NEGOTIATING SHAREHOLDER EXITS: WHAT ARE YOUR OPTIONS?

In this article we consider the options available to a shareholder who wishes to dispose of their interest in a proprietary limited company.

As a shareholder of a proprietary limited company, you might be looking to dispose of your shares for a variety of reasons – you might be an employee shareholder leaving the company, considering retirement or redundancy, you might be facing bankruptcy or liquidation, considering other investment opportunities or you may simply wish to reduce your exposure to an under-performing company.

The starting point

1. The Shareholders' Agreement

To work out your options in each scenario, the starting point should always be to identify whether the company has a shareholders' agreement in place.

A shareholders' agreement is a legally binding contract between the company and shareholders. It sets out the rights and obligations of each party and will typically include a procedure which sets out:

- how shareholders can sell, transfer or dispose of shares;
- where shareholders are obliged to sell their shares; and
- where the company may elect to buy-back their shares.

If a shareholder wishes to sell its shares, the shareholders' agreement will usually include "pre-emptive rights" so that existing shareholders are offered the opportunity to buy shares before third parties are able to buy the shares. The selling shareholder might set the price and terms of payment (which will usually reflect price and terms which would be acceptable to a third party), the shares will then be offered to the other shareholders for the same price and terms, and they will be able to acquire the shares in the same proportion as their current holdings.

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If the other shareholders do not want to acquire the selling shareholder's shares, then it is possible for those shares to be offered to a third party on the same terms and for the same price. However, many shareholders' agreements require directors' consent to the new shareholder and it is usually a requirement for the new shareholder to agree to be bound by the shareholders' agreement before the shares are transferred.

These restrictions make it very difficult for the selling shareholder to simply sell its shares to any willing investor. The restrictions protect the on-going shareholders from being forced to buy the shares at any price and from being saddled with a new shareholder who is not desirable (for commercial or other reasons).

Most shareholders' agreements contain provisions which give shareholders the option to buy shares from an existing shareholder if certain events (trigger events) occur. In the case of an employee shareholder, a trigger event would include termination of employment, whether by retirement, redundancy or termination for cause. In all cases, the remaining shareholders will have a call option to buy the exiting shareholder's shares at a pre-determined price. That price might be the market value of the shares determined by an independent valuer or by way of a formula contained in the shareholders' agreement. The price might also be affected by whether the termination is considered a "good leaver" or a "bad leaver" event.

These provisions are again for the benefit of the remaining shareholders, if a trigger event occurs they are not obliged to buy the shares but may elect to do so. This result would be different if the shareholders' agreement also contained a put option where the exiting shareholder has a right to sell its shares to the other shareholders if certain trigger events occur. For example, the shareholders could agree that should a "good leaver" event (such retirement or redundancy) occur, the exiting shareholder has the right to force the continuing shareholders to buy its shares at the pre-determined price. This might also include a period of time over which the price is to be paid so as not to put too much of a financial burden on the continuing shareholders.

A put option is of great assistance to a shareholder employee who wishes to retire or is made redundant, and these types of clauses could also be used for trigger events such as death, total and permanent disablement or trauma. All shareholders should consider the advantage of having a put option clause in the shareholders' agreement but, of course, it works both ways.

The shareholders' agreement might also include drag-along clauses, which force minor shareholders to sell their shares where the majority shareholders wish to sell their shares to a third party, or tag-along clauses which give minor shareholders the right to sell their shares if a third party is wanting to buy the shares of the majority shareholders.

The shareholders' agreement might also provide for the company to buy-back shares in certain circumstances. For example, it may be an option for the company to buy -back the shares if a buyer cannot be found through the pre-emptive rights procedure.

The ability to sell shares in a Pty Ltd company is always an issue. There is usually only a very small market for the sale of a minority share in such companies and usually the on-going shareholders will want to have a say in whom can buy those shares. It is therefore important to carefully examine the shareholders' agreement before you take-up that offer to acquire shares in the company.

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2. Constitution

If the Pty Ltd company does not have a shareholders' agreement (or even if it does), the next step is to look at the company's constitution. This document might also contain requirements as to how shares can be transferred. Most constitutions contain pre-emptive rights rules and rules on the buy-back of shares. If a company does not have a constitution, then the Replaceable Rules in the *Corporations Act 2001* (Cth) ("**Corporations Act**") may also have some application. For example, it contains rules for the transfer of shares on death, bankruptcy or mental incapacity.

If there is no shareholders' agreement, after completing the pre-emptive right procedure there is usually no restriction on the sale of shares to third parties as long as it is for the same price and on the same terms offered to the existing shareholders.

While this might seem attractive for a minor shareholder, it should be remembered that in most cases the only people who would be willing to buy your shares are the other shareholders, so you might be left with nowhere to go unless you can force a purchase of your shares through the exercise of a put option contained in the shareholders' agreement.

3. Commercial Negotiation

The alternative to a sale in accordance with the shareholders 'agreement or the constitution is to simply enter into negotiations with the other shareholders. The negotiations will focus on the price to be paid and the terms of payment, both of these factors are often a cause for much debate. Minor shareholders often have an unrealistic view of the value of their shares and major shareholders will often seek to discount the value because of the lack of control over the affairs of the company of a minor shareholder. It is usual to obtain an independent valuation or rely on the formula contained in the shareholders' agreement.

The terms of payment will depend on the amount to be paid and the availability of funds. It is not unusual for the payment to be spread over a number of months. Where this is the case, the seller should consider whether interest and security should be included in the arrangements.

If the company agrees to buy-back your shares, the seller must ensure that proper taxation advice is obtained. In some circumstances, the profit component attached to the buy-back price can be regarded as a deemed dividend, which can result in a higher tax cost for the transaction.

Conclusions

Being a minor shareholder in a Pty Ltd company will allow you to share in the distribution of profits and benefit from any capital growth in the shares. However, difficulties often arise when a minor shareholder wants to sell the shares. It might not be a convenient time for the other shareholders to buy the shares and it will usually be very difficult to sell small parcels of shares to third parties. It is also likely that the directors will have a say in who can buy those shares.

A shareholders' agreement is essential. It provides protections to all shareholders and can provide reasonable procedures for the purchase of shares when a trigger event occurs. If you

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are being offered shares in a Pty Ltd company, you should insist that a shareholders' agreement be put in place.

Note: The above is a summary for general information purposes only. It is not intended to be comprehensive or constitute legal advice. You should seek formal legal or other professional advice in relation to your particular circumstances before relying on the content of this article.

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