SMES, DIRECTORS & SHAREHOLDERS

What can a shareholder do to exit a company?

10 frequently asked questions

FRANCIS WILKS & JONES

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INTRODUCTION

As a shareholder there will undoubtedly come a point when you wish to relinquish your shareholding in a company for various reasons, perhaps by reason of retirement, a desire to exit as a result of a fall-out with co-shareholders or a wish to withdraw your investment.

Sometimes the exit may be contentious and sometimes it may be by agreement of all shareholders, in which case an agreed settlement should be relatively straightforward.

The situations in which a shareholder may seek to exit a company are varied and in this article we attempt to address questions relating to a shareholder exit, particularly where the situation is contentious.

1 What are the practicalities behind exiting a company?

A shareholder in a listed company on a stock exchange merely needs to place his or her shares for sale with the appropriate agency to exit his/her investment. This is a very straightforward transaction which occurs almost instantaneously and allows a shareholder to exit his or her interest in that company.

In a private limited company, the exit is slightly different as there is no publicly regulated market for the shares to be sold and neither is there any recognised share price. However, subject to a valuation of the shares, the transaction itself is identical and relatively straightforward, by completion of a stock transfer form, filing the appropriate forms to deal with the necessary tax aspects and also managing the exit from that individual's point of view in terms of any guarantees provided to lending institutions or third parties.

Aside from this, the company acting via its directors will also have to approve the transfer of shares and agree to place the incoming entity's name (whether that be a company or individual) on the share register. At all times it is for the company to determine whether an incoming shareholder can be registered on the company's share register, although it will usually be bound by its articles of association and any shareholder agreement.

Other practicalities include the method of payment of the shares, good leaving provisions, rights of third parties and the arrangement for repayment of the purchase monies. These are all necessities which will be incorporated in a properly drafted share exit agreement.

Without a share exit agreement, a simple transfer of shares on the stock transfer form will not protect or indemnify the outgoing shareholders from any potential claims that may arise against him or her resulting from circumstances that existed prior to his or her departure.

2 What are the usual circumstances of a shareholder exit?

The most common circumstance of a shareholder exiting a company exists where that shareholder may be retiring or seeking to depart the company for various personal reasons and wishes to dispose of his or her interest.

In such circumstances the exit is not contentious and should be relatively straightforward with all parties agreeing to the method for the shareholder's exit in terms of the method of transfer, valuation, payment terms and any tax or other indemnities.

Other circumstances which are more contentious include where shareholders fall into a dispute with each other and the only way of settling this dispute is by each of the parties going in separate directions. This may often comprise an arrangement whereby one shareholder buys the other out (or a group of shareholders could buy them out) for an agreed price, in which case it is recommended that a share exit agreement be drafted as the outgoing shareholder will want various indemnities as regards tax obligations of the company and in respect of any other matters which they may be liable for as at the date of exit.

If all shareholders of a company are seeking to retire or otherwise dispose of their interest, then it may be more profitable to sell the company on the open market. However not all private limited companies are that easy to sell and an alternative method commonly used will be to wind-down the affairs of the company in an organised fashion via a statutory scheme, known as a members voluntary liquidation.

A members voluntary liquidation is a solvent liquidation (there is no element of insolvency) of the company's assets and business. It enables appointed liquidators to wind-up the company's affairs in a controlled fashion, ensuring that all liabilities are paid and all statutory returns are made to Companies House so that the shareholders can depart with clean hands whilst simultaneously maximising the return from their interests.

This is one of the most common form of exit by shareholders reaching retirement and is by far the cleanest method of exit. We have a variety of insolvency practitioner contacts who can assist with such matters and should you require any assistance in this respect please do not hesitate to contact us.

3 What restrictions apply to a disposal of my shares?

The most common restriction on disposal of an individual's shareholding is referred to as pre-emption rights.

A pre-emption right will be set down in the company's articles of association and/or in any shareholders agreement (which normally amends such rights relevant to the individual shareholders' interests). They will describe the restriction on the disposal of any shareholding and this will usually require that the price offered by an interested third party must first be offered to the existing shareholders, who should have the first opportunity to purchase such shares (with a view to avoiding external third party interference with the company and its original common objectives).

