Preparation of Shareholder Agreements in Practice

Peter English – Director

Surry Partners Lawyers

www.surrypartners.com.au

SURRY PARTNERS

Table of Contents

Preparation of Shareholder Agreements in Practice

1. Background – Do you need a Shareholder Agreement?

To understand the role and value of a Shareholder Agreement, it helps to have an understanding of how shareholder relations would be governed if there were no formal agreement.

This requires an understanding of the different functions and decision making capacity of directors and shareholders. It also requires an appreciation that usually, in the context of small to medium enterprises (**SMEs**), directors are usually shareholders and/or control the shareholders. Their interests are often aligned or, if they start aligned, may end up diverging.

A Shareholder Agreement is the preferred way of establishing a set of rules to maintain alignment and, most importantly, when and if the alignment goes awry, managing the process of conflict. Think of it as a corporate insurance policy.

In the absence of a shareholder agreement, shareholder relations will be governed by a combination of statute law, common law and the company's Constitution.

1.1. Corporations Act

The *Corporations Act* 2001(Cth) (**Corporations Act**) codifies the statutory obligations of directors [ss. 180 - 197] and provides safeguards for shareholders in respect of range of conduct that is discriminatory, or oppressive [ss.232 - 234]. It also sets out the rights of shareholders to obtain certain company information and to call for meetings to vote on issues of concern [s.249F and s.249N]. The underlying principle is to provide protection for shareholders in relation to the decision making of directors, in whom the management function of the company is placed. The ability of shareholders to vote to appoint and remove directors [s.203C and s.249F] is a key protection for shareholders, but it's a protection that may not be required if there is an adequate/appropriate Shareholder Agreement in place.

The Corporations Act also sets out "replaceable rules" that govern shareholders dealings and directors' dealings that are summarised in s.141. They do not have statutory force, but can be enforced as a contract between the members [s.140] and/or can be modified or replaced by the company's Constitution [s.134].

1.2. Constitution

The Constitution is a useful document for regulating shareholder interaction, but unless it is customised, its function is usually limited to something of a basic rule book that governs the mechanical operations of a company. Most shelf companies are supplied with basic constitutions. Typically, the Constitution will address matters like:

- Defining classes of shares and the rights attached to those shares
- Processes governing the issue of shares
- Rules regarding transfer or transmission of shares on death or insolvency
- Rules governing shareholder meetings
- Appointment, removal and remuneration of directors
- Powers and duties of directors, and
- Rules governing director's meetings

1.3. Common Law

Shareholder relations are also governed by common law considerations that may raise issues of good faith, misrepresentation, fiduciary duties, false and misleading conduct – together with overlaps in the Australian Consumer Law and state based Fair Trading legislation. There are also remedies which are available in equity (injunctions and specific performance) that do not require specific documentation to be invoked.

1.4. Shareholder Agreements in Practice

The value in Shareholder Agreements is their ability to address matters that the Corporations Act, the Constitution and the common law do not address. In addition to the matters dealt with in the Constitution, they can include:

- Adoption of agreed business plans
- Agreed funding arrangements
- Financial reporting obligations
- Pre-agreed dividend distributions
- Veto or special majority requirements for certain decision making that would otherwise be the domain of the directors
- Provisions for changes in share ownership (tag-along and drag along)
- Restrictions on the transfer of shares
- Agreed methods for share valuations
- Alternate remedies for dispute resolution
- Deadlock provisions
- Confidentiality and non-compete provisions.

Drafting a shareholder agreement and knowing what to include and what to leave out will require a balance between practicality and complexity, depending on:

- The number of shareholders
- Their objectives
- Their sophistication and the sophistication of their funding arrangements
- The nature of the business or the industry in which it operates.

The scope and the level of detail required in a Shareholder Agreement for a company in which a private equity firm has invested funds, with a targeted IPO in 12 months will be very different to a shareholder agreement for a small building firm where the founder works in the business and his co-shareholder has a passive funding role.

