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## Shareholder Agreements – variations to the standard form

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### 1 Introduction/Overview

#### 1.1 Why have a shareholder agreement?

Nowadays, not even a constitution (in the traditional sense) is compulsory, let alone a shareholders agreement.<sup>1</sup> They can be expensive and are generally time-consuming to prepare, especially when there are a large number of shareholders with competing interests and agendas.

Various interests of minority shareholders are protected under the *Corporations Act*, and the company constitution (or replaceable rules) set the ground rules for much of a company's day to day administration. In short, why would you bother?

Like in most relationships, the answer to this question may not become clear unless the shareholders have a dispute over a material issue. Shareholder agreements are commonly compared with prenuptial agreements for married couples. This analogy is reasonably helpful.

At the commencement of a business venture, before substantial trading has begun, it is easy for investors and management personnel to believe that they will overcome any potential disagreements in the future by discussion and negotiation. In reality though, one person's opinion on, for example, what is a reasonable capital contribution, may vary greatly depending on their own financial circumstances. Equally, unless the members have discussed and implemented a strategy to fund the acquisition of a deceased shareholder's interest, they may find that they are left running a business with a widow who has neither the expertise nor the time to operate the enterprise.

From these examples, it is easy to see why investing in a shareholders agreement makes good commercial sense. Not only will members and company officers save time by pre-determining the procedure/outcome for key events (such as new share

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<sup>1</sup> Corporations Act 2001, s134



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issues and transfers) but they will also provide certainty and confidence for members by entrenching certain rights and obligations that are not usually provided for under the constitution or at law.

Needless to say, many shareholders do not recognise the value or importance of having a shareholders agreement until it is too late. That is, when they are embroiled in a dispute, they are unable to rely on a simple, pre-determined contractual remedy.

## 1.2 **Shareholder Agreements: A bespoke contract**

Perhaps more than any other non-transactional commercial document, by its nature, the shareholders agreement is a highly customised contract. It is a tailored set of instructions designed to reflect and regulate the administrative framework for owning and managing a company.

Not surprisingly, the style and content of these agreements can vary widely depending on such factors as:

- the size of the company and the number of shareholders (consider closely-held proprietary company vs. widely-held unlisted public corporations);
- the kind of business carried on by the company;
- the degree of management participation by the members; and
- whether any individual or membership group requires special rights not available to all members.

Despite the inherent distinctions between different business enterprises and shareholder groups, it does not stop many business owners (particularly SME's) from asking for an "off the shelf", "standard-form" or "template" shareholders agreement.

Usually this is a result of a lack of understanding of the way that a shareholders agreement can be drafted to suit a particular set of circumstances and needs. In our experience, an accountant or advisor may have recommended to the owner(s) that it would be prudent to invest in a shareholders agreement. Usually this recommendation is made before the members introduce a new business partner, undertake a capital-raising or other significant milestone in the enterprise.



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Generally speaking, most owners will appreciate that such an agreement is a “good idea” to protect voting and sale rights, but many will not realise how, with careful instructions, such agreements can also regulate and streamline the decision-making process and pre-empt many potentially explosive management or ownership issues that may affect the company in the future.

In addition to the “standard” issues that one would expect to find in a shareholder governance document (e.g. voting and share transfer rights), bespoke agreements can be created to accommodate the special requirements of a particular company, an individual or a special class of shareholders.

Using practical examples, this paper describes some of the clauses and drafting techniques that can be used in a shareholders agreement to allocate decision-making power and rights and to provide procedural certainty for a number of common issues that are of interest or concern to special categories of shareholder.

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## 2 Partnership-style Agreements

As mentioned above, it is not uncommon for clients to ask for a ‘standardised’ agreement that simply covers the ‘big’ issues (e.g. board composition, voting, transfers, default and dispute resolution). Usually, such a request comes from people who, for the reasons discussed above, would prefer to invest some time and money now to avoid the stress, cost and administration in dealing with a shareholder dispute in the future.

Even a short-form, unsophisticated agreement can be of tremendous assistance to the parties in the event that the members have a disagreement over a major issue affecting the company.

### 2.1 50/50 partnership style relationship

Consider, for example, two individuals who each have a 50% interest in a company which owns a sole asset, being a block of land that is leased to a third party. One shareholder wants to sell the property, and the other wants to retain it. In the absence of a pre-agreed deadlock provision, the shareholders are at a stalemate which, in the absence of persuasive argument or a commercial compromise, may only be brought to a head via the winding-up procedures under the *Corporations Act*. Such a path can lead to an uncertain (if any) outcome and is invariably time consuming and expensive for the parties.



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Even where a member makes such an application, there is no guarantee that the application will be successful. In the above example, a court may not consider that it would be “just and equitable” to wind up the company in circumstances where there is no question as to the validity of the lease and it does not expire for (say) another 8 years. This provides commercial certainty to the company until end of the current term and it could be very difficult to convince a court that winding up is justified in such circumstances.

## 2.2 **Shareholders agreements may not be appropriate in all circumstances**

Where the business model is unsophisticated (eg an interest in land) and there are relatively few shareholders with equal interests, a simple-form agreement may cover enough of the ‘essential’ elements to provide a basic comfort for the members on key issues. In fact, a full-form shareholder agreement may not be necessary at all. In a two person, ‘50/50 entity with a ‘partnership-style’ business model, it may be counterproductive and confusing to include, for example, mechanisms to distribute power between the members and the board of directors when they are one and the same people.

