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TAXATION & BUSINESS LAW

Shareholders Agreement

In running a company, there are many decisions to make and the interests of many people to balance. A shareholders agreement governs the rights and responsibilities of a company's shareholders and directors.

It also sets out the relationship between shareholders and directors and ensures everyone is on the same page about how the company will be run. The directors and shareholders of your company should understand how decisions are made, who has the authority to make which decisions, and how the shares of the company will be managed.

A good shareholders agreement has been prepared with your individual business in mind and will assist the various stakeholders understand their rights and responsibilities. The process involved when preparing a good shareholders agreement will, of itself, assist in bringing everyone together on the same page.

This guide will explain what the key terms in a shareholders agreement are, including:

- How the board and shareholders will make decisions and conduct meetings;
- Key parties covered by a shareholders agreement;
- How directors are appointed and removed;
- How shares are issued and sold;
- How shareholders and directors resolve issues and disputes;
- The process to sell existing shares;
- What events may lead to a shareholder having sell their shares and leave the company;
- Retention incentives for employee shareholders (i.e vesting and leaving provisions);
- The information that must be provided to shareholders;
- How the company protects itself, such as non-compete clauses and ownership of IP.

Key Parties Covered by a Shareholders Agreement

A shareholders agreement governs the rights and responsibilities of shareholders and directors in the company. It also sets out the relationship between them.

What is a Shareholder?

Shareholders own the shares in a company. Shareholders can be individuals, or they can be entities such as companies. Shareholders are also referred to as the company's 'members'.

The rights that shareholders have are set out in the shareholders agreement. The rights each shareholder has depends on the class of shares they own. If your company has different types of shares, you should look to both the company constitution and the shareholders agreement to determine shareholder rights.

Generally, the company's constitution will set out the specific rights that attach to the different classes.

The shareholders agreement will set out the general rights given to all shareholders, such as:

- decision making or information rights; and
- any other bespoke rights for certain classes of shares, for example veto rights for preference shareholders and founders. A right of veto means that the status quo will continue in the event of disagreement between different classes of shares.

Two common types of shares are 'ordinary shares' and 'preference shares'. Preference shares can have different rights depending on what the company negotiates with the shareholders.

What is a Director?

Directors are responsible for managing a company. A group of directors is referred to as the company's 'board'.

Different types of directors on a company's board play distinct roles in the company and bring different perspectives.

	Role
Executive Director	An executive director describes a director who works in the business and performs day-to-day management functions in the company, for example, the CEO. They have a deep understanding of the business, its strategy and direction.
Non-executive Director	A non-executive director describes a director who does not work in the business. They are often appointed because of their understanding of the industry or their experience successfully running similar businesses.

Representative Director	A representative director is a director that a shareholder appoints to represent their interests. It is common for people with a significant ownership stake to appoint representative directors (for example, original founders or external investors who have a keen interest in the direction of the business).

Key Details About the Shareholders and Directors

A shareholders agreement sets out the details of the company and each shareholder and usually, each director. This is important so that the company and each shareholder have each others' contact details for notices and correspondences. For example, when the board provides notice of an upcoming shareholders meeting.

Your shareholders agreement may present the information of the company, shareholders and directors as follows:

Name and ACN	Contact Person	Address	Email
474 Square Building and Construction Pty Ltd ACN 873 189 766	Martina D'Souza	9 George St, Sydney NSW 2000	info@square.com.au

Shareholder Name	No. of Shares held	Share Class	Percentage of Shares held	Representative Director
Martina D'Souza	80,000	Ordinary Shares	80%	Martina D'Souza
Investor Pty Ltd as trustee for Investor Deals Trust	20,000	Preference Shares	20%	Lola Jeffries
Total	**100,000**		**100%**	

How Directors Are Appointed and Removed

As most company decisions are made by the directors, it is very important to understand who can appoint directors and when they can be removed. This reduces the risk of a dispute arising as to whether a director was properly appointed and therefore has authority to make decisions on behalf of the company. The shareholders agreement will have clauses setting out who can and cannot appoint and remove directors.

Who Can Appoint a Director?

