

What is the effect when an existing Shareholders' agreement is inconsistent with the Companies Act or the company's Memorandum of Incorporation?



A question that often arises is whether a shareholders' agreement is subject to a company's Memorandum of Incorporation (Mol).

Unlike the regime under the previous Companies Act 61 of 1973, the most important document governing a company in terms of the present Companies Act 71 of 2008 is the Mol.

The Mol sets out the rules governing the company, as adopted by its incorporators and owners.

In a previous blog we discussed '*Directors' misconception of what their obligations and liabilities are*', in this article we discuss in more detail whether a Shareholders' agreement is subject to a company's Memorandum of Incorporation (Mol).

What are the requirements for the content of an Memorandum of Incorporation (Mol)?

Section 15 of the present Companies Act imposes certain specific requirements on the content of an Mol and sets out *the rights, duties and responsibilities of shareholders, directors* and other *persons involved in a company*. It further protects the interest of shareholders in the company, and provides for a number of rules / alterable provisions which companies may accept or alter as long as it is in line with the Companies Act.

What is the purpose of a Shareholders' Agreement?

The aim and purpose of a shareholders' agreement, separate from the company's Mol, are to regulate matters *inter se* (between) shareholders. Generally, this will include clauses relating to the rights of shareholders, disposal of shares, deemed offers, obligations of shareholders to provide capital to the company, and other matters relating to the rights and obligations of shareholders.

o Buy and Sell Provisions

These provisions set out the rights and obligations of shareholders to dispose of their shares in certain circumstances, including insolvency, disability, death or retirement. Generally, a price or valuation mechanism should be included.

o Financing

Every shareholders' agreement should specify how shareholders will contribute towards the working capital of the business and the implications for any shareholder who does not contribute in proportion to their shareholding.

o Share Transfer Restrictions

In smaller companies with only a few shareholders, shareholders' agreements often contain detailed clauses restricting share transfers so that all shareholders have some control over the identity of those with whom they are in business. Share transfers of private companies are restricted in terms of section 8(2)(b)(ii)(bb) of the Companies Act by, for instance, requiring director (board) approval or giving existing shareholders first rights to buy shares if a co-shareholder wants to sell shares.

◦ **Dispute Resolution**

A shareholders' agreement should set out the consequences for a shareholder who is in breach of the agreement and should contain a quick process for resolving disputes between shareholders as parties. Arbitration is suggested as a quick way of resolving disputes between shareholders.

◦ **Confidentiality**

The terms of a shareholders' agreement are generally confidential to the parties unless they agree otherwise. A provision to this effect should be inserted into every shareholders' agreement.

◦ **Company Contracts**

A shareholders' agreement should permit shareholders of the company to contract with the company or, alternatively, prohibit them from doing so. If contracting is permitted and there are any terms or restrictions that must apply, then these should also be specified, for instance where shareholders are also directors, to avoid a conflict of interest.

◦ **Accession Procedure**

These clauses provide for the procedure that must be followed before new shares are issued or transferred. In addition, when a person becomes a shareholder in the company, he or she is generally required to execute a 'deed of accession' whereby they agree that the shareholders' agreement is binding upon them.

◦ **Observer Rights**

Some shareholders will only be shareholders, not directors, of a company. Shareholders may, however, be given 'observer rights' to attend board meetings (or certain parts of those meetings), but may not vote.

◦ **Protecting the Company**

Shareholders' agreements should contain clauses that protect the business interests of the company. For example, shareholders may be required to disclose conflicts of interest, be restrained from being involved with competing businesses, and have restrictions imposed on them in dealing with customers of the company.

o **Deadlock**

Deadlock provisions deal with circumstances where shareholders cannot agree on a given course of action (i.e. shareholders deadlock). This is particularly important where there are only two shareholders, each owning 50% of the company's shares.

There are a number of ways in which a deadlock can be resolved, including the following:

- o Russian roulette: meaning one shareholder has to buy the other shareholder's shares or sell their own.
- o Mediation: the shareholders must agree to mediation (or some other form of dispute resolution) to assist them in resolving their disagreement.
- o Texas shoot-out: each shareholder will put in a sealed bid to buy the other shareholder's shares and whoever places the higher bid must buy the other shareholder's shares.
- o Deterrence: a price is fixed, where one shareholder has to buy the other person's shares at 125% of market value.

Regardless of the method of resolution chosen, it is of utmost importance that a method is specified to give effect to the deadlock provisions.

Hierarchy of application

In terms of section 15(7) of the Companies Act 71 of 2008 ("Companies Act"), the shareholders of a company are entitled to enter into an agreement concerning any matter, provided that it is consistent with the Companies Act and the company's Mol. Any provision of such an agreement that is inconsistent with the Companies Act or the company's Mol is deemed void to the extent of the inconsistency.

Consequently, where a company adopts a new Mol by means of a special resolution, it will effectively amend any shareholders' agreement concluded between the shareholders of such company (to the extent that it is inconsistent with the Companies Act and/or the company's Mol) or may even cancel a pre-existing shareholders' agreement. In the case where the shareholders' agreement is inconsistent with the company's Mol, the shareholders' agreement will be null and void.

Conclusion

When a Company considers adopting a new Mol, risking any pre-existing shareholders' agreement becoming invalid and not binding on the parties thereto, with retrospective effect from the date of adoption of the new Mol, such company and its shareholders are advised to determine whether: (i) the current pre-existing shareholders' agreement in any manner conflicts with the new Mol; or (ii) the new Mol cancels, expressly or implicitly, the pre-existing shareholders' agreement; however, in either event, the company and the shareholders should procure that any new or pre-existing shareholders' agreement is drafted and/or amended to align the provisions thereof with the new Memorandum of Incorporation.

Therefore, a shareholders' agreement will only be valid and enforceable if is not inconsistent with the Companies Act and Mol of the company.

SERR Synergy assists businesses to comply with the new Companies Act and amended Close Corporations Act by bringing all relevant company documents in line with new legislation. This include *assistance with the alignment of company documents, such as the Memorandum of Incorporation (Mol)*, with the new Companies Act and other legislation as well as setting up of Shareholder Agreements for companies and association agreements for close corporations.

About the Author: Ursula Jordaan gained valuable experience in her previous roles as creditor's clerk and HR manager. She joined SERR Synergy in 2018 and currently works in the Ownership Department as a Corporate Legal Advisor. She is currently involved with the implementation of collective ownership structures and shareholding transactions for businesses.

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