



Shareholder Agreements – issues for consideration

Shareholder Agreements are contracts that regulate the rights and obligations of Shareholders (Members) of a company. Unlike a Constitution or the Replaceable Rules as defined by the *Corporations Act 2001* (Cth) these agreements are not mandatory. However, on incorporation many Shareholders choose to regulate the rights and obligations in addition to controlling various aspects regarding the management of the company by entering into a Shareholders Agreement.

Matters that aren't generally regulated by a Constitution

Shareholders Agreements generally regulate and control matters on which a Company's Constitution (or the Replaceable Rules) as the case may be are silent. Shareholders Agreements may include provisions relating to:

- **confidentiality** – obligations on the parties;
- **dilution of a Members interests** – provisions requiring a certain Members level of interest in the company to be maintained at a certain level;
- **dispute resolution mechanisms;**
- **Director's meeting procedures;**
- **dividend distribution policy** – for the distribution of profits;
- **exit strategies** - agreement to sell their shares on the occurrence of certain events such as death, trade sale, an initial public offer is made by the company to list on the Australian Stock Exchange (ASX);
- **financing policy** – the way that the company is to be financed including the obligations of the Members to invest further equity or loan funds to the company;
- **operating procedures** for almost any part of the company's operations from budgeting and accounting to the way in which directors meetings are conducted and minutes recorded;
- **objectives of the company** - specify and limiting the business activities of the company
- **obligations and rights of shareholders** in certain circumstances;
- **protection** of any minority shareholder rights;
- **shareholder loans** - requirements and terms and conditions for any shareholder loans that may be made by shareholders and Directors;
- **restraint of trade** on directors and shareholders;
- **rights to appoint directors** - a shareholder's right to appoint directors and the number of directors;
- **pre-emptive rights** to acquire another Members shares in the event that one member wishes to sell (for whatever reason);
- **warranties** by the shareholders;
- **voting** in certain situations involving major decisions.

A great source of conflict in companies without Shareholder Agreements appears to be where one party thinks the others are getting a "free ride" in exchange for their equity.

A Shareholders Agreement is a mechanism used to regulate the rights and obligations (and importantly to communicate expectations) of Members as practice shows that many companies fail because they Members expectations are not aligned.

Perceptions of differential value of sweat equity

Experience has shown that a great source of conflict can arise in start-up companies without Shareholders Agreements where the expectations of party's obligations differ. In other words where one party thinks the other is getting a "free ride". For example if the parties are receiving 'sweat equity' and the exact obligations are undocumented, then conflict may arise when one party values their own contribution at more than the others, or one party fails to contribute to the extent that they were 'supposed to'. This issue becomes particularly problematic in two situations:

- Where things are going particularly well (consequently one party wants a greater piece of the action); and
- Where things are going badly (where one of the parties wants to withdraw from the relationship);

A well drafted Shareholders Agreement can go a long way towards the minimisation of conflict.

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