1.5. Overview

Clearly there will be overlaps between the Constitution and the types of matters that a Shareholder Agreement can and should address. There will also be overlaps with the relevant provisions of the Corporations Act 2001 (Cth). Usually, the matters that a Constitution won't address and matters that are not governed by the Corporations Act, are the matters which are the focus of this paper.

2. Taking instructions from multiple parties

2.1. Who is your Client?

Commonly, a two shareholder business will have shareholders who are also the directors and who work in the business. Can you act for both of them ? The answer is that you *could*, but you *shouldn't.*

The Law Society says it's OK to act for multiple parties in a non-contentious transaction provided you have the **informed consent** of all the parties, but there are obvious risks and it's not recommended.[1]

For example, one party might say, years after the event when there is a dispute concerning the valuation of shares for a buyout, that you failed to explain to them the effect of the share valuation clause – that your drafting favoured the other shareholder, or that you failed to incorporate an appropriate restraint in the exit clause that has allowed the exiting shareholder to set up in direct competition with the business. You may not want to test the scope of how informed the consent was that you obtained from your clients.

Ideally, don't act for both or all shareholders. You should only act for one and the other(s) should obtain independent legal advice on the document.

2.2. Informed Consent

In the real world, in a small to medium size commercial legal practice, your clients will say – "*We don't need two lawyers. We're great friends. We trust each other and we don't need to incur further expense at this stage of the business.*" This is quite common at the enthusiastic start up stage of the company. What do you do?

After you've read rule 11.5 of the Conduct Rules, you start by advising them that you should only act for one, however, if they agree to jointly instruct you and you are retained by them to document the agreement they have reached, you might consider something I usually do in practice. You could say – "*I can act for you both, but there may be*

[1] See Australian Solicitors' Conduct Rules 2011 and Commentary – August 2013 published by the Law Council of Australia Rule 11 – "*Conflict of duties concerning current clients*".

circumstances where you cannot agree on how a particular provision might work in practice. For example, you may not agree on how a proposed deadlock clause might operate and/or how a share valuation provision attached to it is going to apply. In that event I will recommend that you obtain independent advice to resolve the position and document what you subsequently agree. If you can't agree, it's probably best to know that now."

2.3. Getting Instructions

So now you should ask a range of questions.

Our approach to this engagement is derived from an experience I had as law student. I was introduced to a woman who was very senior in the Australian advertising industry at the time. Her name is Jaqueline Huie. She made it possible for me to observe a number of client focus groups and the planning sessions that followed them. The focus of her practice was to build value in brands.

We talked about careers and interests and she referred to an idea that she had stuck with throughout her business career and advice she gave to selected clients. It was – "***You should never go in to a business without planning an exit***."

While on the face of it, that could seem like a very negative proposition, on reflection, it's full of promise. If you are starting a business, be clear on your objective, have a value proposition and a point of difference to your competitors, but plan to get out. Build value in to the business which is not personal goodwill and develop a strategy to be able to sell the business for the best price you can.

That thinking can then help the lawyer inform the client about how they might think about setting the business up. The strategy that might apply to a structure designed to maximise revenue, protect assets and stream profits to shareholders, is unlikely to be the same strategy adopted for a company that is focussed on long term growth, staged equity funding, possible strategic partnerships and an exit via a trade sale or IPO.

With that in mind, the first question should be the most important:

2.4. Why ?

- Why establish the company to run this business ?
- What is your objective ?
- Is the focus on financial rewards ?
- Is it to provide you with a lifestyle and work flexibility ?
- If it's about money, is it to make money spend on something else, or is it about building the business up to sell it ?
- If it's the latter, have you talked through and agreed on your strategy to get there?

The responses you get to these questions will help to get the client(s) focused on their objectives and allow you to draft a shareholder agreement that is tailored to their needs.

