COOPER GRACE WARD
LAWYERS

Private company shareholder agreements

Issues for consideration

Management and funding issues

1. There should be a clear framework for the management and administration of the business.

2. The shareholder agreement should deal with issues such as:

   (a) who comprises the board

   (b) whether any individual or blocks of shareholders have the right to appoint a representative director

   (c) whether any principals of the shareholders will be employed by the business.

3. The agreement should outline the levels of authority of management and clarify which, if any, decisions require approval from the shareholders or a particular majority of shareholders/directors. These might include issues such as:

   (a) approval of annual budgets

   (b) decisions on incurring capital expenditure in excess of a specified amount

   (c) sale of the business or substantial assets of the business (e.g. to a consolidator)

   (d) employment of new staff (above a given threshold salary)

   (e) admission of new shareholders

   (f) any significant borrowing in excess of a specified amount

   (g) declaring dividends.

4. What obligations (if any) will shareholders have to inject further capital?

Entry/exit of shareholders

5. It is important to agree at the outset on issues such as:

   (a) when a party may retire and sell shares

   (b) when a party may be required to retire and sell shares

   (c) what price will be payable on retirement/expulsion

   (d) how the continuing parties will fund the purchase of shares of an outgoing shareholder

   (e) whether an outgoing shareholder who is paid an amount for their shares, which reflects a value for goodwill, is to be subject to a restraint of trade covenant

(f) how transfers or sale of shares to an associated entity of the shareholder will be dealt with.

6. It is quite common to allow a shareholder to retire on giving reasonable notice. In those circumstances, the usual approach is that the continuing parties may, but are not obliged, to purchase the shares of the outgoing party.

7. The agreement should stipulate 'triggering events' that will entitle a majority of principals to require another party to sell their shares. Common triggering events are:

   (a) death

   (b) total and permanent incapacity

   (c) bankruptcy

   (d) unremedied breaches of material terms of the agreement

   (e) criminal conduct

   (f) no longer being an employee of the business.

   The above list is not exhaustive and the events can be tailored to your particular circumstances.

8. It is important to provide clear guidelines as to how and when an outgoing party is to be paid.

   (a) If a party dies or is disabled and there is underlying insurance, the date for completion is generally tied in with the payment of insurance proceeds.

   (b) If a person has to sell shares where there is no insurance funding, ongoing parties may be given a reasonable time to pay for the shares transferred or surrendered.

9. If price is paid in instalments, will interest be payable?

Valuation issues

10. It is imperative the shareholder agreement deals with the issue of valuation. A major source of disputes on the exit of parties from a business structure is the issue of what their interest is worth. The scope for dispute in relation to this aspect is significantly reduced if a valuation methodology is agreed at the 'front end'.

11. It is relatively easy to adopt an acceptable methodology for tangible assets. Generally, parties are happy to accept balance sheet values unless there is significant plant and equipment or significant equity in leased equipment.

12. Difficulties usually arise in respect of valuing goodwill or other intangibles (such as intellectual property). Common valuation approaches are:

    (a) fixed value (with provision for periodic review)

    (b) external independent valuation

    (c) agreed formula (e.g. percentage/multiple of average net fees/income or EBIT).

Fixed valuation

13. This approach is simple and provides certainty to all equity participants.

14. It can be applied by directors determining a value for a share in the company at the start of each financial year and having the shareholder agreement provide that this valuation applies to any share dealings within the next 12 month period.

15. Problems can arise is if the parties neglect to adopt a fresh valuation or if there is difficulty in reaching agreement on a fresh valuation for any years.

External valuation approach

16. Under this approach the price payable for shares on the occurrence of a triggering event will be determined by an external valuer, appointed if the parties cannot agree on the price between themselves.

17. This provides flexibility.

18. Often the agreement will set out certain criteria that must be applied by the external valuer.

19. One disadvantage of this approach is that it can involve significant cost.

20. Another problem is that there is no certainty (in that shareholders have no way of knowing what their shares are worth at any point in time).

21. If this approach is adopted, one variation that can be incorporated is to provide that, once an external valuation has been obtained, that will apply to any dealings in shares within a specified period after the date of the valuation.

Formula approach

22. This is a simple approach that still provides flexibility and also provides most shareholders with reasonable certainty as to what their shares are worth.

23. The suitability of this approach depends upon your degree of comfort that the value of the intangibles (e.g. goodwill, intellectual property) of the business can be adequately assessed by applying some pre-set formula.

Other entitlements on termination

24. If a shareholder sells or is required to sell their shares, then typically, that person or associated entities may be owed additional money by the company (or may owe money to the company) at the date of termination. For example, there may be loan amounts previously advanced either way or an undrawn share or profits.

25. The shareholder agreement should clarify what is to happen with these outstanding amounts if a shareholder sells their shares.

Pre-emptive rights and tag along/drag along provisions

26. It is almost universal practice to include a clause in a shareholder agreement that requires that any shareholder wanting to sell their shares must first offer them to the other shareholders who have a first right to purchase on the same terms.

27. If the continuing shareholders do not want to purchase the shares, then a shareholder is generally free to sell to the third party – although this will be difficult to do in practice. In some cases, even this right to sell to a third party is subject to the other shareholders approving the proposed new shareholder.

28. The agreement should also cover the possibility of a third party wanting to purchase all of the shares or the entire business and assets of the company. It is quite common to have a clause (tag along/drag along) under which a specified majority of shareholders can effectively compel all shareholders to agree to a sale to a third party who is interested in buying all of the shares or the entire business.

29. Depending on how involved each of the principals is in the business, you may want to consider death/disablement insurance for some or all of them.

30. The shareholder agreement should reflect how any insurance payout is to be dealt with.

31. The business succession arrangements as well as the way in which the ownership of insurance policies is structured involve complex capital gains tax issues. Consideration of these issues is required to ensure there is no unnecessary capital gains tax payable by a party on exit from the business.

32. Generally, the best approach will be for the policies to be owned by the individuals whose lives are insured, or their spouses – particularly if there is any disability or trauma cover.

33. It is possible for the policies to be owned in a superannuation fund however care is required as this structure will not be appropriate for many people, particularly those who already have substantial superannuation savings.

Business succession funding arrangements

34. Typically, small companies will take out insurance policies on the lives of the ‘principals’ to assist with funding of the buy out of shares on death or disablement.

35. The shareholder agreement should reflect how any insurance payout is to be dealt with.

36. The way in which the ownership of these policies is structured and the business succession arrangements involve complex capital gains tax issues and care is needed to ensure there is no unnecessary capital gains tax payable.

37. Generally, the best approach will be for the policies to be owned by the individuals whose lives are insured or their spouses - particularly if there is any disability or trauma cover.

38. It is possible for the policies to be owned in a superannuation fund but care is required as this structure will not be appropriate for many people, particularly those who already have substantial superannuation savings.

Directors’ guarantees

39. Will any, or all, of the principals (or directors) be required to guarantee the liabilities of the company?

40. If so, the shareholder agreement should make some provision for indemnity, and also for release of those guarantees if the person sells their shares.

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This summary is of a general nature only and is based on Cooper Grace Ward’s interpretation of the law as at the date it was prepared. Clients should obtain specific advice on these issues and any other issues that need to be addressed.