At the other extreme, a shareholders agreement is also unlikely to be appropriate in a widely-held public corporation, where decision-making power and voting rights are distributed between the members, board and senior company executives. Such rights are usually documented in the company constitution.

## 2.3 **Buy-sell Agreements**

In the ‘partnership-style’, 50/50 relationship, a simple-form ‘buy – sell’ agreement may be appropriate. These agreements will incorporate only those elements that are considered necessary for the particular circumstances of the company and the individuals involved. In our example, a guaranteed right to force a party to sell its shares may be appropriate. A discussion of ‘Russian Roulette’ and forced buy/sell clauses is discussed later in section 8.

## 2.4 **Not ‘one size fits all’**

Lawyers should consider the particular circumstances of the company and its members when deciding whether or what form of shareholder agreement may be appropriate.



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An uncomplicated business enterprise, such as our property ownership example, would be well suited to a buy-sell agreement with a simple deadlock resolution mechanism.

As the business model becomes more complicated and the number and character of members increases (and their rights and interests become more varied), it becomes more important to identify and address the goals of particular members, their rights and the level of their control in running the company.

The balance of this paper discusses some of the ways that shareholder agreements can be drafted to accommodate the rights of special member classes and interests in circumstances where not all shareholders are treated the same.

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## 3 **Special member categories & rights**

### 3.1 **Introduction**

In this part of the paper, I consider some of the more common shareholder categories and examine the ways in which they draft shareholder agreements to protect their rights and interests.

The shareholder categories I will consider include:

- founding shareholders;
- management/employee shareholders;
- private equity/institutional investors; and
- family members in a family business.

While some of the drafting techniques and clauses may be suitable to more than one shareholder category, for ease of reference, I have simply selected a few of the key issues affecting each of the above member categories and will discuss some of the various methods used to address and overcome these issues.

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## 4 **Founding Shareholders**

As the name suggests, the founding shareholders are those members/individuals who have come up with the idea and have developed the preliminary concepts for the



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business venture or the core business. To take the vision further or to expand the business, they may need to attract investors to contribute capital. Almost invariably, these investors will become shareholders and their shareholdings will dilute the holdings of the founders. The founders recognise this but many will also want to preserve their ability to control the company's operations and, in some instances, their right to preferential dividends or to a preferential return on a sale of the company, regardless of their own proportionate shareholding.

#### 4.1 **Special Dividend Policy**

Sometimes a founding shareholder (or group of founders) will want to guarantee a minimum dividend entitlement, regardless of the number or proportion of shares taken up by other shareholders or subscribers.

##### **Sample clause**

- (a) *Subject to the provisions of the Constitution, the parties must procure that the Board adopts an initial dividend policy of 60% of net profits after tax, subject to the availability of cash and the future growth requirements of the Business.*
- (b) *The Board may change the Company's dividend policy from time to time to take into account the financial position of the Group and the Business Plan.*
- (c) *When paid, dividends will be paid as follows:*
  - (i) *each A Class Shareholder will be entitled to receive the lesser of its Respective Proportion of the Ordinary Shares and 2% of the total amount of dividends to be paid on the Ordinary Shares, provided that if the A Class Shareholders hold more than 20% of the Ordinary Shares, the A Class Shareholders will be entitled to be paid only 20% of the total amount of dividends to be paid on the Ordinary Shares, and that amount will be allocated amongst the A Class Shareholders in accordance with their Respective Proportions; and*
  - (ii) *F Class Shareholders will be entitled to receive the remainder of the dividends in accordance with their terms and at the discretion of the Board.*

A guaranteed dividend rate (seen here in clause (a)) is often used to give comfort to small-scale managers/investors who rely on dividend payments as a source of income.



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Less common is the inequitable profit distribution in clause (c) between the A Class and F Class shareholders. In this example, the founders (the F Class shareholders) wanted to ensure that they would always receive at least 80% of any dividends (regardless of the number of investors who subscribed for shares).

To achieve this, they capped the (aggregate) A Class shareholder dividend at 20% and inserted a provision that no individual A Class shareholder would ever receive more than 2% of any dividends.

In this agreement, there was a further clause that granted the F Class shareholders an entitlement to 80% of the proceeds of sale following an exit event (eg, IPO or trade sale), regardless of the proportionate shareholding held by those shareholders.

These examples demonstrate how it is possible to entrench the rights of one class of shareholders to a fixed proportion of profits or sale proceeds, irrespective of the capital contribution made by (or the proportionate shareholding of) those shareholders.

#### 4.2 **Exit Event**

A pre-determined process for a company (rather than member) exit event is common in agreements where a private equity or institutional investor requires a special right to force the company to, for example, undertake an IPO or trade sale at some point in the future.