The shareholders agreement will specify who can appoint a director. Common ways for directors to be appointed are as follows:

	Process of Appointment
Appointed by the Board	The shareholders agreement will set out the number of votes required for the board to appoint additional directors at a board meeting. This could be by a simple majority (50% or more in favour), or a higher threshold.
Appointed by the Founders of the Business	It is often practical for founders to also be directors of the company. In order to maintain their control of the company, the shareholders agreement may provide them an *entrenched right* to appoint a director. This means that even if their shareholding gets diluted as new shares are issued or they sell some of their shares, they will still have a seat on the board. Otherwise, a founder may have the right to appoint a director while they hold a certain percentage of shares (e.g 10%). If they dropped below this percentage, they would lose this right and would have to resign as a director.
Appointed by Shareholders	Shareholders may also have the power to appoint a director. For a shareholder who has a large ownership stake in the company, having a right to appoint a director is one of the key ways they can have a say in the company's direction. The shareholders agreement may provide that shareholders with a certain percentage of the shares in the company (e.g. at least 20%) can appoint a director.

How to Appoint a Director

In addition to specifying who can appoint a director, your shareholders agreement will state what is required to appoint a director. For example, specifying whether notice needs to be given or a resolution passed. The typical process in a shareholders agreement for appointing a director is as follows:

(1) **The director writes and signs a consent to act.** This form sets out your first name, date of birth and address, and that you agree to be a director of the company.

(2) **The director delivers the signed for to the company.** We recommend that you deliver the form either in person or via post. But you can also scan and email the form to the company.

(3) **The company approves the director's appointment, often by passing a director's resolution.** Depending on the company constitution and shareholders agreement, the directors usually approve the appointment by passing a director's resolution.

(4) **The company updates ASIC about the appointment and its *Directors' Register.***

How to Remove a Director

A shareholders agreement should also set out how and when directors can be removed. This is important in the case of any disputes and for directors to understand how protected they are in their position.

For example, as a self-appointed director, you will want to know whether only you can remove yourself or whether other directors can choose to remove you.

The shareholders agreement will set out the typical ways in which directors are removed:

(1) **By voluntary resignation**. The shareholders agreement may specify that a director can resign by providing written notice to the company.

(2) **A decision of the board**. The shareholders agreement will set out whether the board can remove directors by a majority vote (more than 50% of votes), or whether a higher approval threshold is required. This generally only applies to the removal of directors who were originally appointed by the board (and not directors appointed by shareholders).

(3) **A decision of the appointing shareholder**. It is common that a representative director can only be removed by their appointing shareholder. This is sometimes known as an entrenched right to appoint a director.

(4) **The shareholders forcibly remove the director.** Your shareholders agreement should also make clear the situations in which the company's shareholders can forcibly remove a director.

Quick Tip*: The Corporations Act contains a replaceable rule that says that directors can be removed by a resolution of the shareholders. If this is not your intention, you must 'replace' the replaceable rules. This is done by including a section in the company's constitution which states that the replaceable rules do not apply.*

To pass a resolution to remove a director from office, you must give a notice of intention to pass this resolution to the company. You must do this at least two months before you schedule the meeting to be held. After the company receives the notice, the company must give the director a copy of the notice as soon as possible. In response, this director has a right to put their case to the shareholders by providing a written statement and speaking at the meeting. The company must circulate this written statement to the shareholders.

Importantly, when a company does not follow these rules, the company will be at fault regardless of whether the company intended to break these rules or was reckless or negligent. This allows an aggrieved director to sue the company.

How Directors and Shareholders Make Decisions

Decisions are made by the directors or shareholders passing resolutions, and the percentage of approval required to pass a certain resolution will depend on the terms of your shareholders agreement. A shareholders agreement should also clearly set out which decisions are made by directors, and which are made by shareholders. This avoids disputes arising as to who has authority to make certain decisions.

For example, a shareholder may disagree with your company's decision to take out a business loan, however this will not be an issue if it is clear in your shareholders agreement that it is the board and not the shareholders who have the authority to make that decision.

Percentage of Votes Needed to Pass a Resolution

Your shareholders agreement will state how many votes are required to pass a resolution to make decisions. Most decisions are made by ordinary resolution of directors. However, your shareholders agreement should specify which critical business matters require a higher threshold of approval by directors (such as by special resolution or unanimous resolution), and which matters require shareholders' approval instead.

Type of Resolution	**Number of Votes**
Ordinary Resolution	Requires the approval of more than 50% of the directors or shareholders holding more than 50% of the shares, who are present at the meeting and entitled to vote.

Special Resolution	Requires the approval of at least 75% of the directors or shareholders holding at least 75% of the shares, present at the meeting and entitled to vote.
Unanimous Resolution	Requires the approval of all the directors or shareholders present at the meeting and entitled to vote.

How Directors Make Decisions

Your shareholders agreement will also set out the process for directors to make decisions.