If the focus is on generating profits and distributing them equally, you can recommend that they should agree in advance on a dividend policy. If the focus is on building the business with a view to creating value and profiting from a future sale, their focus will be on future share sales and/or share valuation provisions. If the business has substantial intellectual property assets, should they be held in a separate company and licensed to the operating company to use? Getting the shareholders thinking and talking about an exit plan/strategy from day one, can be a very useful exercise. It will also guide you on your shareholder agreement drafting.

There are a range of other questions you should ask, that are all related to “why”:

- What is the business?
- What is your experience in the industry that the business operates in?
- Have you discussed what each of you are going to bring to the business in terms of funding and in terms of ongoing work contributions?
- Are you both going to work in the business? Have you set clear guidelines on which each of you will do? Think of it like a job description.
- How are you going to fund the business – are you contributing equity, or putting funds in as loans, are you obtaining third party funding?
- Are you both/all prepared to give personal guarantees for third party funding?
- If your contributions of capital, or contributions of other assets like customers, or contacts or intellectual property are not equal, have you discussed how you might take that into account – for example, will your profit share vary?
- Would having different classes of shares help?
- How much do you each expect to be paid?
- Are you happy to appoint a particular accountant to do the books?
- Have you agreed on where you are going to bank?

All of these questions are intended to get the parties thinking about why they need an agreement to regulate their working relationship.

2.5. A Practical Tip

A practical tip here is to invite the shareholders to independently prepare a document that sets out their understanding of how they propose to fund it, what they will draw out, what their role is in the business and what their co-shareholder(s) role in the business is, what their intentions for the business are and what their personal objectives are – then exchange them. The process will confirm what they agree on and throw up issues that could usefully be resolved before they start.

There are other questions that should be asked, like:

- Have you been a director of a company before?
- Have you considered your statutory obligations as a director?

- Have you looked at your company's Constitution?
- Do you know what your company's Constitution does?

This should lead to a discussion about the relationship between the Constitution and the shareholder agreement and the relationship between the directors and the shareholders concerning decision making.

3. Decision Making

3.1. Director's Roles

The guiding principle here is that, as a starting point, management of the company is vested in the directors. It is important to draw a distinction between the duties of directors and the powers of directors. It is also important for clients to have a understanding of what rights the shareholders have to control the decision making capacity of directors.

Section 134 of the Corporations Law provides – "*A company's internal management may be governed by provisions of this Act that apply to the company as replaceable rules, by a constitution or by a combination of both.*"

Section 198A, which is a replaceable rule, provides that "(1) *The business of a company is to be managed by or under the direction of the directors*. *(2) The directors may exercise all the powers of the company except any powers that this Act or the company's constitution (if any) requires the company to exercise in general meeting*

Most standard constitutions will contain articles that deal with:

- Appointment, removal and remuneration of directors
- Powers and duties of directors
- Rules governing director's meetings.

Where all shareholders have representation on the board of a company, the line between directors decision making and shareholders decision making becomes blurred.

Shareholders get to appoint and remove directors and can, in accordance with sections 249E and 249F of the Corporations Act, require the directors to convene general meetings at which they can propose resolutions.

3.2. So what decisions are reserved for shareholders?

In the absence of a shareholder agreement that reserves certain decisions to the shareholders, shareholders are not involved in the day to day management of the company. Their decision making is restricted to include matters like approval of related party transactions [s.208], varying the share capital of the company by changing the rights attached to certain shares [s.246B] and voluntary winding up [s.491].

Clearly there will be overlaps between constitutions and the types of matters that a Shareholder Agreement can and should address. There will also be overlaps with the relevant provisions of the Corporations Act. No provision in a Shareholder Agreement will be effective to restrict the operation of the Corporations Act.

The most effective solutions to balancing the power of directors and the interests of shareholders is to have a well drafted Shareholder Agreement. The Shareholder Agreement can nominate certain subject matter that must be referred to shareholders for determination. Bear in mind that the decision making could be determined by a simple majority (51%), a special majority (75%) or unanimously. Deciding on which control level to adopt will depend on your instructions.