##### **Sample clause**

- (a) *All of the F Class Shareholders may, at any time, give a notice to the Company (**Exit Notice**) requiring it to:*
- (i) *undertake an Exit Event, in the manner decided, or to be decided, by all of the F Class Shareholders; and*
  - (ii) *give notice to the other Shareholders of the F Class Shareholders' election.*
- (b) *Following receipt of the Exit Notice, the Company and each Shareholder (and each Shareholder must procure that each Director, or director of any member of the Group controlled by or appointed by it) must cooperate and use their best endeavours to do all acts, matters and things within its power to effect the Exit Event, including, but not limited to:*



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- (i) *the appointment of an investment bank or stockbroker of good standing nominated by the F Class Shareholders in their absolute discretion to act on behalf of the Group and all Shareholders in relation to the Exit Event; and*
- (ii) *waiving any applicable pre-emptive rights a party may have under this agreement or the Constitution.*

In this agreement, '**Exit Event**' was defined as either an IPO or a Trade Sale. These terms were broadly defined as follows:

***IPO** means an initial public offering of shares in the Company or a Subsidiary of the Company for the purposes of a listing on the ASX or other securities exchange.*

***Trade Sale** means a sale either by way of a sale by the Group of the whole or a substantial part of the Business or a sale by all of the Shareholders of all of their Shares.*

Such a clause gives extraordinary power, in this case, to the F Class Shareholders, to require the members and the board, at any time, to do what is necessary to either:

- undertake an IPO;
- sell all of their shares; or
- complete a sale of all of the assets and undertakings of the business.

In this agreement, these rights override any pre-emptive sale or acquisition rights.

#### 4.3 **Death or disablement of Key Shareholder**

Where shares are owned or controlled by an individual who has a critical operational or managerial role in the company, it is common for the members to agree on a process to acquire that person's shares (and/or the shares belonging to his or her nominee company) in the event that he or she dies or is totally and permanently disabled.

Sometimes death and disablement are simply categorised as 'events of default' which give the remaining shareholders the option (but not the obligation) to acquire the 'defaulting' shareholder's interest upon such event. This is a simple technique that may be appropriate where it is either expected that the remaining shareholders will have ready access to the finance required to complete the purchase, or in



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circumstances where the remaining shareholders and the disabled individual (or his/her heirs) are comfortable to coexist regardless of the departure of the particular individual.

A more prescriptive clause, under which a sale is not optional but instead is required, will step through the process for giving notice, valuing and paying for the relevant share parcel. Before drafting such a clause, a number of important considerations must be canvassed:

- who will have the right to buy/sell? Will it be the disabled individual (or his/her heirs), the remaining shareholders, or even the company itself?
- If the shares of the dead/disabled shareholder can be forced on or 'put' to the remaining shareholders or the company, how will that acquisition be financed?
- How will the shares be valued?

#### **Sample clause**

#### **4.3 Effect of death or Disablement**

- (a) *If the Key Individual dies or suffers an event of Disablement and the Key Shareholder wishes to sell all or some of its Shares (**Key Shares**), the Key Shareholder may, within 60 Business Days of the Key Individual's death or Disablement, direct the Board to obtain a valuation of the Key Shares from an Independent Valuer in accordance with schedule 1.*
- (b) *Using the valuation of the Key Shares as determined under clause 4.3(a), the Board must calculate the number of Key Shares that are equal to the proceeds of the Key Shareholder Insurance received by the Company (**Buy-back Shares**).*
- (c) *Subject to the determination under clause 4.3(b) the company must grant the Key Shareholder an option to put (sell) all (or at the Key Shareholder's discretion, some) of the Buy-back Shares to it (by way of share-buy back) (**Put Option**). The Put Option will remain exercisable for 30 Business Days.*

#### **4.4 Share buy-back**

*If the Key Shareholder, in its absolute discretion, exercises the Put Option in accordance with clause 4.3, then all parties must, within 30 Business Days after the Put Option is exercised, take all reasonable steps in their respective powers to:*



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- (a) *comply with all requirements under the Corporations Act to authorise the implementation of a buy back by the Company of the Buy-back Shares, including convening a general meeting of the Company on short notice for the purpose of considering and passing a resolution to authorise the Company to effect the buy back of the Buy-Back Shares, or the passing of a written shareholders' resolution to the same effect, except that this clause will not require any party to take any action, or procure to occur any matter, that is not permitted by law;*
- (b) *ensure that the share buy-back of the Buy-back Shares under this clause 4.4 will be funded from the proceeds of the Key Shareholder Insurance;*
- (c) *ensure that all necessary filings are made with the ASIC; and*
- (d) *seek and obtain any necessary third party consents.*

In this example, a unilateral right to 'sell' was granted to the 'Key Shareholder' who, in this case was the founder and principal of the business. Rather than a sale to remaining shareholders, the share disposal is achieved by way of a buy-back by the company itself. This avoids the need to go through a process of nomination and apportionment between remaining shareholders who may or may not wish to receive some, all of or more than their proportionate share. For simplicity, it also means that only the company (not the shareholders) need be named as the insurance policy owner.

Here, the share buy-back was to be funded from the proceeds of insurance taken out in the name of the company. Whether the buy-back was whole or partial was dependent on the value of the shares at the time and whether the insurance proceeds were sufficient to meet the cost of the entire parcel. Alternatively, if the shareholders choose not to insure the key person but they still require an option for a forced sale upon death/disablement, it is common to allow each remaining shareholder to pay off their portion of the sale price over a period of time, interest free.

In addition to the key shareholder's put option, a more equitable approach would also give the company a call option to buy-back (or the remaining shareholders to buy) the shares of the deceased/disabled shareholder.



