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CPD Seminar to Accountants proudly presented to you by Barrister and Accountant Mr Geoffrey McDonald and Gavin Parsons and Associates Solicitors

Do you have a Shareholders Agreement?

10 reasons why you should not conduct business without a Shareholders Agreement

Introduction

A Shareholders Agreement is invaluable to the operation of a successful multi-shareholder company. It is a critical document: a binding and customised contract setting out the control, ownership and management of a company.

Shareholders Agreements primarily set out the rights and obligations of company shareholders. They usually include, amongst others, terms in relation to dividend payments, issuing new shares and resolving shareholder disputes. They protect shareholders, facilitate efficient operations and reduce the company's exposure to risk and liabilities.

A Shareholders Agreement should also outline a company's management structure including the delegation of responsibilities between shareholders and directors.

1. Avoiding Disputes and Dispute Resolution

A Shareholders Agreement should clearly and comprehensively set out the rights and obligations of the shareholders for a variety of circumstances as this avoids costly and time consuming disputes when any such circumstances arise as the shareholders argue different positions depending on their respective interests.

A common shareholders' dispute relates to the purchase and sale of shares. A Shareholders Agreement should include a clear mechanism setting out the rights and obligations of each party when it comes to the purchase and sale of shares and this commonly includes the requirement of a professional valuation being conducted and the shares being purchased at the amount valued by the expert valuer. However, many people, particularly shareholders of smaller companies, often want to avoid the significant expense of obtaining an expert valuation.

Savoy Clause
As discussed in detail during the seminar, one savvy option to avoid the expense of an expert valuation of the shares is to have a "Savoy Clause" (AKA a "Russian Roulette Clause") in the Shareholders Agreement.

In short, a Savoy Clause operates like this: the parties agree that if either party wishes to sell their shares (**Party A**) to the other party (**Party B**), then Party A will write to Party B and offer to sell Party's A's shares to Party B at a particular price (say $10.00 per share). Party B will then have a set period of time to confirm that they will buy Party A's shares at the price proposed by Party A ($10.00), failing which Party B <u>must</u> sell Party B's shares to Party A at that price of $10.00 per share and Party A must accept the purchase of Party B's shares at that price.

Dispute Resolution
Shareholders can experience many disputes between each other and that's understandable and not uncommon, as in any relationship. Shareholders must have ongoing open and honest discussions from the beginning of their business relationship. These discussions should include how their respective interests in the company should be managed in the event they cannot agree upon key operational decisions.

In any event, there are certain disputes that are unable to be resolved even after open and effective communication between the parties. Therefore, a Shareholders Agreement will provide that well-needed clarity and a clear mechanism to resolve both the foreseeable and the unexpected disputes that may arise between shareholders from time to time.

If a certain event is foreseeable the parties can decide what should happen in that event and record the specific procedure for that event in the Shareholders Agreement. However, for unexpected events the Shareholders Agreement should set out the general dispute resolution procedure to be taken in the event of any other shareholder dispute. Such procedures usually require the relevant parties to engage in one or more alternative dispute resolution options (such as informal or formal settlement meetings, mediation and/or arbitration) prior to commencing formal legal proceedings.

It is very common for the relationship between shareholders to deteriorate in the event of a dispute and this can severely disrupt the smooth operation of the business and can be very costly and, amongst other things, adversely effect staff morale, which can impact customer service, productivity, staff retainment, staff recruitment and much more.

It is important for shareholders to keep in mind that things will not always (and often don't) go as planned, even where the shareholders are family, friends or long-term associates. As such, having a well-drafted Shareholders Agreement will ensure that the shareholders have a clear plan or procedure to resolve the unexpected dispute when things don't go as expected at some time in the future. In fact, in order to avoid relationship break-down, it is even more important than normal for shareholders who are family, friends or long-term associates to have a Shareholders Agreement as those relationships are often much more valuable than normal business-only relationships and inter-family or inter-friendship shareholder disputes can also cause further adverse consequences such as emotional and other damage, or otherwise cause strain on or the deterioration of other relationships in the family or circle of friends, in addition to the relationship between the shareholders who are in dispute.

Importantly, a Shareholders Agreement can provide the "rules" and procedure for when and how a shareholder exits the business when faced with, for example, a difficult conflict and how this can be done on mutually agreed terms without negatively impacting the business.

Whereas a standard company Constitution will often not provide much, if any, insight towards a shareholders' rights and protection regarding their investments and contributions' made towards the company, if disputes become unmanageable, a Shareholders Agreement is the shareholders invaluable tool to refer to during these tough times.

We therefore recommend that shareholders conduct meetings and hold discussions regarding plans for when the unexpected occurs, and for those strategies and procedures to be expressly incorporated into their Shareholders Agreement from the beginning as it's the safest way to save the business and the shareholders themselves from unwanted disputes, costs, loss, damage and other liabilities.

