

## Shareholders' agreements—the basics

A shareholders' agreement is a contract between some or all of the shareholders of a company in which they agree to regulate the exercise of some of their rights as shareholders over the life of the business.

This fact sheet is designed to provide an overview of the fundamental components of shareholders' agreements and the reasons why it is important the owners of a company have such an agreement in place.

### Benefits of a shareholders' agreement

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Some of the benefits of entering a shareholders' agreement include the following:

1. It forces the parties to consider the procedures which the company and the shareholders will follow if certain events occur (such as a change in a shareholder's circumstances e.g., death or incapacity).
2. If prepared at commencement of the company, then it allows shareholders to address critical issues at the outset rather than as such issues arise.
3. It can assist the shareholders avoid or minimise disputes through the adoption of predetermined dispute resolution procedures and avoid or reduce the costs associated with any disputes.
4. It provides control measures which can assist the company avoid unplanned expenditures, indebtedness or other outgoings.
5. It can document an exit strategy for some or all shareholders.

### Shareholders' agreement or constitution?

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A shareholders' agreement and company's constitution provide similar functions in terms of recording and governing the rights and obligations of a company's shareholders. The question arises therefore, "why is a shareholders agreement needed in addition to a company's constitution?" To answer this question, it is necessary to look at the differences between these documents.

The major difference is a shareholders' agreement is governed by the ordinary rules of contract. The constitution, however, is regulated in part by the *Corporations Act 2001* (Corporations Act). Under the Corporations Act, a constitution can be amended from time to time by shareholders holding 75 percent or more of the voting rights. A shareholders' agreement, on the other hand, can generally only be varied with the consent of all parties. Therefore, it may be preferable for shareholders (particularly those with minority shareholdings) to enter a shareholders' agreement in order to entrench certain rights, for instance, pre-emptive rights in respect of the transfer or issue of shares. In the absence of a shareholders' agreement, minority shareholders may be exposed to the actions of the majority who may amend the rights of all shareholders, providing they hold 75 percent or more of voting rights (notwithstanding that any such action may be oppressive against the minority).

In addition to the above, a shareholders' agreement is also often preferred for particular shareholders' rights as shareholders consider this to be a more private document than the company's constitution.

Generally speaking, a constitution will set out the broad provisions relating to the governance of the company, whilst the shareholders' agreement is a more specialised document tailored to the particular purposes of the company, the nature of its business and the wishes of its shareholders. To the extent the shareholders' agreement and constitution deal with similar issues and there are any inconsistencies, it is common to provide that the shareholders' agreement prevails.

### Main provisions

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Typically, a well drafted shareholders' agreement should cover the following:

1. Board composition and management of the company

It is important to establish the basic provisions relevant to the management structure of the company, including the appointment of directors, composition of the board, whether shareholders can nominate a director and the scope of the managing director's duties.

2. Decision making power

In relation to decision making, it is prudent for the shareholders to agree on those decisions which will require their **unanimous consent**, such as a change in the main activity of the company, a change of the company's name, the removal of a director, and the issue of additional shares in the company.

The shareholders should also identify those decisions which require a certain **special majority** of the board (e.g., 75 percent). These may include the company incurring borrowings or obtaining any other financial accommodation over a set amount, the acquisition or disposal of corporate assets, entering into any joint venture or partnership arrangement, taking steps to dissolve or wind up the company, and applying to list the company on a securities exchange.

Further, the shareholders should identify decisions which require a **simple majority** of the board. These may include entering into leases of real property with rental payments between a certain pre-agreed range, adopting or varying the business plan for the company, declaring or paying any dividend, and entering into any related party contracts.

### 3. Prohibited activities

Shareholders will usually provide an undertaking to the company and to each other shareholder that they will not undertake specific prohibited activities, such as carrying on any competitive business or poaching customers or employees of the company.

### 4. Funding

The shareholders' agreement should make provision for the shareholders' funding obligations in respect of a start up company where the shareholders provide capital to cover the costs of incorporation and to fund the company's operations in its early stages. Provision may also be made for funding to be provided by the shareholders in the future if required.

### 5. Profit distribution

Shareholders should give consideration to how any profits made by the company will be dealt with. The distribution policy should be flexible enough to change from time to time with changes in the circumstances of the company.

### 6. Issue of shares

Any comprehensive shareholders' agreement will almost always contain provisions entitling the existing shareholders to take up new share issues in the first instance before further shares are issued to third parties (subject to certain exceptions). The shareholders' agreement should otherwise include the process to be followed by the company when it is seeking to raise additional share capital.

### 7. Transfer of shares

Similar to an issue of shares, the parties often agree that no shareholder can transfer its shares without the prior approval of some or all of the other existing shareholders. This is designed to prevent the introduction of a new investor to the business who does not share the same vision or objectives as the existing shareholders. The shareholders' agreement should contain prescriptive provisions dealing with how shares in the company may be transferred by an existing shareholder.

### 8. Valuation

One of the most common difficulties in respect of shareholdings in a company relates to the valuation of shares in the event of an issue of new shares or a transfer of existing shares. It is vital the shareholders consider and agree on how the price of shares will be determined in these circumstances. The valuation methodology may involve agreement between the relevant parties, reference to an adopted formula (e.g., based on the net assets of the company or on certain accounting principles), or independent valuation by an appropriately qualified valuer. In some cases, shareholders may rely on a combination of these approaches.

### 9. Dispute resolutions

A pre-agreed resolution process is extremely important and can save the parties to a shareholders' agreement a lot of time, money and inconvenience in the unwanted event of a dispute.

## No "one size fits all"

Despite the main provisions listed above, there is no "one size fits all" approach to drafting a shareholders' agreement. Each agreement must be specifically tailored having regard to the relevant business and the intentions of the parties.



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