Unless shareholder approval is required, directors make most of the key decisions in a company, for example, hiring staff or entering into key contracts. When making decisions, directors will need to adhere to their directors duties.

Most director decisions are made by ordinary resolution at a directors meeting, but some decisions may require a higher threshold of director approval. These are usually decisions that have a significant impact on the company. Examples of such decisions include:

- issuing shares in the company;
- taking out a substantial loan or incurring significant expenditure;
- declaring and paying dividends;
- acquiring significant business assets; or
- entering into a material commercial partnership or joint venture.

How Shareholders Make Decisions

Shareholders make decisions by passing resolutions at shareholders meetings. As most decisions are made by directors, shareholders will meet less frequently and only when there is a matter that specifically requires shareholder approval. Your shareholders agreement should set out what these matters are.

For example, they could include:

- amending your company constitution (such as to create a new share class);
- a major change in the direction of the business (for example if your construction business were to no longer be a construction business, but were to become a law firm; or
- winding up the company (such as to appoint an administrator or liquidator to the company).

Replaceable Rules vs Shareholders Agreement

The Corporations Act contains replaceable rules that can impact shareholder and director rights and responsibilities (including decision making). This table outlines the key differences between the replaceable rules and a Shareholders Agreement.

Replaceable Rules and Corporations Act	**Shareholders Agreement**
Shareholders holding more than 50% of the shares can appoint a director.	Director appointment rights can be drafted to suit the needs of your company. For example, each founder may appoint a director regardless of what percentage of shares they hold.
Shareholders holding more than 50% of the shares can remove a director.	Director removal rights can also be drafted to suit the needs of your company. For example, you may want the founder that appoints a director to be the only person able to remove that director.
For a directors meeting to go ahead, two directors must be present.	If your company has more than two directors, it may be important to you that a higher number of directors are in attendance for a meeting to proceed. For example, your shareholders agreement could say that at least 75% of the directors must be present for a meeting to go ahead.
For the directors to pass a matter, more than 50% must agree.	If your company has three directors, you may prefer that all three directors must agree to pass matters. In this case, your shareholders agreement could say that directors decisions must pass by special resolution (75% of the directors) instead. Alternatively, you might be happy for everyday matters to be passed by a simple majority but certain important matters set out in the shareholders agreement to require unanimous approval.
No pre-emptive rights on the sale of shares by shareholders.	When a shareholder wants to sell their shares, you may want to require them to offer those shares to the existing shareholders before they can offer any remaining shares to a third party. This is called a pre-

emptive right, and can be included in a shareholders agreement.

How Shares Are Issued and Sold

Your shareholders agreement will set out the process of how shares are issued and sold. This is important because share issues and sales change the overall structure of your company and can affect shareholder rights. An issue or sale of shares will need to be recorded in the Register of Members and with ASIC.

Example

As the sole shareholder and founder of the company, you may own 80 shares in your company worth $80. You decide to issue 20 shares to a new shareholder in return for $20. This dilutes your ownership percentage from 100% to 80%. Though dilution is not always a bad thing, as now, instead of owning 100% of a company worth $80, you own 80% of a company worth $100. However, the dilution may change your rights as a shareholder. For example, when you owned 100%, you could pass all resolutions yourself. Now, if a decision requires unanimous approval of the shareholders, you will need the other shareholder to agree with you.

Mechanisms Protecting Shareholders Rights

A key mechanism used to protect the interests of both majority and minority shareholders are drag-along and tag-along clauses. These clauses come into play when shares are sold or the company is being acquired.

	Drag-Along Provisions	**Tag-Along Provisions**
Benefit	Benefits majority shareholders.	Benefits minority shareholders.
Right	Majority shareholders can require minority shareholders to sell their shares to a buyer on the same terms. Minority shareholders cannot frustrate the sale of a company by refusing to sell their shares.	Minority shareholders can join a sale of shares by a majority shareholder and sell to the buyer on the same terms. Minority shareholders can demand that their shares are also purchased or else the sale will not proceed.
Reason	Those acquiring a company generally want 100% ownership.	To protect minority shareholders from remaining in a company that is primarily owned by an unfamiliar third party.

How Shareholders Resolve Disputes

Your shareholders agreement will contain the process to resolve disputes relating to the shareholders agreement.

For example, if someone has breached the decision-making protocol outlined in the shareholders agreement or if a shareholder believes the company did not comply with its obligations to shareholders.

Having a process to resolve disputes as quickly and effectively as possible prevents unresolved disputes impacting the business' operations. For example, if there is a dispute involving majority shareholders, commercial partners or investors may be reluctant to deal with the company.

