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TIME TO SHARE – A NOTE ON THE IMPORTANCE OF SHAREHOLDERS' AGREEMENTS

Friends and potential business partners enter into ventures with the best intentions and with the mindset that should a dispute arise, they will be able to resolve it in an amicable manner. Unfortunately, this is not always the case. Whenever you approach a lawyer regarding a dispute with a co-shareholder, one of the first questions you will be asked is "is there a shareholders' agreement in place?".

We understand that when you start a company and a new business venture, you try and keep start-up costs to a minimum. However, in the event of a dispute between shareholders in the distant future, the costs associated with drafting and executing a shareholders' agreement will seem minuscule in comparison to costs associated with lengthy battles and litigation with your co-shareholder.

Shareholders' agreements govern the way the company conducts business and they make, amongst other things, provision for scenarios where disputes arise or where a party wishes to sell their shares or exit the business. Shareholders' agreements are flexible and can be tailored to the shareholders' exact needs and wishes. Here are some provisions that could be included in a shareholders' agreement:

Management, Funding and Dividends

The shareholders' agreement can make provision for the management of the company and operations of the business. It can govern the composition of the board of directors, the frequency of board meetings, the quorum and voting rights at board meetings, as well as to specify which matters require special or unanimous resolutions. The shareholders' agreement can make provisions for how and when initial and additional working capital is to be sourced from the shareholders directly or from third parties. It can also make provision for how regular dividends are to be paid to shareholders.

Sale and Issue of Shares

It is common for companies to offer shares to employees who have been employed for several years or who meet certain milestones or targets. If that is the case, it is important to include pre-emptive rights provisions in the shareholders' agreement to ensure that if the employee wishes to sell his or her shares either the company can buy-back the employee's shares or the remaining shareholders can buy the employee's shares. The transfer or issue of shares should always be subject to board approval and any new shareholder should be obliged to sign up to the shareholders' agreement before acquiring shares in the company.

Trigger Events and Events of Default

Shareholders' agreements could include events where a shareholder is required to sell his or her shares back to the company or the other shareholders. Such events could include death, disability, mental incapacity, resignation, dismissal, insolvency events, conviction of an indictable offence, legal separation, or divorce. The exiting shareholder will be required to sell his or her shares back to the company or remaining shareholders for a purchase price agreed in the shareholders' agreement. The shareholders' agreement can also make provision for a penalty to apply in certain scenarios. For example, where a shareholder or their respective nominated director leaves the company within 3 years, the shareholder may only be entitled to 80% of the purchase price or market value for his or her shares.

Tag Along and Drag Along Rights

Tag along provisions apply where a major shareholder wishes to sell his or her shares to a third-party purchaser. In this instance, another shareholder may give notice to the major shareholder that the third party is required to also purchase his or her shares. In effect the shareholder "tags along" with the major shareholder and the major shareholder will be unable to sell his or her shares unless the other shareholder's shares are also purchased by the third-party purchaser.

Drag along provisions apply where a third-party purchaser wishes to purchase all the shares in the company. Without a shareholders' agreement, a minor shareholder (remember the employee example) will be able to stop the sale of the shares, which could result in the minor shareholder demanding an exorbitant price for his or her shares in order for the sale to go through. By having drag along provisions, the major shareholders can "drag along" the minor shareholder to ensure that all the shares in the company are sold without being held to ransom by the minor shareholder.

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Restraints of Trade

To ensure that shareholders and their respective nominated directors act in the best interest of the company during their shareholding and tenure and for a reasonable period thereafter, restraints of trade provisions can be included in the shareholders' agreement. Shareholders' agreements are generally also entered into by the directors of the company and as such the restraints of trade provisions could mirror those contained in their employment contracts.

Calculation of the Contractual Price for Shares

When a shareholder wishes or is required to sell his or her shares to the company or the other shareholders, it is important to have a purchase price that can be determined in accordance with the shareholders' agreement. The method of determination of the purchase price could be any of the following:

<u>Market Value</u>

The parties can agree that in the event of a sale of shares, an accountant or valuer be instructed to provide the company with a market value for the shares. The relevant professional will look at assets, liabilities, income, expenditure, past performance of the company, as well as future prospects. This is a fair method to determine the value of the shares, however it could be a costly exercise to undertake every time a shareholder wishes to sell his or he shares.

<u>Past Performance</u>

The parties can agree that the value of the shares will be determined by considering the performance of the company for example over the past 3 years. This could be seen as an incentive to some shareholders to sell their shares when the company has made good profits over the last 3 years, but future prospects seem bleak (think Covid-19 or the GFC).

<u>Fixed Amount</u>

Another option is for the parties to agree on a fixed amount. For example, the purchase price for a share in the company is $100 and upon departure of a shareholder, that shareholder will receive a $100 for each of his or her shares.

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Dispute Resolutions

In the event of a dispute between shareholders, the shareholders' agreement could stipulate the process for the dispute to be resolved. These provisions could include how notices should be sent between the parties, whether or not a mediator and / or arbitrator should be appointed and who will be responsible to bear the costs associated with the dispute resolution process.

Shareholders' agreements are often overlooked or rejected in order to save costs. We strongly recommend that potential business partners or existing shareholders consider drafting and executing a shareholders' agreement. The agreement will provide guidance to the parties and will assist greatly in the event of a dispute or a shareholder not pulling their weight for the greater good of the company and its stakeholders. The principles above also apply to unit trusts, so please consider a unitholders' agreement if you intend to establish a unit trust or if you hold units in an existing unit trust.

For further information or assistance contact Murfett Legal on +61 8 9388 3100.

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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