The Complete Guide to Shareholders Agreements

A white paper by Martin Checketts
— Partner, Mills Oakley Lawyers

March 2010

www.thestrategicexit.com

Business co-owners – have you been thinking about putting in place a shareholders agreement, but don't know where to start?

Have you been told by your lawyer that you need one of these documents, but don't really understand why?

Or, come on, let's say it less euphemistically – why would you go and put a significant sum of money in your lawyer's pocket for a document like this? Won't it just be shoved in the filing cabinet and forgotten about? At the end of the day, why would you bother?

In this white paper I will:

- answer your questions about shareholders agreements
- use simple language to guide you through the main clauses and concepts
- put you in a position of knowledge, so that you may have a well-informed discussion with your co-shareholders, or instruct your lawyer to get started.

Now this is perhaps a bold ambition, but I am aiming not only to convince you that you really do need a shareholders agreement, but also to *make you so well prepared that you will save time and money when instructing your lawyer to draft it.*

So, in this white paper I will not only provide you with substantive information, but will also give you some hints and tips on how to instruct your lawyer efficiently and effectively. In this way, you can hopefully maximise the benefit of the time that you spend with him or her.

As you will appreciate, the information in this white paper is of a general nature only. It is not a substitute for individual legal advice.

What is a shareholders agreement?

A shareholders agreement is a contract between you and the other shareholders in your private company.

It is designed to govern the ongoing ownership and management of your company, addressing issues such as:

1. exit mechanisms (both for individual shareholders, and when you sell the entire business)
2. decision making
3. dividend policy
4. board and shareholders meetings
5. restraint of trade (preventing shareholders from establishing a competing business or soliciting customers or employees)
6. protecting confidential information and intellectual property rights.

Some other types of document that perform a similar function to a shareholders agreement are:

- a partnership agreement (if you run your business through a partnership structure)
- a unitholders agreement (if you run your business through a unit trust structure).

So, if you are a co-owner of a business which has one of these alternative structures, don't stop reading! Most of the information in this white paper will still be useful to you.

Why do you need a shareholders agreement?

If you don't have a shareholders agreement, the rights and obligations of the shareholders in your company will be governed by the (usually standard, off the shelf) constitution of your company, or by the general law.

This fact alone can give you – and I am not exaggerating here – *a terrible outcome* should you end up in a dispute with your co-shareholders, or if an unforseen event such as death or total and permanent disablement occurs.

As you may know, the legal profession unfortunately has a reputation for equivocation and 'fence sitting'. That said, in my capacity as a lawyer, here is one iron-clad assurance that I am more than willing to provide you – I guarantee that it will *always cost you more* to resolve these disputes through the courts than it will cost you to put a shareholders agreement in place to ensure that they never arise.

In my legal practice, I have lost count of the number of clients who come into my office and tell me a story along the following lines:

(a) I am a major shareholder in a private company.

(b) My co-shareholder is lazy / incompetent / has lost his or her mojo / is more interested in other activities than our business *[delete as appropriate]*. Whatever the reason, they are just not contributing.

(c) I don't want them working in the business, and I want to get back their shares

(d) I don't want them approaching our customers and employees after they have moved on

(e) *(and – clang! – here it comes…)* we have no shareholders agreement.

Or, the alternative scenario to paragraph (e) is that the major shareholder pulls out a dog-eared, skinny, and poorly drafted shareholders agreement that their local lawyer prepared 15 years ago when the business was first set up. And believe me, whilst that lawyer may have known a lot about conveyancing, wills, road traffic offences and the like, it quickly becomes apparent that drafting commercial documents was not their strong point. More often than not, the document is full of more holes than Swiss cheese, and is quite inadequate to protect the major shareholder's interests in this difficult situation.

Whilst, depending on the circumstances, there may be some legal angles that we can explore to assist the major shareholder in this common but unfortunate situation, my answer is usually exactly the same.

First, I have to let the major shareholder know that they have no contractual or other legal mechanisms to force their co-shareholder to sell their shares.