Every business is different, and the shareholders may agree on a slightly different process to resolve any issues.

Events of Default

Your shareholders agreement should also include a list of *events of default,* to protect the company and the other shareholders from the detrimental actions of shareholders. An event of default this could be:

- a breach of the shareholders agreement;
- acts of serious misconduct or fraud; or
- a breach of a non-compete clause. A non-compete clause helps to prevent a party from using confidential information, IP or general know-how to compete with the business they used to work for. Further, when drafting or entering a contract, you should thoroughly review any non-compete clauses to ensure that they are reasonable and do not restrain your participation in the market economy.

The shareholders agreement might say that where a shareholder commits an event of default, they will have to sell their shares back to the other shareholders or the company. The sale price will be either market value or a discount to market value, depending on the terms of the shareholders agreement. A shareholder who is a director must also resign.

Share Vesting and Leaver Provisions

Your shareholders agreement should also set out the terms for your company's shareholders who are also employees. Share vesting provisions can incentivise employee shareholders to remain with the company. Leaver provisions protect your company from employee shareholders who have left the business yet continue to own a substantial portion of shares.

- **Share vesting** is the process through which the shareholder earns their shares over time, or by achieving performance-based milestones. The company can buy-back any shares which have not yet vested if the shareholder was to stop providing services to the business.

- **Leaver provisions** require a shareholder who leaves the business to sell all their shares. How this is handled may depend on whether the shareholder is leaving on good or bad terms or upon death.

- **Good leaver:** If a shareholder leaves on good terms, the sale price is usually the fair market value of the shares. A good leaver event is where a shareholder stops providing services to the company for reasons outside of their control, such as retirement, redundancy or illness.

- **Bad leaver:** If a shareholder leaves on bad terms, the company can impose a discount on the sale price. A bad leaver event usually involves an element of 'fault' on behalf of the shareholder, for instance the shareholder's employment is terminated.

Other Standard Clauses in Shareholders Agreements

Aside from the key decision-making mechanisms explained in this agreement, a number of other terms should also be addressed in a shareholders agreement. For example, your shareholders agreement may cover terms including:

Financial Information

Financial information to be provided to each shareholder, for example, profit and loss statements, balance sheets, quarterly management reports and the annual budget. Without this clause the company is only required to provide shareholders with higher level financial reports prepared in the manner prescribed by the Corporations Act.

Company Protection

Terms protecting the company against negative shareholder actions, including non-compete clauses, non-solicitation clauses and intellectual property clauses.

Employee Share Schemes

Terms for any employee share option plans and the maximum percentage of share capital the company can use for this purpose.

Other Documents You May Need

The shareholders agreement is important for dealing with how decisions are made in the company and what processes need to be followed. However, when certain events happen, the company will also need other key documents. A few examples include:

- **share sale agreement** for when a shareholder sells their shares to another shareholder or third party;

- **subscription agreement** covering the terms on which a shareholder will subscribe for new shares that the company issues; and

- **loan agreement** for when a shareholder or director lends money to the company, or vice-versa.

Final Word

In running a company, there are many decisions to make and the interests of many people to balance. The directors and shareholders of your company should understand how decisions are made, who has the authority to make which decisions, and how the shares of the company will be managed. You want to ensure that you have a shareholders agreement for this purpose which is comprehensive and has been prepared with your business in mind.

The rest of this guide sets out issues that should be considered when instructing your lawyer to draft a shareholders agreement tailored to your requirements.

Instructions Checklist - Shareholder Agreements

No.	Issue	Comment
1	**The Company**	
1.1	Does the company (Company) in respect of which the shareholder agreement is to be entered into already exist?	
1.2	What is the name of the company?	
1.3	What type of business does the Company conduct?	
2	**Shareholders and share ownership**	
2.1	Who are the current shareholders? How many shares do they each hold? What class of shares are they (ordinary, preferential, redeemable or convertible)?	
2.2	Who are the incoming shareholders?	

No.	Issue	Comment
2.3	Will the incoming shareholders be issued with new shares or take a transfer of existing shares?	
2.4	If shares are being transferred: • By whom to whom? • How many? • What class (ordinary, preferential, redeemable or convertible)? • Will the transferors give warranties to the transferees in respect of the shares?	
2.5	If existing shares are going to be transferred, will there be a separate share sale agreement?	
2.6	If shares are being issued; • To whom? • How many? • What class (ordinary, preferential, redeemable or convertible)?	
2.7	If the company is going to issue new shares, should there be any warranties provided in respect of those shares? If so, will there be a separate share subscription agreement?	
2.8	Should any special rights attach to any of the shares (voting, capital, dividend or winding up rights)?	