Older companies, perhaps those incorporated as a family company historically, may alternatively provide that shares may only be disposed of to family members. Such a pre-emption right is very restrictive as it prevents the disposal of shares wholly to the world at large and may have a severe impact on the value of any such shareholding.

Shareholder agreements may also include pre-emption rights and will define exactly how shares in a company may be disposed of and this is a very useful tool to prevent outside unwanted interference into a private company's business which was set up between associated parties.

4 Can shares be transferred to a company?

It is quite common for corporate shareholders to exist as part of either a group UK corporate structure or for various purposes using offshore companies.

It is not uncommon for an individual to dispose of their shares to an offshore company which may act as a vehicle for a self-administered private pension or as part of another investment structure.

However, as from 2015, the Small Business, Enterprise and Employment Act 2015 states that the company must continuously maintain a register of the beneficial ownership of shares.

You should of course seek professional accounting and tax advice on any such tax arrangements before making any such decision to transfer shares out.

5 How do you value a shareholding?

Obviously the first point of call where a minority or just one shareholder is seeking to exit or otherwise dispose of his/her shareholder is to ensure that all parties (especially the acquiring parties, be that co-shareholders, external parties or the company itself) are in agreement as regards the valuation of the exiting shareholder's shares.

A valuation of a shareholding in a private limited company is normally determined by way of a valuation of the company's business and assets which would be provided by accountants, who can provide either a basic business valuation, a written speaking valuation (one which provides information and support of findings) or a detailed comprehensive valuation report.

Depending upon the detail required by both parties and the circumstances of the shareholder's exit, the costs of such a valuation will usually be borne equally.

Where proceedings potentially exist between shareholders (who may be in dispute) then it is advisable to get such a valuation on an independent basis and that the parties between them agree the instruction of the valuer. The instructions should also include a requirement that the valuation be provided in accordance with part 35 of the Civil Procedure Rules 1998, so that any such valuation can be used in subsequent court proceedings.

If a valuation is sought on this basis, the joint instruction letter is critical to get right, as this will determine the scope of the valuation. A mistake on the instruction letter could severely jeopardise one or the other's interest in the transaction.

6 Is the valuation determinative of the price to be paid?

Once the valuation is provided it will undoubtedly be the case that one party or the other will be unhappy with the reported value or seek to challenge the valuation agent's view. Normally a proviso of the scope instruction will be to enable representations to be made to the valuer before the valuation report is made final.

Thereafter, it is not uncommon for the parties to use this only as a basis for future discussions and the end price agreed may not necessarily reflect the valuation report but will reflect what one party can commercially afford (if that is acceptable to the exiting party).

The valuation report is an important document as it gives both parties a real sense of their commercial interest, and will allow for the reduced value attributed to minority shareholdings and may also be key to breaking any deadlock negotiations where one party may have previously had an overly optimistic view of the company's value.

7 What of the value of a minority shareholding?

Minority shareholders by reason of their minority interest are often in a weaker position when seeking to exercise their rights or even threatening to exit.

If they have complaints or disputes about decisions being made by co-shareholders or directors, they have recourse to the courts in terms of derivative proceedings and unfair prejudice proceedings (please see our booklet entitled "How to protect minority shareholder interests" which addresses these areas). However these can be costly solutions and may not necessarily be preferred by the minority shareholder, who wants to maximise the value of their interest and minimise their exposure to costs as part of any potential exit from the business.

As a result of this, the minority shareholder's bargaining power will be weak, especially as a contested valuation of their shareholding may not reflect their interest in the company, by reason of the absence of any other competing interest that may exist to gauge the value. For example, if an individual owns 20% of a company valued at £1 million then his shareholding will not be worth £200,000 as, on the open market, an investor is unlikely to pay the asset value of such an interest where there is no controlling power in respect of company decision-making and where dividend returns are only available at the discretion of directors/other shareholders.

Accordingly minority shareholdings are often valued below the total company value and this has to be considered before any minority shareholder seeks an exit from the company.