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## 5 **Decision Making: Private Equity & Institutional Investors**

### 5.1 **Corporate legal decision making – form & substance**

In a corporate enterprise, where the real power resides will depend on the size and complexity of the company and the objectives and relative interests of its members and managers.

Generally speaking, the Corporations Act is non-prescriptive and companies are free to determine whether, for example, they have a board of directors, managing director or any formalised structure for allocating power between its managers and its members. Accordingly, and as has been discussed above, the way that members choose to allocate decision-making power in their organisation can be highly customised.

In this section, I use the example of a company involved in a management buy-out or MBO (that is, an acquisition of a company in which the management of the company participates in the acquisition) to consider how competing interest groups (most notably, the management team and the institutional investor) can use a shareholder agreement to allocate this power in particular ways.

### 5.2 **Managing Control Rights in the Portfolio Company (MBO example)**

In an MBO which is financed by institutional backers (**Institutional Investors**), the Institutional Investors join with the current management team to take control of the business.

However, in most buy-outs, the Institutional Investors are generally not interested in becoming involved in the day-to-day management of the company.

Their role, in the practical sense, is to add value strategically and financially – not operationally. In purely economic terms, their objective is simply to achieve a positive (and significant) return on their investment. To achieve this they are prepared to give management a fair amount of leeway to run the business, so long as they have mechanisms in place to control the budget and key strategic decisions of the business.



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Although confidence and trust in the management team is important to the success of an MBO, Institutional Investors recognise that appropriate controls on the decision-making process of the company are necessary to protect and grow their investment.

During the operational stage of the MBO, the existing management team will (in most cases) take responsibility for the day-to-day operations of the company (subject always to a budget).

Significantly, management's considerable responsibility in these operational decisions will often be disproportionate to the comparatively low level of equity that management may have in the company.

The Institutional Investors, on the other hand, will ordinarily assume responsibility for (and control of) the significant financial decisions and the strategic direction of the company, and will also have the exclusive right to determine when and how the company ultimately will be sold.

The underlying philosophy behind this allocation of control rights is that the existing management team has the know-how and the experience to run the operational aspects of the company most productively.

On the other hand, the rights granted to Institutional Investors are usually focused on the need to protect their investment and control its growth. To this extent, Institutional Investors will generally have significant control or influence over major corporate decisions, either through its powers as a holder of equity interests or through its nominees on the board of directors.

Having control over various aspects of corporate decision making will enable the Institutional Investors to properly monitor the company's business (through the flow of information that will accompany this control).

Importantly, when establishing these control requirements, Institutional Investors must take care not to smother the skills and expertise offered by the management team they have chosen to partner with. To the contrary, many management teams are specifically looking for a more relaxed approach to operational decision-making than was the case under the pre-MBO corporate environment. Micro-management of key principals can be intrusive and counter-productive, so any controls need to be



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carefully balanced to allow the management team to properly function while still keeping the Institutional Investors informed and the management team accountable.

### 5.3 Voting Rights and Board Rights

Generally speaking, there are two broad categories of control rights in companies:

- shareholder voting rights; and
- board rights.

'Voting rights' are the rights that accompany the ownership of the equity interests in the company, while 'board rights' refers to the right to appoint directors to the company's board and to influence corporate decisions through the participation of those directors in those decisions.

The allocation and composition of these rights are usually documented in a shareholders agreement.

#### **Sample clause**

##### ***Board Decisions***

###### ***(a) General management by the Board***

- (i) Subject to those decisions requiring Director Special Decisions or Shareholder Special Decisions under clause (b), decisions that are not part of the day to day management of the Company must be made by a resolution of the Board.*
- (ii) Any Director may make a submission to the Board specifying matters that are not within the day to day management of the Company, including those matters set out in part 3 of schedule 4.*

###### ***(b) Director Special Decisions and Shareholder Special Decisions***

*In addition to any resolution or approval required by the Constitution or the law, the Company or any Subsidiary of the Company must not do, or commit to do, any of the actions described in:*

- (i) part 1 of schedule 4 without a Director Special Decision; or*
- (ii) part 2 of schedule 4 without a Shareholder Special Decision.*

Please note the following definitions:



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***Director Special Decision** means a vote, resolution or consent passed or given by 70% of the Directors, except that where a Director, the Shareholder who appointed that Director or a Key Individual nominated by that Shareholder, has a material personal interest in the matter that is the subject of the vote, resolution or consent (**Interested Director**), in which case, Director Special Decision means a vote, resolution or consent passed or given by 70% of the Directors excluding the Interested Director.*

***Shareholder Special Decision** means a decision consented to in writing by Shareholders holding at least 70% of the Shares except where a Shareholder has a material personal interest in the matter that is the subject of the decision (**Interested Shareholder**), in which case, Shareholder Special Decision means a decision consented to in writing by Shareholders holding at least 70% of the Shares excluding the Interested Shareholder.*

Preceding this sample clause was a general comment to the effect that ordinary, day-to-day decisions (i.e. those that are not ‘Shareholder Special Decisions’ or ‘Director Special Decisions’) would be made by the Managing Director.

