Companies

Shareholders' Agreements

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WHY USE A SHAREHOLDERS' AGREEMENT?

Is it not unusual for parties entering into business together to choose to incorporate a company as the vehicle to operate the business. However in many instances little or no thought is given to the need to define the rights and responsibilities of the parties as shareholders, directors or employees of the company and an assumption is made that the company's Constitution will sufficiently address any important issues. This approach fails to appreciate the limits on the Constitution and the Corporations Act in regulating the rights and responsibilities of the shareholders and directors.

For example, the rights under a company's Constitution are not normally sufficient to confer personal rights upon a shareholder, such as:

- The right to be employed by the company
- The right to ensure that other shareholders do not compete with the company
- The right to confidentiality in respect of a shareholder's information
- Detailed rights and obligations protecting the interests of minorities
- 'Drag along' and 'tag along' rights in the event of a proposed sale
- Termination, forced sale and other exit provisions

A Shareholders' Agreement is a useful tool in defining the rights and obligations of the parties when a private company is used as a vehicle for a business venture. It serves to fill the gaps in areas not covered by the Corporations Act or a company's Constitution and explicitly confirms important commercial terms of agreed arrangements which would not otherwise be captured in a contract between the shareholders.

COMMON FEATURES OF SHAREHOLDERS' AGREEMENTS

Typically, a Shareholders' Agreement will address the following issues:

- Initial contributions and the rules governing additional capital requirements
- Management structure, including appointment and powers of a managing director
- The number of directors each shareholder may appoint, controlling appointment and removal of directors and the rights of shareholders to replace their nominee directors
- Specific provisions dealing with conflicts of interest
- Detailed provisions regarding meetings and voting rights (often different from the normal provisions in the Constitution)
- Specific management and decision topics requiring unanimous or special resolutions
- Requirements for business plans, budgets and accounts
- Restrictions on encumbering shares
- Restrictions on transfer of shares, including pre-emptive rights
- Compulsory share transfer events including 'drag along' and 'tag along' rights
- Detailed valuation provisions
- Dispute resolution provisions and provisions dealing with consequences of deadlocks

- Obligations of shareholders, including non-compete provisions
- Restrictions on contracts between the company and shareholders or directors
- Confidentiality provisions

DIFFERENT BUSINESSES NEED DIFFERENT AGREEMENTS

While there are many common features found in most Shareholders' Agreements, it would be a mistake to conclude that there is a standard form of Shareholders' Agreement which can be used in every case. The topics to be addressed in a Shareholders' Agreement might be similar in each case but the way in which the specific provisions are drafted depends very much on the particular business, the relationship between the parties, their contributions and entitlements. Identifying these elements is a fundamental step in drafting a Shareholders' Agreement.

Shareholders' Agreements are used in large and small enterprises, in a wide variety of circumstances. Examples include:

- Quasi partnerships
- New ventures established by promoter or operators of existing businesses
- Start up or growth companies seeking investors
- Incorporated joint ventures

QUASI PARTNERSHIP

It is not uncommon for a small group of individuals to operate a business using a company as the operating entity in circumstances where, but for the corporate structure, the business would in fact be a partnership. A small business operated by 2 or 3 partners' is a good example. In these cases, the following basic principles and assumptions normally apply:

- That each shareholder would be entitled to be treated fairly and equally.
- That (subject to any agreement as to differing equity proportions or involvement) each shareholder will make an equal or similar contribution to the venture (both in terms of capital and personal effort) from the outset and will make further capital contributions (in proportion to their interest) if required.
- That each shareholder has a right to be a director or to appoint a director.
- That minorities will be protected to some degree in the exercise of powers by the majority.
- That each shareholder will have an ongoing entitlement to employment or a specific position within the company's business, subject to appropriate conditions.
- That the company's income will be distributed and that any retention of income for reinvestment will either be subject to further agreement or within fixed parameters expressed in the agreement.
- That the parties will be bound by appropriate confidentiality obligations and non-compete obligations (both during the relationship and after the relationship ends).
- That there will be even-handed "buy-sell" arrangements, both to protect continuing shareholders and to ensure that outgoing shareholders receive fair value.
- That disputes will be subject to an orderly dispute resolution procedure and that harsh remedies, such as winding up the company will only arise in the event of unresolved deadlock about major matters.

- That, because the business relies on the personal input of the “partners”, provision of funding for the “buy-sell’ arrangements will be considered and might include provisions to address death, permanent disability or trauma of a principal.