Secondly, because of this fact, I break the bad news that they will probably have to pay their co-shareholder well over the odds, and suffer considerable further pain, to make this problem go away.

There is then a simple decision to make – will the major shareholder pay me to 'go aggressive' and fight their co-shareholder through the courts, or will they try to do a deal? Or, will they look to take the Armageddon approach of winding up the company?

My rough guesstimate, which I would hasten to add is based on experience rather than any rigorous analysis, is that most major shareholders who are in this position end up paying a premium of somewhere between 20% and 50% above the actual value of their co-shareholder's shares in order to buy them out and make this problem go away. They may then be up for an additional severance or redundancy payment, plus legal costs.

In this situation, the lazy / incompetent / distracted co-shareholder unfortunately just holds so many cards. They cannot be compelled to sell their shares in your company. They are not bound by restraint of trade obligations to prevent them from setting up a competing business or approaching clients following the termination of their employment. And, they have the full suite of minority shareholders rights, such as the right not to suffer oppressive treatment and the right to attend and vote at general meetings. If they are well advised, they will trumpet those rights aggressively, and become a thorn in your side until you buckle under the pressure and make a 'knock out' offer to buy their shares.

Similar issues can also play out upon the death, retirement, or total and permanent disablement of one of your co-shareholders.

Exit mechanisms

The above paragraphs highlight what is, to me, the biggest reason for putting in place a robust shareholders agreement – *it is seriously useful in governing the orderly exit of co-owners should the need arise.*

In that context, here are the main clauses and concepts that you should know about:

1. Linking share ownership to employment

In a private or family company where the shareholders work in the business, you generally need to link share ownership to the ongoing employment of each shareholder.

So, if a shareholder is dismissed or resigns from their employment, they will also be obliged to sell their shares to the remaining shareholders.

This type of mechanism is particularly important in the case of employees who are being sold or given shares as a reward for strong performance, or in order to 'lock them in'.

The next thing that you need to think about is at what price will the shares be sold upon the termination of employment? In particular, will they be sold at market value, or at a discount to market value? How will that value (and / or discount) be determined? And, will the full sale price be payable upfront, or in 'chunks' over a period of time?

Sometimes, the reason for the termination of an employee shareholder's employment is a relevant factor in deciding how much they will be paid.

For example, if an employee shareholder is retiring after many years of loyal service, he or she may perhaps expect to sell on more favourable terms than if his or her employment was terminated for gross misconduct. Clauses that link the departing shareholder's sale price to the circumstances that surround the termination of their employment are sometimes called 'good leaver / bad leaver provisions'.

2. Death or total and permanent disablement

Always think carefully about what would happen upon the death or total and permanent disablement ('TPD') of a shareholder. In particular, should this trigger the forced sale of their shares to the other shareholders? If so, on what terms?

You should also consider whether ownership protection insurance may be useful. An ownership protection policy pays out upon the death or TPD of a shareholder in a private company, and funds the acquisition of their shares by the remaining shareholders. You may also choose to extend this insurance cover to trauma events such as a non-fatal stroke or heart attack.

Through the use of ownership protection insurance, you can derive enormous peace of mind from the knowledge that, if you die or suffer a TPD event, the purchase of your shares will be funded for the benefit of your family. And, for the remaining shareholders, they will not have to be in business ongoing with your widow or widower.

Your financial planner can provide you with some seriously useful advice about these kinds of policy. For your own comfort, make sure that you find one who is a specialist in this area. Tax advice is also important to ensure that the insurances and associated contractual rights are structured appropriately.

3. Drag along rights

You will need to give thought to the situation where a third party makes an offer to buy your entire company.

In particular, you may wish your shareholders agreement to provide that those who hold (say) more than 50% of the shares have the right to require *all shareholders* to sell to that third party buyer. This is what is known as a 'drag along right' (or, sometimes, a 'come along right').