#### 5.4 Shareholder Voting Rights

Shareholders agreements can be used to establish rights granted to shareholders in respect of the approval required to make certain decisions

There are two issues to consider when assessing voting rights:

- the matters that are subject to the right to vote; and
- the number and composition of the votes that are required in order to approve a particular action.

Under the *Corporations Act*, shareholders are entitled to vote on a relatively small number of matters. For example:

- the election and removal of directors<sup>2</sup>;
- alterations to the company’s constitution<sup>3</sup>; and
- the consolidation and subdivision of shares.

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<sup>2</sup> Corporations Act s 203D (1)(c)

<sup>3</sup>Corporations Act s 136(2)



However, shareholder voting does not have to be limited to the matters allocated to them under the *Corporations Act*.

Under a shareholder agreement, a company can agree with its shareholders that those shareholders (or one or more classes of shareholders) will have the right to vote on a range of additional matters.

Institutional Investors usually take advantage of this ability by requiring the prior approval of its shareholders before the company takes various significant decisions or engages in conduct that directly affects the Institutional Investors' core interests.

## 5.5 **Board Rights**

In considering the board rights that are given to the Institutional Investors, parties need to consider both:

- the extent to which the Institutional Investors have the right to appoint one or more directors; and
- the number and composition of director votes that are required in order for the board to take a particular action.

If the Institutional Investors hold a majority of the company's shares, it's not usually necessary to specify in a shareholder agreement that the Institutional Investors will be entitled to appoint the company's directors, as that would normally follow from the majority shareholding.

However, in some cases, the Institutional Investors may not hold the majority of the company's shares. Or in the case of a single investor with a minority interest in the company, such investor may individually have the right to appoint a director through a specific contractual right.

Even if the Institutional Investors do hold a majority of the shares, they may want to give the key management staff one or more board seats as an incentive to those managers to fully commit his or her skills and expertise to the development of the company's business.

Accordingly, the allocations of board seats may not always reflect the ownership interests in the company.



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Indeed, many Institutional Investors in an MBO company are willing to share control with management in regard to the general operational matters overseen by the board because of the perceived importance of management to the eventual success of the company's business.

In an MBO, the underlying theory of the transaction is that the Institutional Investors and management are joining together to acquire the company. In such a context, it makes sense that it would be important to management for them to be an integral part of the decision making process at the board level.

Having the board seats would also protect management against any arbitrary or capricious exercise of power by the Institutional Investor director nominees (particularly in regard to sacking management).

The Institutional Investors, on the other hand, might be willing to allow management to participate in board deliberations as a performance incentive to management, so long as their board nominees retained control over certain key director decisions.

Giving Institutional Investor nominees a veto power over key matters (such as hiring/firing executives and variations to their remuneration packages) allows the Institutional Investors to control the extent to which management is able to confer private benefits upon themselves, and accordingly reduces the risk of agency costs that arises out of a structure where management has significant control over the operation of the business.

Finally, the use of independent (non executive) directors can also help the process appear more impartial and fair, in that either the executive directors or the Institutional Investor nominees would be required to persuade the independent directors that their position is the better one in order to override the other director group.

### **Sample clause**

Example Key Decisions Requiring Majority Institutional Investor Approval:

*The company will not do any of the following without the approval of the "Institutional Investors":*

- (a) issue, redeem, buy back, purchase, create a new class of or reclassify any of its shares or grant options over any of its shares or reorganise or reduce its share capital;*



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- (b) *pay any dividend or other distribution;*
- (c) *acquire or make any investment in another company or business;*
- (d) *dispose of all or a substantial part of the company's business or assets;*
- (e) *engage in an initial public offering of shares in the company or list shares in the company on any securities exchange;*
- (f) *materially change the nature or scope of its business or commence any material new business;*
- (g) *merge or amalgamate with any person;*
- (h) *borrow any money other than normal trade credit of \$500,000 or less or vary the terms of any borrowings; and*
- (i) *incur any research and development expenditure over \$250,000 in any 12 month period that is not in accordance with the operating budget that was approved by the company's board of directors.*

These decisions give an idea of the kinds of decisions that an Institutional Investor may wish to retain control over. Note generally that these matters relate to:

- the strategic direction of the company;
- spending money – or other decisions affecting the finances of the company; or
- the manner of the exit of the company.

The manner of the exit is a particular example of a decision that is of fundamental importance to the Institutional Investor, because it is generally the main reason they became involved in the MBO in the first place. Refer to the sample clause described in paragraph 4.2 above for an example of how these clauses might operate.

## 5.6 Shadow Director issue

In the context of this discussion around the 'special member' decisions reserved for key shareholders or Institutional Investors, it is worth noting that courts have been willing to find that a shareholder may be a "shadow" director where that shareholder exerts a significant level of influence or control over the board. In the case of *Standard Chartered Bank of Australia Ltd v Antico*<sup>4</sup>, it was found that the majority

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<sup>4</sup> (1995) 38 NSWLR 290, BC9504683.



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shareholder's influence over major strategic decisions meant that the shareholder was in fact acting in the capacity of a shadow director. This decision is troubling for institutional or founding shareholders, as it is likely that those are the kind of decisions that these shareholders will be granted in a shareholders agreement.

