CONTROLLING SHARE TRANSFERS

When an inventor builds a machine, he makes sure that he knows how each of the parts work and how they fit together. The more planning and preparation he puts into the machine, the more smoothly it operates when he switches it on. If the same kind of detailed planning and preparation are put into the legal administration of a company, then selling that company should be a much smoother process. The intention of this series of articles is to assist with that planning by looking at some of the cogs in the machine and providing some insight into what each one does.

In the early stages of a company's life, issuing shares (primarily to early investors and to employees) is a vital cog in the machine that we considered last month. Every cog considered in this series of articles requires maintenance. A drag-along right (from the September issue) should be checked periodically, and after any big event in the company's life, to make sure it still fits the company's situation – and altered if it doesn't, rather than trying to alter it when an exit deal is on the table.

The company's shareholder base, however, requires ongoing maintenance and should be provided for in the company's articles of association. Investors will understand that the company has issued equity to earlier investors and employees, but they will be wary of the problems that can be caused by ex-employees, or third parties to whom employees have transferred their shares. Many corporate actions require all, or a certain percentage, of the company's shareholders to approve them – these shareholders are far more likely than employee shareholders to have moved without telling the company (so no paperwork can reach them), lost interest in the company entirely (so that they ignore it) or, if they left on bad terms, actively seek to prevent the deal.

NOSTICK LTD.

It is common that a company adopts "leaver provisions" in its articles of association, which are provisions that compel an employee to sell their shares to the company or its shareholders in the event that their employment ends. Generally they divide the employees into "good leavers" and "bad leavers", depending on the circumstances in which they leave, and then provide that bad leavers receive

only nominal value for their shares but good leavers receive a fair market value. There are many variations on this theme, from vesting schedules through to multiple classes of leaver, but the aim of the provisions is always to ensure that when employees leave they can't take their shares with them.

NoStick Ltd. had leaver provisions in its articles, and had several employee shareholders who were allotted and issued shares by the board. One employee shareholder left the business on bad terms, and dealing with various other aspects of that departure unfortunately meant that the share transfer paperwork necessary to recover his shares was forgotten. After leaving the business, he had no interest in signing the necessary paperwork, and ignored all communications from the company.

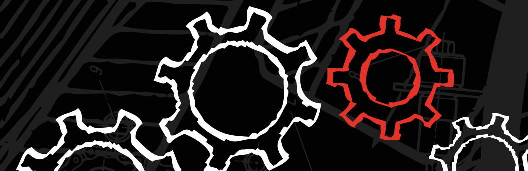
NoStick could sue the ex-employee – he is in breach of the articles of association until he hands over his shares. The time and money cost of doing so, however, would be significant. If the business is bought then the operation of the drag-along right will forcibly transfer his shares – but that may not be for some time. In the meantime, the ex-employee remains a shareholder and is entitled to vote, receive dividends and so on. The usual structure of leaver provisions is such that if the leaver retains their shares having left the business, there is little that the company can do to compel them to sell - companies usually ensure that the share transfer is on the table at the same time as the employee's compromise agreement – and before they get whatever payment they are receiving in connection with it.

This approach, however, fails in a situation where the leaver's shares are worth more than the severance payment, or no payment is being offered. A better approach is to have employees to whom shares are issued sign a simple document that gives any director of the company from time to time power of attorney only in respect of their shares, in the event that the leaver provisions are triggered. This means that a director can sign share transfer paperwork on the leaver's behalf – even if the transfer is left until after the actual departure. This provision cannot be in the articles of association – a power of attorney must be a deed – but such a limited agreement should not be objectionable to an employee about to receive equity in the business.

NORESERVES LTD.

Another point in which leaver provisions often fail is the identity of the buyer. NoReserves Ltd. had standard leaver provisions, and when an employee shareholder came to leave the business the directors remembered that those provisions would be triggered. An issue arose because NoReserves's articles of association specified that NoReserves would be the buyer of the employee's shares. English law limits the circumstances in which a company can buy back its own shares – if a company has "distributable reserves" (net accumulated profits) then the process is relatively straightforward, but NoReserves did not.

There are other routes available, but they are expensive and not realistic for such a small buyback. Even the most accessible (a reduction of capital using the out of court method) requires the company's directors to swear a declaration that, given its likely liabilities over the next 12 months, the company is solvent – and for a relatively early-stage company, as No Reserves was, this is often not an option. The end result was that the employee left the business with their shares.



The best way to avoid this problem is to have the articles of association be more flexible as to the identity of the buyer(s), and have potential buyers who are not bound by the same rigorous requirements as the company is when it comes to buying the company's own shares.

Typically the other shareholders of the company might be given the ability to act as the buyers, either before or after the shares are offered to the company. Alternatively, some all-purpose language could be used that would give the company a period in which it could attempt to locate a buyer for the shares.

WIDOWSPIQUE LTD.

Companies with leaver provisions generally also have a general prohibition on transfer of shares, other than with the permission of the company or a major shareholder. This again helps to control the shareholder base – some minor movement of shares to family members or trusts for tax planning is generally allowed, but overall the company can keep a tight rein on its capital.

Before WidowsPique Ltd. began to issue shares to employees, it amended its articles of association to include leaver provisions and a general prohibition on transfer. The provisions that were inserted were sensible, but the company and its advisers did not conduct a full review of the other provisions of the articles of association. As a result no change was made to the standard article on "transmission", that allowed shares to pass from a shareholder to their beneficiary by operation of law when they died.

This issue came to light when one of the founders died, leaving to his widow shares that had a special right to appoint a director to the board of WidowsPique. The widow argued that transmission of the shares occurred automatically on death, and under WidowsPique's articles therefore entitled her to take ownership of the shares, so even though the leaver provisions purported to apply (death was one of the "good leaver" events) the shares had already moved on. Those provisions could only apply to a shareholder's death where there was no transmission of the shares. She then promptly appointed herself as a director, much to the consternation of the others.

This argument may not have held up in court, but it was by no means a certainty that it would not. The other founders of WidowsPique agreed to buy all of the transmitted shares rather than go to the cost and negative publicity of taking the widow to court for delivery of the shares. Failure to check that the new provisions meshed properly with the rest of the document into which they were being inserted cost the directors personally.

CONCLUSION

Having one former employee retain their shares when they leave the business is unlikely to present an issue for a late-round investor or buyer of the company, but allowing the register to slip out of the company's control may present more serious problems. Tracking down former employees who have moved, or dealing with the estates of those who have died, is at best an unnecessary cost and delay to add to the transaction – and at worst may prevent it taking place. Paying attention to this cog, keeping it maintained and ensuring that it fits with the others, is vital for the smooth running of the machine.