2. Protection, Certainty and Clarity

It goes without saying that all shareholders should want contractual protection of their rights and for the rights and obligations between the company, directors and shareholders to be clearly expressed in a Shareholders Agreement in order to provide clarity and certainty to all parties.

A shareholder can buy peace of mind – by having a Shareholders Agreement!

For example, shareholders often want protection in the event of unexpected circumstances and for the Shareholders Agreement to provide clarity and certainty as to who they will be in business with in the event a shareholder dies, becomes incapacitated or seeks to sell their shares to a third party.

If you are thinking of establishing a business with a potential party, a well-drafted Shareholders Agreement will be your best friend, strategically setting out the business relationship between the shareholders involved and their established duties, rights and obligations. Therefore, it is crucial to know at all times as to who they are and who you will be conducting business with.

Some examples of unexpected circumstances, just on the topic of who the shareholders will be in business with are:

1. what if there is a death of a shareholder;
2. what if the other shareholders' shares are subject to a matrimonial settlement;
3. what if one of the shareholders suffers a permanent disability or becomes incapacitated.

In these circumstances the surviving/other shareholder may find that the new shareholder is not someone they want to be in business with. This may be because of a personality conflict, a lack of skills, maturity, experience, professionalism, knowledge or some other reason. A Shareholders Agreement can provide protection, clarity and certainty as to what happens if any of these events occur.

The future is unpredictable, comprised of the unexpected. In any contract or relationship, you should want clarity and certainty. A well-drafted Shareholders Agreement provides the required clarity and certainty and this is important to avoid disputes, avoid costs, avoid relationship breakdown, avoid irreparable damage to the business … the list goes on …and on ...and on.

Company Constitutions – particularly standard, template or 'off-the-shelf' Constitutions – may not include clauses that sufficiently protect the surviving/remaining shareholders in such unexpected circumstances. In other words, without an effective Shareholders Agreement, the surviving/remaining shareholders may not know who they will be in business with as a result of such unexpected circumstances.

Thus, a Shareholders Agreement can protect the interests of the remaining shareholders, their rights to acquire the relevant shares first and on reasonable terms to ensure shareholders are not forced into unintended business relationships with unknown parties.

3. Death of a ~~Salesman~~ Shareholder

We briefly touched on unexpected events above, including this topic, however, the death of a shareholder usually has such severe and wide-spread consequences that it is of itself a very good reason to have a Shareholders Agreement – hence it made our top 10.

A well-drafted Shareholders Agreement should cater for many potential scenarios including some that are less likely to occur, particularly if that scenario would create significant chaos or difficulties should the event occur, such as the death of a shareholder.

It is important to be realistic: if you are going into business with another person, they will not live forever. Unfortunately, you are mortal, and so are your fellow shareholders.

So, what are some of the consequences of failing to prepare for an unexpected circumstance such as the death of a shareholder? What happens if you don't have a Shareholders Agreement?

Well, under succession laws (and the replaceable rules provided by the *Corporations Act 2001*), a deceased shareholder's shares form part of the deceased's estate and are ultimately transferred to the applicable beneficiary or beneficiaries in accordance with the deceased's Will (or per Statute if no valid Will exists). Do not become the victim of an unknown Will and have an incoming shareholder thrust upon you and the business as a result of your co-shareholder's death.

If you do not have a Shareholders Agreement that addresses these issues, you should be concerned about these things and you need to consider such questions as:

1. Do you know who your shareholders' beneficiaries are, and who you will be in business with when they die?
2. Does the beneficiary have the skills, knowledge and expertise in order to comply with the obligations of the deceased shareholder?
3. Does the beneficiary have the personality and character traits of someone that the surviving shareholder(s) would want to be in business with?

4. If you don't have a Shareholders Agreement, do you have a company Constitution and, if so, are these issues covered in the Constitution?
5. What does the Constitution say about this?

A Shareholders Agreement can address issues including the above. For example: the surviving shareholders can have a right to purchase the deceased shareholder's shares (usually at market value determined by an expert valuer) and retain control of the company.

4. Tailor made

A Shareholders Agreement should be customised according to specific shareholders' needs in relation to the specific company and business. If a potential shareholder has strong desires about specific things that the company and/or shareholders can or cannot do, then these should be recorded in a properly drafted, comprehensive Shareholders Agreement from the beginning.

As mentioned above, template Constitutions may not provide the necessary tailor-made protection desired by the parties.

5. The Alignment of Shareholders expectations

Different people often have different expectations, just like different shareholders often have different expectations, and in any event those expectations may change over time. It is therefore important to document those expectations, and do so from the beginning of the business relationship.