Under section 9 of the *Corporations Act*, where a person acts in the position of a director or where the directors of the company are accustomed to act in accordance with that person's instructions or wishes, the person will be deemed to be a director of the company. A person who acts in the position of director is known as a de facto director, while a person whose instructions or wishes are generally followed by the directors is called a "shadow director". A de facto director and a shadow director will have all of the liabilities of an appointed director under the *Corporations Act*, including potential liability for insolvent trading under section 588G.

## 5.7 Summary

In summary, capital investors in an MBO company have a range of mechanisms (at board and shareholder level) which can be used to exercise control over the key issues of importance to the investor.

These control mechanisms need not be overbearing, but need to balance:

- the freedom of management to manage effectively; against
- accountability, transparency and the ability for the Institutional Investors to step in when required to protect their investment.

Generally speaking, management will retain operative control of the business to a point. Where that point is depends upon what the Institutional Investor cares about.

The key issues that a Institutional Investor cares about are generally:

- financial controls;
- strategic development; and
- exit.



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## 6 **Conditional share ownership and valuation methodologies upon departure (good leaver/bad leaver)**

As in the following example, it is sometimes considered appropriate that ownership of all or a particular class of shares is conditional upon the continued employment by the company of an individual connected with that shareholder. This condition might be important as an incentive to keep key individuals engaged in the business and the restriction is often compensated by a concessional subscription price.

In an industry roll-up, it is not uncommon for the founding shareholders to give investing principals some equity in the company. Often referred to as 'skin in the game', boards like to know that these principals have a vested interest in the success of the entire company/group, and don't lose interest when they transfer ownership of their business to the company. In addition to specific performance-based incentives, employee/principal shareholding (with special obligations attached) can be an effective way to incentivise principals and drive growth.

The following example was used in a company that was undertaking a roll-up of medical practices. The joining 'Practitioners' were invited to subscribe for A Class Shares which came with special rights and obligations that were distinguished from the F Class (or 'Founder') Shares.

A Practitioner on ceasing to be employed or engaged by a member of the nominated group of companies ('Departing Practitioner') is forced to sell (or the shareholder 'affiliated with' that Practitioner) is forced to sell his/its shares in the company for a price that is determined by:

- the Practitioner's length of service;
- the medical circumstances of the Practitioner;
- the age of the Practitioner; and
- other conditions at the discretion of the board.

These circumstances will, in this example, determine whether the Departing Practitioner is treated as a 'good leaver' or a 'bad leaver' which in turn, will affect the price that is required to be paid for their shares.



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**Sample Clause**

(a) *A Practitioner on ceasing to be employed or engaged by a member of the Group (**Departing Practitioner**) and/or any Affiliate of the Departing Practitioner that holds A Class Shares (together the **Offeror**) must, if required by notice in writing given by the Board to the Offeror and the F Class Shareholders (**Board Notice**), which may be given or not given in the absolute discretion of the Board up to 12 months after the cessation of employment or engagement of the Departing Practitioner, sell all of the Shares held by the Offeror to:*

(i) *the F Class Shareholders; or*

(ii) *if the F Class Shareholders have either:*

(A) *given notice to the Company that they do not wish to acquire the Shares from the Offeror; or*

(B) *not given notice to the Company as to whether or not they wish to acquire the Shares from the Offeror within 10 Business Days of the date of the Board Notice,*

*such person or persons as nominated by the Board (which persons for the avoidance of doubt may be or include any or all of the Company and any other Shareholders or any other person or persons).*

(b) *A sale of A Class Shares under clause (a) must be completed at a price determined as follows:*

(i) *if the Departing Practitioner is a Bad Leaver, the amount the Offeror paid for its A Class Shares.*

(ii) *if the Departing Practitioner is a Good Leaver, an amount per Share equal to the EBIT Valuation for the Measurement Period as at the date of the Board Notice.*

In this clause:

**Bad Leaver** means a Departing Practitioner who is not a Good Leaver.

**Good Leaver** means:

(a) *a Departing Practitioner who ceases to be employed by or to provides services to any member of the Group as a result of his or her:*



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- (iii) *death;*
  - (iv) *resignation or termination of employment or services provision where that Departing Practitioner is subject to serious ill-health, serious injury or serious disability (including mental illness); or*
  - (v) *retirement at the age of 65; or*
- (c) *a Departing Practitioner who has performed at least five years continuous service with the Group from the date which the Departing Practitioner commenced employment with or began providing services to the Group and who since that date has complied with the terms and conditions of this agreement and their engagement agreement or agreements under which they have provided services to the Group; or*
- (d) *any Departing Practitioner the Board decides, in its absolute discretion, is a Good Leaver.*

Careful drafting and cautious advice is required when preparing these ‘good leaver’/ ‘bad leaver’ provisions to ensure that the pre-determined valuation methodologies are not regarded as a penalty and made unenforceable. To be enforceable, these clauses imposing a valuation discount must reflect a genuine pre-estimate of the likely loss suffered by the company/shareholders following the event of departure.

Note, if, as in this example, the default provision involves the forfeiture or dilution of the defaulter's shares for a value that is less than the fair market value, the ‘bad leaver’ may be able to get relief against the forfeiture or dilution.

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## 7 Family Business

In my experience, there are a few common shareholding issues that distinguish a family-run business from a group of unrelated members in a small proprietary company. These issues include a preference to make finance readily available for family equity participation or even offering shares to family members at discounted rates. Although this can be achieved easily enough with different share classes and special class rights, care needs to be taken in practice not to alienate non-family members.

