CORPORATE LAW

Shareholders’ Agreement: Exit Provisions for Shareholders

IN THIS ARTICLE, DATO’ JOHARI RAZAK LOOKS AT VARIOUS EXIT STRATEGIES FOR SHAREHOLDERS.

When embarking on a joint venture, parties usually opt to incorporate a private limited company, where all parties subscribe for shares in that company. To formalize the terms of the joint venture, the parties would enter into a joint venture or shareholders agreement (“the Shareholders’ Agreement”) with each other.

Very often, a shareholder may find difficulty in disposing of its shares in the company. A private limited company’s Articles of Association contain clauses which restrict the right of disposal, for example, pre-emption rights in favour of current shareholders, requirements that shareholders must hold the shares for a certain period of time or even articles which stipulate the parties to whom the shares can be sold. These restrictions exist because section 15 of the Companies Act 1965 stipulates a requirement for a private company to impose restrictions on the right of its shareholders to transfer shares in the company. The Shareholders’ Agreement should therefore contain provisions which allow a shareholder to dispose of its shares in a manner which is equitable to all shareholders.

As mentioned above, a standard restriction in the articles is to provide for pre-emption rights in favour of current shareholders. A basic pre-emption clause provides that if a shareholder wishes to sell its shares (‘offeror’) it must first offer them to the remaining shareholders at a price fixed by the offeror or if that is not acceptable to the other shareholders, at a price to be determined by an independent valuer (usually the auditors of the company). If the remaining shareholders refuse to buy the shares offered, the offeror then has the right to sell the shares to a third party. Under these circumstances, a shareholder should try to ensure that the highest possible value be obtained from the independent valuer. Some possible terms are:

(a) specifying the method of valuation for the shares, for example, on an earnings basis or on a net tangible assets basis. The basis which is likely to give the highest valuation depending on the nature of the business, should be the one chosen;
(b) ensuring that the valuer is not allowed to input a discount value on the shares based on the fact that they are a minority holding;
(c) the shareholder should also ensure that he has the right to withdraw his offer in the event that he is not satisfied with the valuation; and
(d) to provide that any purchase by the other shareholders must be for all the shares offered for sale and not just a portion of these shares and if this is not done, the shareholder can either withdraw the offer or sell to a third party.

A shareholder should also consider other ‘exit clauses’ such as the ones set out below:
1. A put option which entitles a shareholder to require the other shareholders or just the majority shareholders to purchase the shares of the minority shareholders. The exercise of the put option can be made subject to a particular time period or the happening of a particular event. The put option must state the share price or if that is not possible, then a clear formula for calculating the price must be included. The Shareholders' Agreement will have to provide that the pre-emption provisions do not apply in the event of the exercise of the put option or a waiver can be given in advance by other shareholders who are not party to the put option arrangement.

2. The “Tag Along clause” or a “Piggy Back right”. This imposes a restriction on the majority shareholders from selling their shares in the company to an outsider without first procuring the outsider to make an offer for the shares of the minority shareholders on the same terms. The Tag Along clause essentially provides that if the majority shareholder wants to sell, it must first offer its shares to the minority shareholder. If the minority declines to purchase these shares, it can decide to “Tag Along” with the main shareholder and together, they can sell to a third party. Safeguards can be put in place, such as:

   (a) stipulating a minimum price for the shares so that the majority shareholder cannot force a sale below a fair price;
   (b) provisions restricting the time when the main shareholders can use the ‘Tag Along’ clause, such as the expiry of a time period or only after the Company achieves a certain level of profitability, to ensure a minimum share value;
   (c) to allow the minority shareholder a certain period of time to find an alternative buyer for all shares at a higher value before the minority shareholder decides whether to exercise his option to ‘tag along’. If this provision is included, the Shareholder’s Agreement must allow the minority shareholder to require the majority shareholder to sell the shares to the highest bidder should the minority shareholder decide to ‘tag-along’; and
   (d) to provide that in the event of a sale, it is only the majority shareholder who makes and is responsible for the representations and warranties on the company to the purchaser as the majority shareholder is in control of the management and operations of the company.