PROMOTER AND OPERATOR WITH PASSIVE INVESTORS

A promoter who sets up new venture may have invested considerable time, effort and intellectual property in creating and starting the business but may need some additional capital to exploit that potential. They may invite a small number of investors to invest in the company for this purpose, but may wish to retain a considerable degree of control over the operation of the business. If the promoter has a track record of success or can persuade investors that it is appropriate for the promoter to control the business, they likely to give far fewer rights to investors and may include provisions which:

- Give the promoter the right to manage the operation of the business with few constraints.

- Entrench the position of the promoter as managing director, subject to major events, such as death, bankruptcy or gross misconduct.

- Fix a procedure for approval of annual budgets, including remuneration of the promoter and other key employees.

- Entrench rights for the promoter to require the investors to sell their shares if the company is to be sold (“drag along” rights) or to consent to a float if the company is to be listed.

- Limit shareholders’ rights to dispose of their shares to third parties, for a period of time.

START UP COMPANY AND VENTURE CAPITALIST

Where a promoter, developer or entrepreneur has a business or concept capable of rapid development or a large scale development which cannot be undertaken without much larger capital input, a venture capitalist or group of investors may be prepared to invest in the business on the basis that they have a much higher degree of control and the terms of the Shareholders’ Agreement are weighted in their favour. Generally, the greater the financial risk being taken the higher the degree of control which will be required.

Commonly, a venture capitalist will require:

- A detailed business plan and a requirement for updated business plans to be approved before they are implemented.

- Clear restrictions on the company acting outside the business plan.

- Financial targets to be met as a pre-condition of drawdown on funds or further funds being invested.

- Regular audited accounts.

- At least non-executive director representation.

- Significant limitations on the rights of the promoter to make major decisions without their approval.

- Protection of their investment, perhaps by way of convertible preference shares or debentures which might be converted to shares if the company succeeds or otherwise called in as debt.

- An increased shareholding to reflect the risk taken by the venture capitalist.

- Warranties and indemnities by the promoter.

- A well defined dividend policy (perhaps limiting dividends in an initial period).
- Restrictions on the remuneration of the promoter and key executives.
- The ability to dispose of their shares outside the company if pre-emptive rights are not exercised.
- The right to decide on and participate in a float or off-market sale.

INCORPORATED JOINT VENTURES

Incorporated joint ventures are commonly used where two existing companies, each carrying on their own businesses, come together to operate a discreet business. Often the parties will come together because they each have particular assets or structures which can be more effectively used when combined, or because neither of the parties wishes to take the risk of setting up the complete venture or incurring the costs in acquiring assets for that purpose. Examples include a manufacturing joint venture, where one of the parties has an existing factory and the other can supply raw materials, or a distribution business, where one party is a manufacturer and the other party a distributor.

One of the key features of an incorporated joint venture is that the parties are usually equal partners and normally neither party has the ability to out-vote the other party. These joint ventures are often called “dead-lock” companies, as the failure to resolve disputes will trigger the sale or winding up of the company.

A Shareholders’ Agreement for an incorporated joint venture will often include the following features:

- The provision of particular assets by each of the parties (for instance by way of sale or lease of assets to the JV company).
- Clear boundaries for the business activities to be carried out by the company.
- Provisions ensuring equality of decision making rights.
- Restraint of trade provisions.
- A finite term for the agreement, with provision for extension.
- Terms dealing with the provision of security by the company for loans made by the JV partners.
- Equality of voting rights at board meetings, irrespective of number of directors (at least in relation to major decisions).
- A structured dispute resolution mechanism (for example requiring disputes to be ultimately referred to the managing directors or CEO’s of each shareholder for negotiation prior to any action).
- Clearly defined termination rights and consequences in the event of unresolved deadlock (either with or without pre-emptive right opportunities).

MANAGEMENT STRUCTURE AND CONTROL ISSUES

A company’s governance and management is normally divided into three levels:

- Day to day management by executives
- Management by the board of directors
- Overall control by the shareholders

A Shareholder’s Agreement will usually define the principal business activity of the company and confirm that the shareholders agree to work together to promote that business. This can include obligations to use “reasonable endeavours” to ensure that the company successfully carries on the business and obligations to participate in making decisions in good faith and in the interests of the company. Shareholders may wish to reserve an express right to consider their own interests and not be bound to put the interests of the company ahead of their other business or investment interests. This can obviously be a source of tension and is an issue which the parties should consider carefully.

While day to day control of the company’s business may be in the hands of a managing director or other senior employee or one of the shareholders, a Shareholder’s Agreement will normally provide for certain decisions to require either Board approval or shareholders’ approval.