In a drag along scenario, the minor shareholders would generally sell at exactly the same price per share as the major shareholders. In this way, even though the timing of the sale is outside their control, they are not disadvantaged from a value perspective.

A drag along right is a very useful mechanism for the major shareholders. This is because it allows them to control the exit process. As you will appreciate, the third party buyer will generally not be interested in buying only part of your company. The buyer will normally want to acquire 100%, and a drag along right enables the major shareholders to make this happen.

Sometimes, additional ‘bells and whistles’ are negotiated for the drag along right, for example:

- an obligation for the major shareholders to offer their shares to the minor shareholders at the ‘drag along’ price before they are entitled to force a sale of the entire company to a third party
- a minimum sale price which must be achieved before the drag along right can be exercised
- an initial time period before the drag along right can be exercised (say, two years from the date upon which the company is registered).

4. Pre-emption rights

Another important concept that you need to understand is the ‘pre-emption right’.

A pre-emption right is a right for the existing shareholders to buy the shares of a shareholder who wishes to sell, before those shares can be offered for sale to a third party. Pre-emption rights are therefore an important mechanism to prevent the shares in your company being sold outside the existing shareholder group.

When considering the pre-emption rights for your shareholders agreement, here are the main things that you should think about:

- How will the sale price be prescribed or determined?
- If the other shareholders do not buy the selling shareholder’s shares pursuant to their pre-emption right, should there be any further limitations on the selling shareholder’s ability to sell to a third party? For example, would the identity of the third party buyer need to be approved by the other shareholders (with such approval not to be unreasonably withheld or delayed)?

Decision making

Decision making provisions are another important aspect of most shareholders agreements.

These clauses are mainly for the benefit of the minority shareholders. This is because the major shareholders generally have wide-ranging rights to pass resolutions and exert control over the company purely by virtue of their relative percentage shareholding.

So, if you are a minority shareholder, you should be pretty focussed on negotiating some good protections to ensure that you have the right to participate in major commercial decisions.

For example, you could negotiate a clause which prescribes that certain critical decisions must be passed by unanimous resolution of all shareholders. The list of critical decisions could include, for example:

- winding up the company
- employing senior staff members who are paid more than a certain prescribed amount per year
- issuing new shares to a third party
- buying another business
- establishing a new subsidiary
- appointing a director
- selling the business (or any material part of it)

Or, instead of a unanimous resolution, sometimes a special resolution (ie 75%) of shareholders is appropriate.

Appointing directors

Your shareholders agreement may contain rights for each shareholder to appoint a director.

Or, the right to appoint a director could apply only to those shareholders who hold a certain percentage of the company's shares (say 20% or more).

Board and shareholders meetings

Your shareholders agreement may prescribe how often board and shareholders meetings will occur, and how many people are required to form a quorum.

Restraint of trade

One crucial aspect of any shareholders agreement is the restraint of trade clauses.

These are clauses that are designed to prevent shareholders from setting up in competition, soliciting customers, or soliciting key staff away from your business, both whilst they hold shares and also for a certain time period after they cease to be a shareholder.

Without these clauses, departing shareholders can be extremely dangerous and cause significant damage to your business.

One really good reason for putting restraint of trade clauses in a shareholders agreement, in addition to the employment agreements of shareholders who work in the business, is that the prospect of enforcing these clauses is generally better in a shareholders agreement. *So why is this?* I hear you say.

As you may know, the general principle that the Courts apply is that a restraint of trade clause is *void and unenforceable unless you can prove that the clause is reasonable in all the circumstances.*

This is because it is considered to be against public policy to prevent someone from earning a living or plying their trade without having a compelling reason to justify this.

The approach that the Courts normally take is to apply a higher standard of reasonableness to restraints that are contained in an employment agreement than to restraints that are contained in a shareholders agreement.

This is because, in an employment situation, there is generally deemed to be an inequality of bargaining power between the employer and the employee. When you start work, you are handed a standard form employment agreement and are asked to sign it. If you don't sign, you don't get the job.