3. The “Drag Along” clause. Drag along rights would give the selling shareholder the right to compel (therefore the phrase “drag along”) all other shareholders in a sale to a third party, normally at the same price per share as that being offered to the selling shareholder. Drag Along rights are useful in that a potential buyer may not want to buy just a stake in a company but the whole company. Although Drag Along rights are normally given to the majority shareholder, they can also be given to the minority shareholder so as to make it easier for a shareholder to sell the shares at a higher price since a purchaser might be more interested in purchasing all the shares in the company. Similar safeguards such as those outlined in 2(a) to (d) above, can be included.

4. To provide for the voluntary termination of the joint venture. The Tag Along and Drag Along clauses are useful when there are buyers for the shares but where there may not be potential buyers, either because the company is not profitable or the share price cannot be agreed upon, there should be a clause in the Shareholders’ Agreement to provide that upon the expiry of a certain time period or upon the occurrence of an event the joint venture would be deemed to be completed (“the Termination Date”) and the joint-venture will be terminated. One possible scenario for termination is:

   to provide that each shareholder has a right, say within 30 days of the Termination Date to submit a bid which may contain an offer to purchase the shares of the other shareholder or shareholders or alternatively acquire the business of the company. In such a scenario, if the company has significant assets or the company is profitable it is unlikely that no shareholder
will bid because if only one shareholder bids, the other shareholders are bound to sell the shares or as the case may be the company is bound to sell the assets no matter what the price of the bid would be. The shareholder submitting the highest bid is then bound to buy in accordance with the bid; and if no bids are received, the company will be placed in voluntary liquidation.

Another method is commonly known as the ‘Russian Roulette clause’ and is generally only applicable to a two-party Shareholders’ Agreement. It can be employed where the joint venture is to be terminated.

Either shareholder (‘the server’) may serve a notice on the other shareholder (‘the recipient’) which may either require the recipient to sell its shares to the server or buy the shares of the server in either case at a price which is specified by the server. The recipient can either not respond, in which case it is bound by the server’s notice, or it may within, say, 14 days serve a counter-notice which, if the original notice required the recipient to sell its shares to the server, to require the server to sell its shares to the recipient, or if the original notice required the recipient to buy the shares of the server may require the server to purchase the shares of the recipient. The server then becomes bound by the counter-notice.

As the server must name a price at which it is prepared to both buy and sell, the price chosen is likely to be a fair one. It also avoids a valuation which is often time consuming and could produce a price which is not satisfactory to either one of the shareholders. One disadvantage of a Russian Roulette clause is that a financially stronger shareholder will prevail because it can serve a notice to buy knowing that the financially weaker party can only comply, not by itself having the resources to buy. The weaker shareholder will only be able to sell and therefore may not be prepared to serve a notice at all, in case it should be compelled to buy by a counter-notice.

If neither party serves a notice to buy or sell within the time stipulated, then the company will be put into liquidation.

Another possible option to exit is to list the company on Bursa Malaysia Securities Berhad. It is impracticable to provide specific details for a listing exercise and normally a clause on a potential listing contains only a general undertaking that the parties shall use their best endeavours to list the company on Bursa Malaysia Securities Berhad. A listing exercise takes a long time to come to fruition, as the company will need to fulfill many conditions including having a profit track record. Such a clause is normally merely an expression of interest and due to the lack of details not capable of being easily enforced.

These are only some of the more common provision that can be included in any Shareholders’ Agreement to assist a shareholder in disposing of its shares and/or when exiting a joint venture. More often than not during the discussions for a joint venture, parties neglect to adequately provide for such exit clauses and yet this should be one of the main considerations as realising the share value is also an important element of the joint venture.

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