While it is not uncommon to define the requirement for a “special resolution” as meaning a 75% majority, in some cases that percentage may need to be higher if it is to protect minority shareholders. In other cases, the percentage might well be lower. For example if there are three shareholders each with equal shares then the parties might agree that a majority of two shareholders will suffice so that the percentage need only be 68%. What is important is that the parties consider which decisions they wish to elevate to the category of “major decisions” and the level of agreement required in order for those decisions to be made.

In some instances “major decisions” will require unanimous resolution, for example where there are two or three equal shareholders and the parties insist on a “dead-lock” model.

STRUCTURE AND OPERATION OF THE BOARD

A Shareholders’ Agreement will alter the standard provisions in a company’s Constitution to tailor the specific provisions for appointment and removal of directors, the holding of meetings and voting, to meet the requirements of a particular structure. To protect minorities, the voting rights at board meetings may include specific provisions which require unanimous or a high level of consent of the directors. Voting rights can also be further limited by providing that a quorum for any meeting requires a higher majority of the directors or shareholders to be present. The provisions may also exclude the right to appoint alternate directors and the right of a shareholder to replace a director unless the alternate or replacement is approved by the other shareholders.

MAJOR DECISIONS

A Shareholders’ Agreement provides the opportunity for the shareholders to consider at the outset what particular issues and decisions they regard as fundamental. This encourages shareholders to discuss what might otherwise be unspoken expectations about how the company will be run and how decisions will be made. “Major decisions” typically include:

- Allotting additional shares to existing or new shareholders.
- Issuing convertible notes, debentures, rights or options.
- Varying rights attaching to shares.
- Amending of the Constitution.
- Acquiring or disposing of significant assets.
- Selling the business or the acquiring another business.
- Cessation of all or a substantial part of the business.
- Incurring significant debts or expenses.
- Granting a mortgage or charge over the company’s assets.
- Non-arms length agreements.
- Loans to or from directors or shareholders.

- The employment of directors by the company.
- Any decision to sell or float the company.
- The appointment, removal or replacement of the company's bankers, accountants, auditors or solicitors.
- The commencement or settlement of any litigation relating to a claim exceeding a certain threshold value.
- A decision to wind up the company while it is solvent.

SHARED OBJECTIVES AND INDIVIDUAL PERSPECTIVES

The objectives of the parties are an important issue to be considered when preparing a Shareholders' Agreement. At its simplest, the parties will start with a common purpose, usually to establish or operate the business and they will have basic shared objectives of success and wealth creation. However, it is likely that they will have different financial needs and resources, different expectations and different views on the priorities for the investment vehicle. If these expectations and views are not discussed or if the financial circumstances of the parties are substantially different, the risk of a dispute during the course of the joint venture will be significantly increased.

Some of the more common issues affecting individual perspectives include:

- The amount of capital to be invested
- Whether the business should grow organically build up by re-investing income
- How long they are prepared to wait to see if the venture succeeds
- Their capacity and willingness to invest more capital
- The need for a definite income or a return on investment
- The length of time they intend to hold the investment
- Whether the venture is a sole or major source of income or merely one of a number of investments.

If the parties are starting a new venture, it is important that they develop a business plan, even if relatively simple in its terms, which sets out their aims for the future and the methods by which they propose to achieve their objectives. The Shareholders' Agreement should ideally contain provisions requiring the parties to agree on a budget and a business plan each year. The Shareholders' Agreement can then be drafted to ensure that variations from those plans require special majority or unanimous approval, thus providing a safeguard for minority shareholders against activities or expenditure outside the agreed framework.

A business plan is also a useful tool to enable the parties to discuss the company's activities in advance and in a broader, more objective context, instead of having to try to agree on a major decision on short notice or in a more emotive context.

CAPITAL REQUIREMENTS

It is important for the parties to agree on the capital and financing requirements of their joint venture at the outset and it is preferable for the parties to explicitly define the capital requirements of the venture in the Shareholders' Agreement. This involves a number of components:

- The initial capital to be contributed by the parties
- Provision for additional capital to be invested

- Provision for specific external funding

A shareholders agreement will normally set out the capital to be provided by each party and may also set parameters for futures capital injections. In addition, careful thought needs to be given to the structure of clauses dealing with the raising of additional capital.

FLEXIBILITY FOR THE FUTURE

Much of the focus of the provisions in a Shareholders' Agreement is aimed as setting parameters for the operation of the company and its business in order to achieve certainty and to define the parties' rights and obligations. However, a business is rarely static and, particularly over the longer term, it is likely that the business or its circumstances will change or grow in ways which require flexibility. If the parties can identify circumstances which might trigger a need for change in the future, they may be able to flag the approach to be taken if those events occur, in a way which provides guidance in the Agreement and reduces the risk of a dispute.