Business succession issues (including priority rights offered to family members) are another common feature of family-business shareholder agreements. Special care needs to be taken with cascading preferential rights provisions to ensure that



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entitlements to preferential offers and rights are clearly described and that the interests of family vs. non-family members is unambiguous.

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## 8 Dispute resolution/Deadlocks

If members do not have a shareholders agreement, and they don't have a constitution which has a provision for a casting vote in the event of a deadlock, it can be difficult, costly and time consuming to 'resolve' deadlocks under the Corporations Act or at common law.

Even in circumstances where a constitution does provide an individual member or officer with a casting vote, this is no guarantee that the mechanism will survive a challenge from a disgruntled 'minority' shareholder. In *Re Medfield Pty Ltd*<sup>5</sup> an injunction was granted to restrain the chairman from exercising a casting vote on a motion to require one of the "partners" in the company to deliver up a secret formula belonging to the company. The fact that at the time of its incorporation, none of the members had actual knowledge that the chairman had a casting vote was significant.

The following sample clause contains an example of a 'Russian Roulette' type clause, where, following attempts to resolve the deadlock, either party can make an offer to buy the other one out. In the event that the other party rejects the offer to buy, he/she/it must sell all of their shares to the offeror at the same price. This example contemplates a deadlock at board level, and restricts the rights to the holders of a certain category of (founder) shares. It could be easily adapted to apply to a deadlock at shareholder level.

### **Sample clause**

#### **8.1 Creation of Deadlock**

*If:*

- (a) the Directors cannot agree on a material matter regarding an important element of the operation of the Company or the Business and cannot resolve the disagreement within 15 Business Days; or*
- (b) the Board resolves that the Company needs more funding and the Directors cannot agree how to raise the funding;*

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<sup>5</sup> (1977) 2 ACLR 406.



*a F Class Shareholder that owns more than 20% of the total Ordinary Shares may notify the other F Class Shareholders and the Board that a deadlock has arisen (**Deadlock**).*

## 8.2 **Mediation**

*If the F Class Shareholders are unable to resolve the matters the subject of the Deadlock within 15 Business Days of notification of the Deadlock, any F Class Shareholder may require, by notice to the other F Class Shareholders, that a Deadlock be submitted to mediation in accordance with, and subject to, the Institute of Arbitrators & Mediators Australia Mediation Rules, in which event the matters the subject of the Deadlock must be submitted to:*

- (c) a mediator agreed by all of the F Class Shareholders; or*
- (d) if the F Class Shareholders are unable to agree on a mediator within five Business Days after the date of the notice that the Deadlock must be submitted to mediation, a mediator appointed by the then current President or Acting President of the Institute of Arbitrators & Mediators Australia,*

*and the mediation must be commenced within five Business Days after the mediator is selected or a later time as agreed by the F Class Shareholders.*

## 8.2 **Role of mediator**

*The role of any mediator is to assist in negotiating a resolution of the matters the subject of the Deadlock.*

## 8.4 **Offer**

*If an F Class Shareholder has required the matters the subject of the Deadlock to be submitted to mediation and the Deadlock is not resolved within 5 Business Days after the commencement of the mediation, an F Class Shareholder that owns more than 20% of the total Ordinary Shares may give a notice (**Offer Notice**) to the other F Class Shareholders that own more than 20% of the total Ordinary Shares (**Recipients**) stating:*

- (e) that they (**Offerors**) unconditionally offer to sell all their Shares to the Recipients free from encumbrances (**Offer**); and*
- (f) the cash price per Share for which the F Class Shareholder proposes to sell its Shares.*

## 8.5 **Election**

*Within 15 Business Days after receiving an Offer Notice (**Decision Period**), the Recipients must give the Offerors notice accepting or rejecting in full the Offer,*



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*provided that if there is more than one Recipient, a Recipient may accept the Offer in respect of less than all of the Offerors' Shares so long as the total of the acceptances by Recipients are in respect of all of the Offerors' Shares.*

#### **8.6 Acceptance**

*If one or more Recipients gives a notice accepting the Offer in respect of all of the Offerors' Shares, those Recipients must buy all the Offerors' Ordinary Shares for the cash price per Share stated in the Offer Notice in accordance with clause 8.4.*

#### **8.7 Rejection**

*If the Recipients do not give notices accepting the Offer in respect of all of the Offerors' Shares within the Decision Period, each Recipient must sell, and the Offerors must buy, all the Recipient's Shares for the cash price per Share stated in the Offer Notice in accordance with clause 8.4.*

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## **9 Specialist Advisory Boards**

In addition to the appointment of non-executive directors with special skill sets that may be considered appropriate to the industry or enterprise that the company is engaged in, a board may wish to establish (or reserve the right to establish) a 'specialist' or 'professional' advisory board (**PAB**).

Common in companies where industry professionals combine with institution investors, the presence of a PAB may be used by the controlling players to win the trust of the professionals or practitioners who may be sceptical that a group of 'outsiders' are capable of understanding and representing their needs, particularly where the class of professional or practitioner shareholders hold the minority interest.