Shareholders can always try and reach agreement on the terms of a Shareholders Agreement at any time during the life of the business, however, for obvious reasons and those that follow, we strongly recommend that the shareholders should seek to align their expectations and document same in a Shareholders Agreement before the company commences trading. This will facilitate a smooth operation of the company.

During the creation of a new company, shareholders will have extensive discussions with their business partners regarding how they expect the business to operate. These discussions might include verbal agreements relating to the skills, expertise and effort that each shareholder will contribute towards the business' success. However, memories fade with the effluxion of time, particularly when it comes to verbal discussions (and even more so in the event of relationship breakdowns). Without a Shareholders Agreement, how will you evidence what was said, and agreed upon, years after the fact? More importantly, what if a shareholder fails to "uphold their end of the bargain" of a verbal agreement?

Standard, template or "off-the-shelf" constitutions generally fail to address the situation where a shareholder does not (or is unable to) contribute their skills, expertise and effort in accordance with promises previously made. Why should that shareholder be entitled to the same benefits as the other shareholders who have carried their weight and produced the fruits of success?

This is business, and only those who honour their commitments, and contribute to the company's success, as they promised they would, should be rewarded.

6. <u>Investment and Growth</u>

If you are bringing in a new shareholder (issuing new shares or selling existing shares), a well-drafted Shareholders Agreement gives the incoming shareholder/investor peace of mind. A comprehensive Shareholders Agreement can be used to demonstrate to any incoming investor or shareholder the professionalism, organisational skills, and the intellect of the existing business operation and those involved.

From time to time – particularly during growth phases – a business may require capital raising or external investment in order to achieve its goals.

How can the shareholders secure any such investment?

Well, the shareholders' options include, by producing a well-drafted Shareholders Agreement to the investor, demonstrating certainty in relation to the company's control and operation, for example; by way of clear decision-making entitlements and voting powers. Potential investors and/or potential investor-shareholders may seek to negotiate their own rights, for example that certain business decisions be subject to their prior consent or approval.

As a Shareholders Agreement sets out the control and operation of a company, we note that without a Shareholders Agreement, your business may fail to attract the investors or new shareholders that it needs for its continued growth.

7. <u>Funding and Dividends</u>

As aforementioned, shareholders should discuss their respective expectations when creating a new company. These discussions will include expectations as to funding, including initial funding required to create the company, and any future additional funding.

Again, it is important to document these discussions including any verbal agreements relating to funding in a Shareholders Agreement. For example, the founding shareholders might agree to contribute equally to the initial and future funding of the company.

Without a Shareholders Agreement, and in the absence of a tailor-made and thorough Constitution, how will you prove that a shareholder has failed to "put their money where their mouth is", and what consequences will they suffer for failing to fund the company as promised?

A Shareholders Agreement can also document critical agreements relating to dividends, for example the shareholders' agreed approach to retain profits for re-investment into the company's business (rather than the replaceable rules which provide various dividend payment methods including payment of cash).

8. <u>Rights and Obligations</u>

A Shareholders Agreement sets out the company's control, ownership and management. It delegates responsibilities between shareholders and directors. This facilitates efficient operations. For example, without a Shareholders Agreement, the company's time and money can be wasted whilst officeholders seek to clarify who does (and decides) what.

Control, ownership and shareholders

As the name suggests, a Shareholders Agreement is primarily for the benefit of the shareholders, but the company itself obviously obtains many of the benefits mentioned in this paper. As such, a Shareholders Agreement protects and enhances the rights of shareholders over other officeholders such as directors.

A Shareholders Agreement can also assist shareholders in understanding their position in the business. What can (and can't) shareholders do? What rights do they have, and how are these rights restricted? What are their obligations?

A Shareholders Agreement can promote and protect the rights of some shareholders over other shareholders, such as the rights between minority, majority, and classes of shareholders. Importantly, it sets out the critical rights and obligations attaching to shareholders, for example: in relation to voting, dividends, sale/purchase of shares and the issuing of new shares.

If the company already has a Shareholders Agreement (for example, if you are an incoming shareholder), your rights may not be adequately protected because the aims of the shareholders who created that agreement may not have included protecting your rights. In fact, the aims of those original shareholders may well have included specifically restricting any future shareholders' rights! An incoming shareholder should carefully consider their rights in the constitution (or the Corporations Act's "replaceable rules" if no constitution exists) and whether they are comfortable with those rights. Any potential incoming shareholder should also look at the terms of any existing Shareholders Agreement relating to issuing new shares, or the sale/purchase of shares, as appropriate to their circumstances.

Management, operation and directors

A Shareholders Agreement should include fundamental information such as the details of the directors, as well as more complex mechanisms such as the circumstances in which directors can be appointed, replaced and removed.

Another issue to consider is the entitlement of shareholders to be directors or appoint a director as their nominee. For example, do you want all shareholders to be entitled to be directors (or nominate a director on their behalf), or should this important power only be limited to shareholders with a particular minimum percentage of shares in the company?