Topics which fall into this category include:

- Expansion by acquisition of other businesses
- Expansion by introducing new shareholders or "partners" who fit certain criteria
- Retirement of a shareholder
- Sale of parts of the business
- Sale of the whole business

DRAG ALONG AND TAG ALONG RIGHTS

An important aspect of a Shareholders' Agreement is the adoption of clear rules for the minority to be able to require the majority to include them in a sale ("piggy back" or "tag along" rights) and the ability of the majority to force the minority to join in the sale ("drag along" rights).

Where a minority shareholder has a very small interest in the company it would not be unusual for the drag along clause to specify that they must sell their shares at the same price as that negotiated by the majority, irrespective of whether it is a market price, as long as the buyer is an arms length buyer and not a related party of the other shareholders. Where the minority has a greater interest or a stronger bargaining position, the terms may require the sale price to be no less than fair value, as determined in accordance with a valuation mechanism. The particular steps in triggering and implementing drag along and tag along rights should be drafted in a way which makes them both clear and practical to implement.

EMPLOYMENT AND NON-COMPETE ISSUES

Where the incorporated venture is a quasi-partnership between individuals, it will usually be appropriate for the Shareholders' Agreement to confirm that the individuals will be employed by the company and include non-compete provisions which bind the shareholders. The nature and extent of employment and non-compete provisions in a Shareholders' Agreement depend very much on the particular venture and the parties involved.

It is also important to consider whether a shareholder who is a key employee should be required to transfer their shares if their employment is terminated for breach or default on their part, or if they resign. These events (often called "bad leaver" events) may trigger a requirement to transfer at less than full value – particularly in the case of fraud, misconduct or other serious breach.

Where the shareholders or directors are involved in the business then it is also appropriate to considering including specific non-compete provisions which ensure that not only the shareholders and but also directors cannot act to the detriment of the company by engaging in competitive activities. If there are individuals who are not directors, but are the principals of a shareholders, consideration should be given to including them as parties to the non-compete obligations.

The inclusion of non-compete clauses is usually straightforward in the case of quasi partnership but is more difficult where there are external investors or financiers who may have interests in other businesses. If the business venture is a new start up venture or if the business will involve the use of technology or know how contributed by one or more of the parties, then the need to protect the company against competition or misuse of that knowledge or property could be a significant consideration for the shareholders. On the other hand, if the joint venture is a property development and the parties are independently engaged to other development activities, then such a restraint may not be appropriate at all.

DEATH OR DISABILITY

In the case of quasi partnerships or incorporated joint ventures involving key individuals who are active participants in the business, it would often be appropriate to include provisions which deal with the consequences of death or permanent disability of an individual participant. Usually these provisions will include a mechanism for the remaining shareholders to buy the affected party's shares (a call option) and also for the affected party (or their estate) to be able to require their shares to be purchased by the remaining shareholders (a put option).

Aside from dealing with the normal valuation issues and the steps for triggering these put and call options, the parties in these cases should also give consideration to the method of funding the buy out. In quasi partnerships, the most common source of funding is life insurance and total and permanent disability insurance. There are many ways to structure the insurance arrangements, including cross insurance between the individuals, the use of an insurance trust to hold the policies or insurance by the company itself of the particular individuals. There are different advantages and disadvantages in each case and different tax consequences in each case.

DISPUTE RESOLUTION

Broadly speaking, the issues which can give rise to disputes fall into two categories. Firstly there are disputes between the shareholders themselves about the conduct of particular shareholders, which often give rise to claims of "oppression". Secondly, there are disputes which relate specifically to the operation of the company or the venture itself. The first category goes to the heart of the relationship between the shareholders and is often not expressly addressed in a Shareholders' Agreement as it can be difficult to adequately define all the circumstances which might give rise to such a dispute. The parties may prefer to leave the issue to be determined under the provisions of the Corporations Act.[1]

It is not normal to find that a Shareholders' Agreement includes a stepped process for dispute resolution which requires the parties to meet and discuss the issue in good faith and refer the matter to non-binding mediation before commencing any proceedings, provided that the provisions do not prevent a party from seeking interlocutory injunctive relief.