A non-exclusive list of the types of decisions that should be carved out for shareholder determination include:

- a material change or redirection (including cessation) in the general nature of the operation of the Company.
- the sale or other disposal by the Company or any asset or part of an asset having a value in excess of $5,000.
- the acquisition by the Company of any asset or an investment involving a capital expenditure by the Company in the sum of $5,000 or more.
- the issue or allotment of any Shares or options to purchase any shares in the Company to anyone other than the existing proportion to their shareholding.
- any reduction of capital or changing of the capital structure of the Company.
- any alternation in the Constitution of the Company.
- a merger of the Company's business with any business or undertaking conducted by any other entity.
- the approval of the business plans and budgets.
- the development and sale of products or services or entry into markets that are not organic derivatives of the Business.
- borrowing funds and/or the provision of security over company assets.
- the lending of the Company's funds.
- the winding up of the Company.
- the varying of rights attached to shares.
- any alteration to this Agreement.

It is important to note that although the Shareholder Agreement might provide for special majority decision making, if a shareholder ever commanded a special majority position and used that position to discriminate against the minority, the oppression remedy (s.232) may remain available.

4 Fundamental Provisions in Shareholder Agreements

The discussion as to what should be a fundamental provision in a Shareholder Agreement and what should be "optional" or "sophisticated" will usually be dictated by the number of shareholders, their experience and the scale and type of business they are looking to run.

A non- exclusive list of what I consider to be fundamental clauses in Shareholder Agreements (some with short comments) include:

4.1 Definition of terms used in the Agreement

Key terms used in the Agreement should be defined. They should include "business", "confidential information", "event of default", "insolvency event" and other terms which will often be referred to in the agreement.

4.2 Primacy of Shareholder Agreement over constitution

In the event of their being any inconsistency between the Shareholder Agreement and the constitution, you would want the Shareholder Agreement to prevail.

4.3 Term of the Agreement

Usually the term of the Agreement will be until the parties unanimously agree, one of the parties owns all of the shares or there is an agreed exit – via an IPO or trade sale of the business.

4.4 Processes governing the issue of shares

This is a matter likely to impact on future capital raising. Section 254D of the Corporations Act operates as a replaceable rule that requires directors to first offer shares of a particular class to shareholders in that class, before offering the shares to others, unless authorised by an ordinary resolution of shareholders. The rule does not apply to share transfers. If the directors form the view that the company should raise funds through a share issue, the Shareholder Agreement should provide for there to be a pre-emptive right for existing shareholders to subscribe for shares in proportion to their current shareholding. If one shareholder is unable to take up the required subscription, this could lead to one shareholder acquiring a controlling interest in the company. This is a tool which can be used by an aggressive shareholder to put pressure on other shareholders. If the equity raising is external, it should be expressed to give effect to a pro-rata reduction in each existing shareholder's equity.

4.5 Rules regarding transfer or transmission of shares on death, incapacity or insolvency

It is prudent to provide that on the death, incapacity or insolvency of a shareholder, that existing shareholders have the right to acquire the relevant shares on a pro-rata basis at a value to be determined in accordance with another provision of the shareholder agreement. In some cases having appropriate insurance cover in place, with buy/see agreements in place between the shareholders, can provide funding to buy out shares in unexpected circumstances.

4.6 Rules governing shareholder meetings

Consideration should be given to what number of shareholders constitutes a quorum, how proxies might be used and how technology might be used to conduct meetings.

4.7 Rules governing appointment and removal of directors

Usually, in an SME (small to medium enterprise), you would allow for each shareholder to have a board position, for so long as they remain a shareholder. If a shareholders nominated director resigns or retires, the right to appoint a replacement should be reserved for that shareholder. If the shareholding is not equal, the number of directors each shareholder may appoint could vary accordingly.