No.	Issue	Comment
2.9	When will the transfer or issue take place?	
2.10	Has the Company's constitution been reviewed for provisions on pre-emptive rights, etc?	
3.	**Directors and other office holders**	
3.1	Who are the current directors?	
3.2	Should the shareholding entitle the shareholder to appoint a director? (**Note**: This is not possible with a listed company)	
3.3	How are directors to be removed?	
3.4	How are directors to be remunerated?	
3.5	Will directors be entitled to appoint alternate directors?	

No.	Issue	Comment
3.6	How many directors should be required for a quorum at a meeting of directors?	
3.7	Should there be any minimum requirements that certain directors must execute particular documents (e.g. 1 director from each appointor must countersign cheques, etc)?	
3.8	Who will be appointed to the following key positions? • Managing director • Chairperson of board • Secretary	
3.9	Should the chairperson have a casting vote?	
3.10	Does each director have one vote? If not, how many votes will each director have?	
4.	**Dividends**	
4.1	What should be the dividend policy of the company? In particular, will a minority shareholder require a minimum distribution?	

No.	Issue	Comment
5.	**Financing of Company**	
5.1	Are there any existing shareholder loans? Are there intended to be any shareholder loans? What are the details of these loans?	
5.2	Will shareholders be required to provide guarantees to third party financiers?	
5.3	Must any existing debt be refinanced? Will the change in control affect any existing debt instruments?	
5.4	If additional financial contributions are required, will the shareholders be required to contribute? If so, in what proportions?	
5.5	What are the consequences of a shareholder failing to make additional financial contributions to the Company (dilution or loss of voting rights)?	
6.	**Decision making**	
6.1	How will a meeting of shareholders be called?	

No.	Issue	Comment
6.2	Should there be decisions which must only be made unanimously by shareholders? Eg: • the issue of securities; • the variation of rights; • contracts with directors/shareholders; • contracts outside the ordinary course of business; • the acquisition or disposal of real property; • the employment of senior executives/directors; • the appointment and removal of bankers/solicitors/auditors; • borrowing over and above a certain amount. If so what amount; • the creation of encumbrances over the assets of the company; • the giving of third party guarantees; • the implementation of employee share schemes; • the issue of legal proceedings; • the payment of dividends; • the entering into partnerships; • the making of tax claims; • the delegation of certain powers; • the restructuring of the company; • stock exchange listing; • the amendment or repeal of the constitution; • a change in the core business; or • the liquidation of the Company/a subsidiary	
6.3	If some decisions should only be made unanimously by shareholders, how should a deadlock be resolved? In particular, should there be: • a casting vote • a compulsory buy-out; or • a compulsory winding up?	

No.	Issue	Comment
7.	**Breach of Shareholder Agreement**	
7.1	What constitutes a breach/default of the shareholder agreement?	
7.2	How should breaches of the shareholder agreement be dealt with (deemed transfer notice)?	
8	**Share restrictions**	
8.1	Should there be pre-emptive rights on the transfer of existing shares?	
8.2	Should there be some permitted transfers (to a related entity/family)?	
8.3	Should the shareholding be linked to holding a position in the Company?	
8.5	Should there be pre-emptive rights on the issue of new shares?	
8.6	What should be the method of valuing shares upon the exercise of pre-emptive rights (independent valuer in default of agreement)?	

No.	Issue	Comment
8.7	Should shareholders be entitled to rely on the compulsory acquisition provisions in the *Corporations Act?*	
9	**Information / Record Keeping**	
9.1	What specific record keeping/audit obligations should there be?	
9.2	Should there be any confidentiality requirements?	
10	**Dispute Resolution**	
10.1	Should there be a dispute resolution procedure (other than the deadlock procedure)?	
11	**Tag Along / Drag Along / Put / Call Options**	
11.1	Are tag-along rights required?	
11.2	Are drag-along rights required?	
11.3	Are shareholders restricted from competing with the Company? If so: • During what period? • In what area? • What are the prohibited activities?	

No.	Issue	Comment
11.4	Should any party be provided with a put option to dispose of its shares? If so, to whom should the shares be put and in what circumstances should it be able to be exercised?	
11.5	Should any party be provided with a call option to acquire further shares? If so, to whom should the option be given and in what circumstances should it be able to be exercised?	