A Shareholders Agreement can, for example, set out the board of directors' responsibilities, the frequency of meetings, circumstances when a unanimous decision is required and provisions to break any deadlock or dispute between the directors.

9. <u>Cost effective</u>

The initial costs of preparing a Shareholders Agreement are ordinarily far less than the costs the shareholders incur (let alone the cost and damage to the company) when embroiled in protracted legal proceedings relating to a shareholder dispute.

As such, a well-drafted Shareholders Agreement can avoid significant external and internal costs, loss and damage.

10. <u>What if I don't have a Shareholders Agreement (or I'm unhappy with the terms of the Constitution or replaceable rules)?</u>

Without a Shareholders Agreement, a shareholders' rights and duties are governed by general, broad legal principles found in the *Corporations Act 2001*, the common law, and the company Constitution (if one exists). Does your company have a Constitution? If not, the replaceable rules provided by the *Corporations Act 2001* will apply.

If the company has neither a Shareholders Agreement nor a company Constitution, then the shareholders' rights and obligations are found in the *Corporations Act 2001* (the "replaceable rules") and the common law. As most shareholders are laypersons, not lawyers, and would not be familiar with these laws, it is highly recommended that any company has both a customised company Constitution and Shareholders Agreement.

A company's internal management may be governed by a Constitution, by provisions of the *Corporations Act 2001* that apply to the company as replaceable rules, or by a combination of both. There are additional rules about internal management in the ordinary provisions of the *Corporations Act 2001* and also in the common law.

If the replaceable rules apply, the shareholders need to review these rules, identify their statutory rights and obligations, and consider whether they are comfortable with same.

Any potential shareholder should similarly consider (carefully) any company Constitution: review the document, identify their rights and obligations as a shareholder, and consider whether they are comfortable with them and, if not, a Shareholders Agreement should be seriously considered and proposed.

As a shareholder, you need a Shareholders Agreement because, without one, the company Constitution (or replaceable rules) may not satisfactorily protect your rights.

Amendments and inconsistencies

So, a Shareholders Agreement can protect and enhance your rights as a shareholder, by way of including clauses ordinarily not included in a company Constitution (or the replaceable rules). But, can it go further than this? Can you include terms that are inconsistent with – yet prevail over – terms of a company Constitution (or the replaceable rules)? Can it effectively amend the Constitution (or the replaceable rules)?

This inconsistency problem will occur where the same topic/term is included in both documents in such a way that the documents cannot be read together and there is an irreconcilable clash/conflict or ambiguity.

If there are any such inconsistencies, can you require the Constitution (or replaceable rules) to be amended in order to avoid the conflict or ambiguity?

The answer depends on your circumstances. For example, a company with no Constitution nor Shareholders Agreement should create a Constitution including terms that the replaceable rules do not apply and terms consistent with the proposed Shareholders Agreement. A company with a Constitution should amend the Constitution so that it is consistent with the proposed Shareholders Agreement.

You should also include an “inconsistency” (or “conflict”) clause in your Shareholders Agreement. The classic example of that clause looks like this:

> *Where there is any conflict between the provisions of this Agreement and the Constitution of the Company, the provisions of this Agreement will prevail and upon a written request being referred from any party, all parties must cause the Constitution of the Company to be amended in order to remove the conflict.*

This is a “classic example” because it’s taken straight from the authoritative NSW Supreme Court case on point. In 2014 a single judge in that Court made a decision relating to the above clause. The parties to the litigation both agreed that the clause prevailed over the Constitution (hence perhaps there is some degree of a misconception behind the purported strength of such clause), but the judge importantly “*expressed some doubt that a shareholders’ agreement could control the constitution in this way*”. Ultimately, the judge did not have to make a decision as to whether this clause alone did as the parties intended because the Shareholders Agreement could be read together with the Constitution and there was no inconsistency between the relevant topics/terms.

To overcome this potential problem, in addition to including an “inconsistency” (or “conflict”) clause in your Shareholders Agreement you should also amend the company Constitution to reflect this intention. A company may modify its Constitution by special resolution.

The parties should amend the Constitution in order to remove the conflicts or inconsistencies that exist between the two documents. Alternatively, both the Constitution and the Shareholders Agreement should have legally drafted provisions to the following effect: that in the event of any inconsistency, conflict or ambiguity between the two documents, then (for example) the terms of the Shareholders Agreement shall prevail.

A common misconception is that an inconsistency/conflict clause in and of itself in a Shareholders Agreement will prevail over a Constitution (or the replaceable rules) in the event of an inconsistency, **but it won’t!**

Finally, please remember that unless the Constitution is prepared properly, a company can be governed by a combination of the Constitution and the replaceable rules (in addition to any Shareholders Agreement). This should obviously be avoided.