4.8 Rules governing directors meetings

Is there to be a Chairman? Is he/she to have a casting vote? Must directors' decisions be unanimous to be effective? What constitutes a quorum for meetings? May alternate directors be appointed?

4.9 Agreed funding arrangements

Will the funding required to commence the operations of the company be contributed as loans or as equity? If the money is going in as loans, what are the terms? Are they to be secured over available company assets? Usually you would allow for the repayment of shareholder loans and any accrued interest as a priority to dividend distributions. If future funding is required, what happens if one or more shareholders do not have funds available to contribute? This is potentially a matter for significant future conflict.

4.10 Banking, and accounting arrangements

It is prudent for shareholders to agree from the outset on where they are going to do their banking and who they are going to appoint as the company's accountant.

4.11 Pre-agreed dividend distribution policy

These types of clauses can be customised, but they are worth agreeing in advance. Usually, subject to s.254T of the Corporations Act, directors determine whether dividends should be paid (s.254U sets out the replaceable rule). This is a common source of dispute between shareholders, particularly where one shareholder is not working in the business and may be relying on dividends to justify their investment.

We recently drafted a shareholder agreement for property development company where the dividend policy required that, subject to all applicable laws, the Company must declare and pay a dividend of all available profit of the Company within 90 days after the end of each of 30 June and 31 December each year. In another agreement for a PR company 75% of all profits made in respect of services provided to one client were to be distributed to one particular the shareholder, the residue to be distributed, first in reduction of shareholder loans and thereafter as the directors agreed.

4.12 Restrictions on the transfer of shares, incorporating pre-emption rights

The Shareholder Agreement can address this to require exiting shareholders to offer their shareholding to existing shareholders first, on terms no less favourable than those offered to a third party.

4.13 Veto or special majority requirements for certain decision making

See the commentary in section 3 – Decision Making. The agreement should nominate whether the agreed list of matters that are to be reserved for shareholder determination are to be determined by unanimous resolution, a special resolution or ordinary resolution. We recently prepared a Shareholder Agreement for a company where the founding shareholder agreed to dilute his interest over a period of 18 months to 75% of the issued share capital. The incoming investor insisted that the agreed list of matters reserved for shareholder determination require a unanimous vote to be approved. Our client countered that an 80% majority should apply, to incentivise the incoming investor to contribute all of the funds it had agreed to contribute in tranches that allowed for a 5% equity for each instalment. If the final instalment was not contributed, the control factor would not apply.

4.14 Agreed method(s) for share valuations

I won't say much on this given that there is a paper to follow dedicated to share valuations, but to avoid future disputes, it would prudent to pre-agree the valuation method. It is common to provide for the appointment of an external valuer and set the criteria for the valuer to follow. In some circumstances a discount might apply to a minority shareholding. You might also provide for a valuation discount in respect of a defaulting shareholder – sometimes referred to as "bad-leaver" provision. For a useful summary on this subject, look at

Backoffice Investments v Campbell [2007] NSWSC 161 (para 134 about valuation.)

4.15 Setting out consequences of default events

Commonly, an un-remedied default could trigger an obligation on the defaulting shareholder to transfer their shares to their co-shareholders at a value determined in accordance with the Shareholder Agreement. It is also common, to provide for Power of Attorney provisions to facilitate the transfer(s) of an uncooperative shareholder.

4.16 Alternate remedies for dispute resolution

No different to the concept of alternate dispute resolution you would expect to see in any commercial agreement. Our preference is to provide for a prescriptive mediation process as a pre-requisite to any formal litigation.

4.17 Deadlock provisions

A resolution for deadlocked decision making may, or may not involve the concept of a "shotgun" provision. As a practical matter, it will only apply in respect of two shareholder companies. The shotgun clause works to provide a shareholder with the opportunity to break a deadlock by offering to purchase the shares of the other shareholder on terms set out in the offer. That will trigger a right for the other shareholder, within a tight timeframe, to purchase the shares of the party making the first offer on the terms contained in the offer. If the offer is rejected, the shareholder receiving the offer must sell. We favour "shotgun" clauses as a device for focussing the shareholders on the consequences of failing to compromise to reach an agreement.

