Commercial Insights

The importance of an up to date and relevant shareholders' agreement

A shareholders' agreement is a contract between a company's shareholders (sometimes the company itself is also a party), setting out the rights and obligations of the shareholders in relation to the affairs of the company and how it is to be managed. If the company is the trustee of a unit trust the agreement relates not only to the shares in the trustee company but the units in the unit trust. In this article, the reference to shareholders' agreements refers to agreements that regulate both kinds of business structure.

We regularly assist shareholders who fall into dispute in circumstances where they did not enter into a shareholders' agreement, or the agreement they did enter into is ambiguous, and over time their views about the affairs of the company, or their involvement in it, have diverged. Company law is complex and disputes between shareholders and directors can cause substantial disruption and expense. That is why we always recommend to our clients that they enter into a shareholders' agreement <u>before</u> they start business together.

The importance of having a shareholders' agreement

A shareholders' agreement usually operates in conjunction with a company's constitution and, where there is conflict or inconsistency between the two, the shareholders' agreement should contain a term providing that it prevails over the constitution.

In closely-held proprietary companies we recommend that shareholders do not simply rely upon the company's constitution as their only contract regarding the affairs of the company. These documents are usually 'off the shelf' documents that adopt a 'one size fits all' approach, and do not deal with a range of matters that a well-drafted shareholders' agreement does. Furthermore, a shareholders' agreement will usually cover specific business and shareholder requirements.

Important parts of a shareholders' agreement at a minimum

Shareholders' agreements should include provisions relating to decision making. They should detail decisions that can be made by the directors of the company and those that must be approved by shareholders. For decisions that can only be made by shareholders, the shareholders' agreement may also contain provisions relating to whether a matter can be passed by ordinary resolution (more than 50% of votes) or by special resolution (75% or more of votes). Some shareholders' agreements also specify whether matters of significance require a special majority (including unanimity) of directors for the passage of the resolution.

A shareholders' agreement may also include provisions for resolving deadlocks. This is particularly important for small companies where there is an equal number of shareholders and directors. Deadlock provisions may not be appropriate where there are majority and minority shareholders. Well drafted exit mechanisms will sometimes be a better means of providing the parties with the incentive to resolve their disputes.

Whether a shareholder is entitled to be, or to appoint, a director should also be addressed in a shareholders' agreement. Some shareholders' agreements provide that a minority shareholder is not entitled to appoint a director to the board until the shareholder holds a minimum threshold of shares in the company (for example, 20%). Where the shareholding is equal you would typically expect that each shareholder is entitled to appoint a director, and the agreement should provide for this.

A shareholders' agreement should deal with issuing new shares and selling shares and also deal with how the company can raise finance and in particular, circumstances in which finance can be raised through equity. Whether a share issue can be approved by an ordinary resolution of the directors (which is the standard position under the Corporations Act and a standard constitution), or requires a special or unanimous resolution of the directors or shareholders, will depend on the dynamics of the company's share register and the nature of the relationship between the parties.

It is critical that a shareholders' agreement includes mechanisms for the disposal by a shareholder of their shares. Some agreements include pre-emption rights, while others provide that the continuing shareholder or shareholders have an option to purchase the outgoing shareholder's shares. The appropriate management of shareholder exit is important – whether caused by unexpected events (death or TPD), default or retirement.

A common area of dispute is, unsurprisingly, the value of the exiting shareholder's shares. A good shareholders' agreement will include a clear process for the valuation of the shares if the parties cannot agree.

In some start-up businesses, where the founding shareholders have a medium to long term plan to build goodwill and then sell by way of a trade sale or IPO, the shareholders' agreement will include what are known as 'drag along and tag along' provisions, designed to ensure that minority interests cannot veto the founders' exit plans.

The matters referred to above may sound straight forward, and in some respects they are. However, it is these types of matters which, if not dealt with in an appropriately and well drafted shareholders' agreement, can result in costly disputes.

Reviewing your existing shareholders' agreement

It is not uncommon for companies to develop over time in ways that were not originally expected. Circumstances change and expectations change. It is worthwhile regularly reviewing your existing shareholders' agreement in order to determine whether any new provisions need to be added or whether any changes should be made to reflect and appropriately address changed circumstances. It is usually easier to agree on changes to documents of this kind if there is a regular process of review rather than leaving the review during a dispute.

March 2021

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