Also, boards of smaller companies may consider it prudent to establish a PAB to ensure that the company has ready access to accurate information on relevant industry or professional standards and regulations and to ensure compliance (e.g. a company who requires specialist accounting or taxation advice).

Finally, where shareholding is conditional upon continued employment with the company and/or the maintenance of certain qualifications, a PAB can be used as a 'review panel' to ensure that any industry-specific considerations are taken into account before the board rules on the requirement to sell and the valuation methodology to be employed.



**Sample clause**

**9.1 Role of PAB**

*The PAB will consist of a group of independent, experienced and qualified physiotherapists or other participants in the physiotherapy industry, who will advise the Board on matters relevant to the physiotherapy industry and will serve as a reference point to ensure that professional standards are maintained and medical issues relevant to the Group are communicated to the Board.*

*The PAB will be established to:*

- (a) review and make recommendations to the Board on the practice and future development of physiotherapy practices within the Group;*
- (b) advise the Board on physiotherapy and practice management education strategies to ensure both professional standards and practice performance mechanisms and standards are maintained and are consistent across the Group;*
- (c) review and make recommendations to the Board on training and professional development of any or all current and potential future Practitioners within the Group;*
- (d) review and make recommendations to the Board on training and professional development of any or all current and potential future practice managers (chiropractic assistants) within the Group;*
- (e) review and make recommendations to the Board on practice coaching of any or all current and potential future Practitioners within the Group;*
- (f) assess and recommend to the Board qualified physiotherapists for participation in the Company as Practitioners;*
- (g) review and advise the Board on the professional standards and conduct of individual Practitioners as and when required;*
- (h) develop, in consultation with the Board, appropriate physiotherapy practice management plans and oversee their execution and implementation; and*
- (i) consider such other matters as may be referred by the Board from time to time.*

**9.2 Appointment of PAB members**

- (a) The members of the PAB will be appointed by the Board in its absolute discretion, and may include one or more Practitioners and/or*



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*physiotherapy industry, health industry or training and development industry participants.*

- (b) *All members of the PAB will be appointed by the Board for a term of one year only, which may be renewed at the Board's discretion.*
- (c) *The Board may appoint one Director to be a member of the PAB. In addition, the Board may appoint a member of the PAB to act as the Chairperson of the PAB.*

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## 10 Unitholder and Securityholder Agreements

Where a company is the trustee of a unit trust, often it will be the case that the key assets of the enterprise are owned on behalf of the trust. If the 'real' value of the enterprise lies with the units of the trust, unitholders will be interested in controlling rights to issue, encumber and transfer these units just as much as the shares in the trustee company.

Practically speaking, most of the same issues that arise in the drafting of a shareholders agreement will be encountered in a unitholder agreement. Where the one agreement regulates the control and management of both the trust and the trustee (securityholder agreement) usually the parties will ensure that the units and shares in each entity are equal in number and that the shares and units, if transferred, must be transferred in equal proportions:

### **Sample clause**

#### **10.1 Issue of Securities**

*The Parties agree that the Shares and Units are stapled. Accordingly, Shares and Units may not be issued unless the same Proportionate Amount of Shares or Units are issued.*

#### **10.1 Transfer of Securities**

*The Parties agree that the Shares and Units are stapled. Accordingly, Shares and Units may only be transferred if the same Proportionate Amount of Shares or Units are transferred.*

In this clause:

***Proportionate Amount*** means



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(a) *in relation to Shares, an amount of Shares expressed as a percentage of the total number of Shares; and*

(a) *in relation to Units, an amount of Units expressed as a percentage of the total number of Units.*

#### 10.2 **Decisions and actions of the Trustee**

(b) *Subject to the Corporations Act and the law generally, and subject to any provision in this deed, the Trust Deed or the Constitution, the Director(s) will make decisions and otherwise perform any actions relating to the Trustee as considered necessary.*

(c) *In addition to any resolution or approval required by the Constitution, the Trust Deed or the law, the Trustee must not do, or commit to do, any of the actions described in schedule 4 without a Shareholders Unanimous Decision or Unitholders Unanimous Decision (as the context requires).*

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## 11 **Joint Venture Agreements**

Joint ventures are often appropriate where two or more individuals or entities want to carry out an activity together through a separate business from their own activities. Often joint ventures arise where each party contributes particular assets or resources which together are used for the particular venture.

The joint venture vehicle is usually either:

- a company incorporated and owned by the collaborating entities; or
- an unincorporated entity, operated under a distinct business name.

It can be a special purpose venture, such as a specified property development, or an ongoing business, such as a mining joint venture.

In either case, the parties need to be clear on the terms which will govern their relationship, including the extent of their authority to operate the business and incur debts, what each party is to contribute to the venture and what happens if either party wants to terminate the relationship or sell their interest in the venture.

Consequently, many of the same issues that arise in a shareholders agreement will also need to be considered when drafting a shareholders agreement.



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12 **Conclusion**

- SH deeds (or a variation to the form) are beneficial to the companies relying on them
- Not every company will need a shareholder agreement
- no single prototype for the corporate form and no prototype shareholder agreement
- Those who may benefit from a shareholder agreement will need one for different reasons and will require different agreements
- No shareholder agreement can prepare for every contingency – but a good agreement can prescribe a clear process for determining that contingency, should it arise