our several friends who came together because their chemistry and business know-how was a winning combination. They will not want to jeopardise this formula when one of their number wishes to leave the company and dispose of her shares, maybe to a newcomer undesirable to the others. Table A (reg. 3) does give the directors the right to reject the transfers of shares if they do not approve of the transferee, Invariably however this is not enough and so it is common place to provide for extensive pre-emption rights. The existence of pre-emption rights means that a member can sell all or her remaining shares to outsiders, but only after first offering all of her shares to the existing shareholders (in proportion to their existing holdings).

You should consider the inclusion of a pre-emption clause.

In this consider whether regard you should also other issues including:

a shareholder should be allowed to dispose of only part of her holding as it may leave a partly committed member in your company; structuring the preemption process so that it can be carried out speedily since a proposed purchaser can tire of the wait while the pre-emption process is being

carried out and become less enthusiastic about buying; the mechanism for determining the price that the shares will be offered at' whether the vendor shareholder should have the right to state her asking price or whether there should be an independent determination and what method should be used' and whether minority holdings should have an appropriate discount applied and conversely majority holdings a premium.

(f) Negative Control of a Minority Shareholder

A minority shareholder may have considered some of the above. Similarly she may have considered the fact that her majority shareholder partners have the right to choose whether or not to declare dividends, may run the company badly or pay themselves excessively. She may already know that minority shareholders do not have an automatic right to see the accounts of the company. She may be aware of a host of other possible actions which could be taken that may affect her investment deleteriously but which her minority holding means she is out-voted in any attempt by her to prevent. Most of these situations can, if considered beforehand, be dealt with effectively by well-drawn articles. However, it should be remembered that the articles of association may be altered back again at any time by the party or parties with 75% or more of the vote (i.e., by a special resolution). If a minority shareholder does not have negative control, i.e., over 25% of the vote, all the efforts to protect her position may have been in vain.

You should consider weighting the voting rights on certain issues or having the rights set out in a separate shareholder's agreement, which cannot be altered without unanimous consent.⁶

(g) Joint Venture Companies & Wholly-Owned Subsidiaries

These types of private companies require extensive amendments to Table A in order to deal with the myriad of scenarios which exist in practice. No attempt will be made here to deal with them as any such effort will not do the subject justice. Suffice it to say, you should speak to your professional advisor who can guide and assist you.

(h) Conclusion

In the honeymoon phase of a business enterprise where all the parties are friends and the energy level is high, disagreements over small issues will probably be overlooked and even disagreeable decisions ratified without too much rancour. However, even entrepreneurial honeymoons inevitably draw to a close and a business may incur losses at times. It is at times of poor business performance and psychological stress that long-agreed terms are forgotten', patience thins, and contentious issues less likely to be overlooked. Difficult times provide a perfect environment for disagreement. The commonest legal means of resolving disputes i.e., litigation, can be expensive and does not always provide a satisfactory result. However, forethought (by way of well drawn articles and in some cases a separate agreement too) can often dissipate disagreements early on or if they continue, provide a means by which they may be dealt with speedily.

Ensure that the articles of association of the company of which you are a member/investor are adequately and appropriately drawn to protect your interests.

Separate shareholders' agreement are by far under estimated and accordingly under-utilised in Jamaica. Most business people believe, in my view wrongly, that once one has incorporated a company, the articles of association fully protect one's interests. This is not so in every case and there are several reasons why a separate agreement is often desirable. 1. The articles of association as part of the constitution of the company are always open to inspection by members of the public - a separate agreement can house provisions which are private between the members and thus preserve confidentiality. 2. A separate agreement can include non-management issues relating to the parties' agreements. 3. A shareholder's agreement may confer personal rights on a member which the articles (by virtue of statute) cannot e.g., the right to be appointed a life-time director. 4. Being a creature of contract and not statute, a shareholder's agreement (NS) be changed by agreement and is usually much more flexible. 5. The protection of minority shareholder rights can be addressed quite comprehensively.

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