VALUATION ISSUES

Care also needs to be taken in drafting the valuation clauses used in Shareholders' Agreements. What may seem to be relatively standard valuation clauses may not be appropriate in all cases. For example, parties may wish to consider whether they prefer to provide for a "fair value" valuation or a "market value" valuation, as there is a difference between these valuations. The parties also need to be aware that agreeing to an independent valuation mechanism is a two-edged sword – a party who is dissatisfied with the valuation may have little scope to challenge the valuation. A valuation made in accordance with the terms of the Agreement is very difficult to challenge, even if it can be shown that the valuer made a mistake or was mistaken in their application of valuation principals.

PRE-EMPTIVE RIGHTS

An alternative to triggering a buy out mechanism of this kind is to attempt to use the pre-emptive rights provisions in the company's Constitution or the Shareholders' Agreement. Typically however, the pre-emptive rights in the Constitution will not be adequate as they are normally confined to offering the

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[1] See for example Corporations Act Section 232

shares to the other shareholders before selling them to third parties and are constrained because the Constitution will normally give the directors the ultimate discretion to approve or not approve a share transfer. Pre-emptive rights provisions generally do not provide an ideal solution in small companies in any event as there will often be no external party to whom a minority shareholder can sell their shares. In larger ventures the ability to allow investors to exit the company using effective pre-emptive rights provisions can be quite useful, particularly if there is some safeguard to ensure that fair value is paid. Even in those cases, a Shareholders Agreement offers the opportunity to improve significantly on the effectiveness of the pre-emptive right provisions.

MINORITY RIGHTS GENERALLY

Minority shareholders in private companies are often in the unenviable position of being investors in a company over which they can exercise little or no control, in circumstances which make it difficult, if not impossible for them to realise their investment in a simple and effective way. Despite the apparent disadvantages of being a minority shareholder, the fact is that many parties readily enter into positions where they are minority shareholders. The reason for this is that there are often other benefits for them which go beyond the mere value of their shares. In some cases, the minority shareholder may not have the capital required to commence or expand the business and the only way they can achieve their goal is to introduce other shareholders who can fund growth. If others are taking the capital risk then the minority will benefit if the project succeeds.

Problems usually arise when there are a larger number of shareholders and the dynamics of control of the company change, although quasi partnerships are not without risk. For example if there are three equal shareholders but two of them act collectively and exercise their majority rights against the wishes of the third.

While the Corporations Act contains provisions which may come to the aid of a minority shareholder by way of relief against oppression, fraud and oppression are exceptions to the ruling *Foss v Harbottle.* In essence that rule prevents a minority shareholder from suing for a wrong done to the company in circumstances where the majority are entitled to ratify the action. While minority shareholders may feel aggrieved, the prospects of succeeding in an oppression action in the Supreme Court are not high and represent a significant risk to the minority. Because of this risk minority shareholders should seek whatever additional contractual protection they might obtain through a Shareholders' Agreement.

The most common complaints made by minority shareholders include:

- Exclusion from management.
- Little or no participation in profits.
- Majority paying themselves excessive remuneration.
- Limited access to information about the company's affairs.
- No involvement in important decisions.
- Inability to prevent dilution of their equity stake.
- No freedom to transfer shares.
- No market for their shares.
- Majority operating a competing business.
- Bad management by the majority.
- Majority obtaining tax advantages not available to the minority.
- Majority have altered or interfered with the rights of the minority.

The list demonstrates that there is often a need to take these issues into account when preparing a Shareholders' Agreement.

CONCLUSION

Parties wishing to operate a business using an incorporated "quasi partnership" or other incorporated joint venture should not rely exclusively on the provisions of the Corporations Act and the company's Constitution but should enter into a Shareholders' Agreement to more fully and carefully define their rights and obligations. This requires careful consideration by the parties involved. Their advisers need to understand the issues and the risks limitations inherent in using a company structure and attempt to craft an agreement which fits the particular circumstances.

Dealing with these issues effectively in a Shareholders' Agreement not only has the potential to improve the position for the minority shareholders, but it will assist the majority shareholders in reducing the risk of subsequent disputes and litigation by setting an explicit framework within which the parties can operate.

While many Shareholders' Agreement do have similar terms, there is really no such thing as a 'standard' agreement and each agreement should be tailored to meet the particular needs and interests of the parties involved in the business.

Teece Hodgson & Ward regularly advise on Shareholders' Agreements and provide advice about these agreements. Our services include:

- Drafting Shareholders' Agreements
- Advising on rights under Shareholders' Agreements
- Negotiating buy-outs
- Assisting in Dispute Resolution
- Acting in Court cases about shareholder disputes

If you require further information or advice concerning the above please contact Shah Rusiti using the following contact details.

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