Shareholders' agreements for new companies and start-ups

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- A shareholders' agreement allows shareholders to regulate in great detail all aspects of the company's management and control.
- A shareholders' agreement can set qualifications of directors and their term, who elects them and how they can be removed.
- Shareholders' agreements can determine which decisions are reserved for shareholders and which are delegated to directors.

Shareholders' agreements are essential tools for ensuring that relationships in closely held companies are conducted on appropriate terms, while also providing protection for shareholders. Failing to enter into a shareholders' agreement appropriate for the nature of a given company can result in serious problems down the track, including unwanted new shareholders becoming involved against the wishes of existing shareholders, an inequitable bearing of ongoing funding requirements and loss of rights available to minority shareholders.

An appropriate shareholders' agreement can also be an essential element of provision of private equity funding.

Well-drafted shareholders' agreements help to manage disputes and control risks

The discipline to implement a shareholders' agreement can be important for new companies to align shareholders' objectives and expectations with the business plan and to confirm short, medium and long-term business goals. Often, when commencing a new business, promoters are unwilling to direct their minds to provisions that control their mutual exercise of rights, dispute resolution and breakdown of their relationship. However, failure to provide for these circumstances can be a costly and time-consuming mistake.

Investors and shareholders may have different investment goals

Founding shareholders often imagine their business to be a long-term investment and want to manage for long-term growth. Third-party investors may share the founders' optimism in the company's future, but are interested in shorter-term profits, dividends and an ability to sell their shares (at profit).

Other investors may seek to use their investment to influence the company's business plans as a primary objective. Friends and family may become shareholders to support the participants and expect a passive role sharing in any success of the business.

The purpose of the shareholders' agreement is to balance these conflicting interests so as to avoid future conflict.

The basics around company ownership and management

A company is owned by its shareholders, but management power is legally vested in the directors.

Shareholders may manage a company directly, where shareholders and directors are synonymous. However, where shareholders and directors are not mirror images (eg where there are 'passive' investors), shareholders rely on company directors to run the business, taking their interests into account.

Directors are elected by shareholders. A director may or may not be a shareholder. In many cases, non-shareholder directors, or 'independent directors' are appointed to bring a fresh perspective on management. This can be confirmed in a shareholders' agreement.

Directors have obligations imposed by law as to corporate governance and compliance. Directors may directly manage a company's day-to-day operations themselves, or may appoint an executive (a managing director or a chief executive officer) to manage the day-to-day affairs of the company. The executive may be authorised to hire a team to operate the company. The leader of the executive team usually reports to the board of directors, the latter retaining overall control over the company and having ultimate legal responsibility as fiduciaries for conduct of the company's affairs.

What is a shareholders' agreement? And does your company need one?

The *Corporations Act 2001* (Corporations Act) regulates all Australian companies. The Act defines the rights and obligations of shareholders, company directors and officers, and imposes a basic structure pursuant to which shareholders appoint directors to manage companies without further agreement. Many companies regulate their governance using only the provisions of this Act and informal arrangements. The Act contains certain provisions directed at regulating some of the uncertainties, called Replaceable Rules, but they generally do not go far enough to address all relevant issues.

Where a company's shareholders want greater certainty as to the implementation of a certain business plan, composition of management and the management of desired short and long-term objectives, a shareholders' agreement can be useful to provide all shareholders comfort as to the company's direction and management. By way of example, the Corporations Act places no limit on a shareholder selling its shares to someone else, even if the buyer is someone with whom the other shareholders do not wish to associate or to have a say in the composition of the board.

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A shareholders' agreement allows shareholders to regulate in great detail, all aspects of the company's management and control. It can also set out the company's purpose and objectives. It can set out the roles and responsibilities of its shareholders, directors and executives, be an important tool for successful company management and determine when and on what terms shareholders are admitted to or exit the business.

Setting rules in a shareholders' agreement to create more certainty as to mutual rights and responsibilities is very useful when a company is held by few shareholders who work together closely in circumstances similar to business partners, because it is flexible enough to provide for a partnership-like relationship among shareholders, ensuring equal say in things and preventing new persons coming into the business without consent of the other shareholders. It also benefits companies with more diverse shareholders, setting standards that passive shareholders can rely on and allowing passive or minority shareholders access to the board or veto rights over certain important decisions.

Shareholders' agreements are critical when existing shareholders wish to attract additional investment from third parties, who will want structural certainty around mutual rights and responsibilities as a condition of their cash coming in.

Items that might be included in a shareholders' agreement

Shareholders' agreements vary from company to company. There is no 'one size fits all'. Common items to include in shareholders' agreements include:

1. Management power and the company purpose

Shareholders' agreements regulate the management of the company (having regard to the legal obligations of directors), who is going to manage it and what rights they have. It is particularly important to set out the purpose of the company right from the start to focus the minds of the early stage investors. It is important to:

- clearly define the company's business
- address the company's business plan and steps the company must take to achieve its goals
- address the process for reviewing the company's progress against the business plan to allow regular review and evolution of goals.