Of course, where shareholders enter into business together with mutual understandings as regards their interests, in contested negotiations it is not unusual for shareholders to agree between themselves that the minority interest will be valued at full market value (i.e. without any discount). This will depend on the circumstances and the parties' requirements.

On the contrary, if the court ordered the company or a co-shareholder to buy out such a minority shareholding (perhaps in unfair prejudice proceedings) then it could well also require that there be no discount (especially where the shares are purchased by majority shareholders or the company) and it is often the case that the potential benefit of court proceedings outweighs the legal costs involved.

8 How can I force an exit from a company where no other solution exists?

It may be the situation that a minority shareholder or other shareholder is unable to exit the company because they are unable to sell their shares. As there is no statutory right to a dividend, it is not uncommon for this situation to roll on for years, with the shareholder getting nothing for their interest and the majority shareholder just continuing to draw a salary and expenses (which the minority shareholder may consider are exorbitant but who otherwise has no power to control such matters). These circumstances may be insufficient for any finding of unfair prejudice or any other claim for loss to the company.

Under Chapter 10 of the Companies Act 2006 a non-contentious solution exists which allows the company to purchase such shares and thus, if the other parties agree, it may be possible to use the company's resources to manufacture an exit.

However, there may be circumstances where both the co-shareholders and the majority of directors (or all of them) of the company do not wish such a share purchase to occur. In such circumstances, and subject to any pre-emption rights in the company and the ability to sell the shares on the open market, then the shareholder may have little alternative but to seek a just and equitable winding-up of the company.

A petition for a just and equitable winding-up of the company requires that the company must be solvent (otherwise the shareholder has no interest in the winding-up) and may be accompanied by a petition for unfair prejudice against the wrongdoer (usually the majority shareholder or co-director/shareholder), where complaint is made as regards how the company is run to the petitioner's detriment.

As part of the combined petitions for the just and equitable winding-up and unfair prejudice, the court may order either the company or the wrongdoing co-shareholder to buy-out the shares of the minority shareholder and it is at this point that the independent valuation report (drafted in accordance with CPR 35 as described above) is of greatest use in assisting the court to determine the value to be ascribed and any payment terms.

9 What other considerations are there when exiting the company?

Obviously the valuation of shares and the requirement or agreement (by court proceedings or otherwise) to purchase a shareholder's shares does not necessarily provide that shareholder with a resolution unless they can secure payment in full.

Sometimes a company will have assets to secure lending against, or sufficient distributable funds for the purpose of acquiring such shares, but this will have to be considered before taking any such steps.

It is often the case that shares are purchased with payment terms over a period of time and dependent upon the success of the company's business. This is obviously a precarious situation for the outgoing shareholder and sometimes a shareholder may wish to consider accepting a lower sum paid earlier rather than risking a larger sum over a longer period of time.

Another consideration is whether there are any sums to be set off against the valuation of the exiting shareholder's interest. The most obvious example is any balance on a director's loan account they may owe to the company and any interest and taxes accruing therein. As part of the negotiations, these risks should normally be provided for by a sufficiently experienced Solicitor as part of the share exit agreement.

In addition to these risks there are the shareholder's personal taxation liabilities, which the shareholder should take advice on. As of writing there is entrepreneurship relief available in respect of capital gains tax and should you require more assistance with this we can direct you to somebody who can advise on these matters.

10 Is a share exit agreement always necessary?

We would always recommend that a share exit agreement is executed on behalf of both the shareholder exiting the company and the acquiring party (be that the company or co-shareholders).

This agreement will secure that no future liabilities arising from circumstances existing prior to that shareholders departure (unless that forms a term of the agreement) are pursued by the company against that shareholder, or alternatively it may provide that the company will indemnify the shareholder for such liabilities accruing.

The share exit agreement will also provide a good basis for enforcing any liability for unpaid sums and/ or enabling the outgoing shareholder to secure his or her interest until the exit has been completed. If a simple stock transfer form is completed rather than a share exit agreement executed, then none of these protections exist.

Should you require any further assistance at all in this area of the law, please contact one of our shareholder specialists and we can help you today.

Talk to our team

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- No obligation
- Expert advice from a friendly team

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