NAVIGATING A SHAREHOLDERS AGREEMENT: FINANCING THE COMPANY

In the fourth of our HFW Insights: Navigating a shareholders agreement series, in which we distil common corporate and transactional issues into bite-sized insight, we explore key financing issues in the context of joint ventures.

Key to the success of a joint venture is ensuring that adequate funding is made available on a timely and ongoing basis.

Future funding of the joint venture company can, however, be a potentially contentious matter.

"Establishing a clear funding plan is vital in enabling the commercial success of the joint venture and avoiding potential disputes between the joint venture parties."

A shareholder may not always be willing to commit to providing or guaranteeing future funding for a variety of reasons. For instance, it may have insufficient resources or feel that its concentration risk for the particular market segment is already too high.

To prevent disputes from subsequently arising, parties in a joint venture should consider its needs at the outset for on-going financing and the means by which such future finance will be obtained.

Broadly speaking, financing options can be divided into the following categories:

- external loan finance
- shareholder finance – which can be further broken down into shareholder loans and shareholder equity or a combination of the above

Common issues

While the funding provisions in each shareholders agreement should be tailored to reflect the commercial intention among the parties thereto, we have set out below some common issues for consideration.

Amount and timing of funding calls

- Will the joint venture parties be obliged to provide additional finance (e.g. if external financing is not commercially viable)?
- If so, is there any limit to such funding obligation? Shareholders typically want to avoid being responsible for unlimited mandatory capital contributions in the future.
- What circumstances will trigger an obligation to provide further finance? Or will funding calls be entirely at the discretion of the board of directors of the joint venture company? From the perspective of minority shareholders who do not have any control or veto power in relation to board decisions, an objective trigger event (e.g. exceeding a prescribed debt to equity ratio) would be preferable.
- How much notice in advance of a funding call must be given? Is each shareholder able to raise the requisite amount of funds within such time?

Priority of funding

- Is there an order of preference in terms of funding methods? Will the availability of external financing be considered in the first instance before shareholder finance is sought?
- In the context of shareholder finance, will shareholder loans be preferred to shareholder equity? There may be reasons to prioritise the former:
  - (i) debt ranks ahead of equity in an insolvency scenario
  - (ii) it is easier to pay interest on loans than it is to pay dividends since the joint venture company may not have sufficient distributable reserves at the relevant time even if the business is doing well.
- Where shareholder finance is concerned, in order to retain the respective shareholding percentages among the joint venture parties (and thus the voting structures set in place in the shareholders agreement), any further extension of shareholder loans or subscription for shares will normally be made pro rata to the parties' shareholdings.

External loan finance

- Will such external loans be recourse or non-recourse in nature (i.e. will the shareholders be obliged to provide any guarantees, securities, indemnities, warranties or other undertakings)? Non-recourse finance is extremely rare and, in most cases, banks will require some (limited) recourse to the shareholders.
- If recourse debt is contemplated, how will such undertakings be apportioned between the shareholders?

- Will guarantees be given by the shareholders on a several basis or on a joint and several basis?

Shareholder loans

- Will such shareholder loans be subordinated to external bank debt?
- Will such shareholder loans bear interest? Where the shareholder is a corporate entity and is considering making an interest-free loan, the board of directors of such shareholder must give due consideration to the corporate benefit to the shareholder in making such loan.
- What are the repayment terms? In order to avoid one shareholder being preferred over the others, parties may wish to stipulate in the shareholders agreement that such shareholder loans shall be repaid by the joint venture company on a pro rata basis according to the parties' respective loan contributions.

Shareholder Equity

- Are contributions in kind (e.g. assets) accepted? If so, the shareholders agreement should stipulate the manner in which such non-cash contributions will be valued.
- Will this be subject to the condition that the auditors have issued an opinion that the issue price is fair?

Default in funding obligations

The consequences of a shareholder's failure to comply with its mandatory funding obligations typically include one of more of the following:

- In the context of shareholder loans, a late payment interest charge being levied on the non-funding shareholder and payable to the funding shareholders who have made up the shortfall in funding.
- In the context of shareholder equity, the funding shareholders being entitled (but not obliged) to subscribe for shares in respect of which the non-funding shareholder has failed to subscribe for, thereby diluting the shareholding of the party in breach.
- Suspension of the non-funding shareholder's rights under the shareholders agreement (e.g. board representation, reserved matter rights, dividend rights, etc.).
- The non-funding shareholder being subject to –
  - a put option in respect of the funding shareholder's shares at a premium over market value or
  - a call option in respect of its shares at a discount to market value.

Key takeaways

While negotiating funding arrangements can be a heated topic, it is arguably one of the most important.

Establishing a clear funding plan is vital in enabling the commercial success of the joint venture and avoiding potential disputes between the joint venture parties.

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