To this end, detailed provisions are often included around the procedure for adoption and amendment of business plans, as well as actually exhibiting an initial business plan within the shareholders' agreement. With this in place, actions and expenditure outside the budget in the business plan can be controlled.

> Shareholders' agreements can provide mechanisms for ensuring the availability of additional working capital, to be provided under set circumstances by existing shareholders.

2. Directors

In Australia, a proprietary company must have at least one director, but may have as many directors as shareholders agree.

A shareholders' agreement can set qualifications of directors and their term, who elects them and how they can be removed.

The ability to appoint and remove directors is a key management control that can be used to protect minority shareholders, whose relative power to appoint directors may not correspond to their shareholding in the company. Combined with super majority voting rules (see below), guaranteeing board representation is a good way of protecting minority shareholder interests and balancing the power of majority shareholders over them.

3. Timing of board meetings

A shareholders' agreement can set how often a board of directors must meet, who has the right to set the agenda and add agenda items, quorums, and whether there is a chairperson.

4. Majority and super majority voting requirements

Shareholders' agreements can determine which decisions are reserved for shareholders and which are delegated to directors. Major decisions, such as sale of the company, change of business plan and starting litigation, may need approval by both directors and shareholders.

Shareholders' agreements can also define how votes are taken. For instance, is a vote approved on a simple majority or should some decisions be a super majority or even unanimous?

Common majority voting issues include:

- adoption or material revision of the business plan and annual budget
- raising debt or issuance of guarantees
- acquisition, investment or capital expenditure above a certain amount
- IPO, merger or similar
- joint ventures
- asset acquisition or disposal above a certain amount
- accounting policies
- director remuneration
- appointment of CEO and other senior management roles.

Super majority votes are for decisions requiring either unanimous or super majority directors' votes, as they concern fundamental issues, such as:

- change of business, company name or capital structure
- dividends
- variation of rights attached to shares
- classes of securities
- changes to board of directors
- changes to constitution.

Super majority voting arrangements are used to protect minority shareholders, to ensure they have a say in key decisions that affect their investment in the company. They are often used by private equity investors to protect their investment. Absent such provisions, enticing investors to take up minority positions can be very difficult.

5. Changes to shareholders and shareholdings

Defining the process around changing shareholders and shareholdings is important to include, as it allows decisions to be made in a rational manner in times of stress or panic. The shareholders' agreement should set out the process on how and when shares can be transferred and to whom.

Rules are usually included to define how and to whom new shares can be issued. This prevents investors' interests in a company being diluted by the issue of new shares to existing or new shareholders. For example, provisions often require that existing shareholders have the right to take up new shares first, before new investors are offered shares.

Take, for example, a situation where a 50 per cent shareholder who is closely involved in the management of a two-shareholder company suddenly passes away. Absent appropriate provisions in a shareholders' agreement, the shareholder bequeaths their 50 per cent interest in the company's shares to their 16-year-old son. The son is now a 50 per cent business partner with the surviving shareholder, with equal voting rights and an entitlement

to 50 per cent of dividends. One can see how this is not a desirable situation for the remaining shareholder.

6. Dispute resolution

Success in the market often requires decisions to be executed quickly.

Deadlock at board or shareholder level needs to be resolved before the company suffers. Deadlock provisions, such as referral to a committee, mediation, or alternating decision-making, should be considered.

7. Tag-along and drag-along rights

A tag-along right assures all shareholders that if a majority (or a particular shareholder or group) of shareholders sells their stake, minority holders have the right to join the deal and sell their stake at the same terms and conditions as would apply to the selling shareholder.

Drag-along rights are a related right that enables a majority shareholder to force all shareholders to join in the sale of shares, to allow a buyer to buy all outstanding shares. This helps prevent minority shareholders stopping an advantageous sale taking place or exercising a veto as a way of extracting more value for themselves.

8. Company as a party to shareholder agreements

The company may be included as a party to shareholders' agreements. The purpose is to ensure that each individual shareholder obtains rights against the company that it can enforce itself. Such rights usually pertain to access to books and records, maintenance of accounts and maintenance of directors' and officers' insurance.

9. Intellectual property protection

Shareholders' agreements often contain detailed provisions for the use and protection of intellectual property. These are valuable tools in protecting these mission-critical assets and complement corresponding provisions in employment and consultancy agreements, especially where shares are not held by natural persons involved in the business, but by entities controlled by them.

10. Funding

Shareholders' agreements can provide mechanisms for ensuring the availability of additional working capital, to be provided under set circumstances by existing shareholders. This can be important where there is a risk that some shareholders may not want to provide necessary funding. Care needs to be taken to ensure that funding mechanisms do not create an obligation on shareholders to provide funds to a company that can be enforced by an external administrator, as this can negate the benefits of limited liability. However, when properly drafted, funding provisions can create equitable mechanisms for sharing funding obligations among shareholders. ◩

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