Contrast this with a shareholders agreement. A shareholders agreement is a commercial document which is tailored to your business and is usually negotiated in detail between all parties with the benefit of legal advice. The shareholders are not just employees, they are business owners who know what they are getting themselves into.

So, you can derive some serious comfort through including well drafted restraint of trade provisions in your shareholders agreement.

The alternative is to 'roll the dice', cross your fingers, and hope that the restraints in your co-shareholder's employment agreement will stand up.

A final tip for the unwary is to ensure that each shareholder is *personally bound* by the restraint of trade obligations in your shareholders agreement. This means that they should each sign the restraints in their personal capacity, and not just via the investing vehicles through which they hold their shares in the company. If shareholders are not personally bound by the restraints, then you may experience enforcement difficulties.

Dividend policy

For many shareholders, and particularly minor shareholders, it is important to enshrine a dividend policy in your shareholders agreement.

So, for example, your shareholders agreement might provide that (say) at least 50% of all profits (after appropriate retentions for working capital and the like as determined by the Board) will be distributed on a quarterly basis. You might also prescribe that the dividend policy may only be varied by (say) a special resolution of shareholders.

These provisions can be particularly important where one shareholder has recently bought into the business using debt funding, and therefore wishes to be sure of a regular dividend stream in order to fund their interest payments.

Funding requirements and new shareholders

Your shareholders agreement will normally address how any new capital is to be contributed by the shareholders.

For example, it may set out the basis and terms upon which any shareholder loans are to be made, or the basis and terms upon which shareholders may subscribe for new shares.

If a new shareholder is to buy into the business, this would normally be a decision that is reserved for a unanimous or special resolution of the shareholders. That new shareholder would also normally be obliged to sign a 'deed of accession', which binds them to the terms of your shareholders agreement.

Hints and tips on how to instruct your lawyer effectively

So, assuming that I have been able to convince you that putting a shareholders agreement in place is a good idea, how do you best go about this?

First, find a lawyer who can demonstrate to you that he or she regularly advises on this type of document. *And I mean regularly.* Not just once a year or so as part of a more general practice.

If your lawyer doesn't have this level of experience, you will be paying for him or her to learn on the job. And, your shareholders agreement is likely to be of inferior quality.

Secondly, the key to saving time and legal costs is in ensuring that you instruct your lawyer effectively. *It is all about you, your co-shareholders, and your lawyer working efficiently together.*

The main way in which I have seen lawyers and clients get this wrong and create cost 'blow outs' is by moving too quickly to preparing the first draft of the shareholders agreement. They jump into the drafting straight away, before going through a rigorous process of discussing and agreeing all issues with the shareholder group. Then, when they serve up the first draft, the shareholders start negotiating and requesting changes. This turns into a merry-go-round of continual amendments, with your lawyer charging you for each and every redraft.

In contrast, the approach that I now take when drafting a shareholders agreement is to seek agreement between the shareholders on every single major term upfront, before lifting the drafting pen. So, we discuss, workshop and reach consensus on everything upfront. This often takes some time – maybe two or three long meetings with all shareholders present at which the issues are tabled and discussed in detail. It can also be really useful to include other professional advisers in this process, such as your accountant or financial planner.

Once we have workshopped and reached a considered consensus on all issues, I prepare a short (one or two page) heads of agreement to reflect what has been agreed. The shareholders then all sign the heads of agreement to confirm what they have agreed in principle. Only then do I start drafting the shareholders agreement.

By taking this approach, I find that I can produce a first draft shareholders agreement which is about 95% complete straight off. There is then generally only one round of minor amendments required before your document is finalised for signature.

***Martin Checketts** is a partner in the corporate advisory team of Mills Oakley Lawyers. He is the author of 'The Strategic Exit – how to maximise value on the sale or transition of your business'.*

*For more useful business succession information and tools, please visit Martin's website **www.thestrategicexit.com** or contact him on **mchecketts@millsoakley.com.au.***