4.18 Confidentiality and non-compete provisions for departing shareholders

Company constitutions and the replaceable rules provided for by the Corporations Act make no provision for confidentiality or the protection of a company's goodwill. The restraints that might reasonably be imposed on a departing executive in an employment agreement can be incorporated into the Shareholders Agreement to restrain departing shareholders and/or the individuals that control the shareholder if it is a company.

4.19 Boilerplate clauses

These will include provisions for giving notices, the severability of clauses that might be unlawful, the exclusion of pre-agreement negotiations, warranties about authority to enter into the agreement and a governing law and jurisdiction provision.

5. Optional and Sophisticated Provisions in Shareholder Agreements

I have added some examples of clauses that are relatively uncommon in Shareholder Agreements.

5.1. Incorporating business plan and marketing plan obligations

(i) Adoption

The Shareholders **must ensure** that the Board considers and adopts in respect of each Financial Year an annual work programme and budget which contains the matters specified in clause # (**Annual Programme and Budget**).

(ii) First Annual Programme and Budget

The First Annual Programme and Budget is Attachment B to this Agreement.

(iii) Subsequent Annual Programmes and Budgets

In the case of all Annual Programmes and Budgets other than the First Annual Programme and Budget, the Board must consider and adopt the Annual Programme and Budget no later than 31 May in the Financial Year prior to the Financial Year to which the Annual Programme and Budget relates.

(iv) Contents

Each Annual Programme and Budget must contain in respect of the Financial Year to which it relates:

(a) a description of the proposed activities of the Company during that period;

(b) a budget containing an estimate of the income to be received and the expenses to be incurred in implementing and carrying on the Business during that period and an estimate of the anticipated capital expenditure to be made during that period;

(c) a forecast of cashflow for that period; and

(d) a program for debt or equity contributions, if any, to be made by the Shareholders during that period.

(v) Amendment

The Board may from time to time by Unanimous Resolution revise and amend an approved Annual Programme and Budget.

5.2 Provisions for changes in share ownership (tag-along and drag along)

Depending on your experience with drafting shareholder agreements and/or advising shareholders, tag along and drag along provisions may be common. Where one shareholder has a majority shareholding and their interest in the company is to build its value for a future sale, clauses that require them to take the minority shareholder(s) (**tag along**) or force the minority shareholders to sell to the party acquiring the majority stake (**drag along**) are useful tools to streamline the process. For an interesting discussion on the application of drag along clauses in practice, see *William McCausland v. Surfing Hardware International Holdings Pty Ltd* [2013] NSWSC 902.

(i) *Tag Along Option*

(a) If, in relation to a proposed Dealing in a Share, a Shareholder (Selling Shareholder) is entitled to transfer that Share to a third party under this agreement (including after compliance with clauses # to #), each other Shareholder will have the option (Option) to require the Selling Shareholder to cause that third party to purchase up to the same proportion of that other Shareholder's Shares as the proportion of the Selling Shareholder's Shares which are to be purchased by that third party bear to the total number of Selling Shareholder's Shares.

(b) The price per Share and terms upon which the Selling Shareholder must cause that third party to purchase each other Shareholder's Shares will be the same as those applicable to the sale of the Selling Shareholder's Shares to that third party.

(c) As soon as is reasonably practicable after the other Shareholders became entitled to exercise the Option, the Selling Shareholder must give each other Shareholder written notice written notice must specify the number of the other Shareholders' Shares which the Selling Shareholder is required to cause to be be purchased by that third party (Tag Along Shares).

(d) If a Shareholder exercises its Option by giving written notice to the Selling Shareholder no later than 30 days after receiving written notice from the Selling Shareholder under clause 7.7(c):

i. the Selling Shareholder must take all steps (including making it a condition precedent to completion of the sale of the Selling Shareholder's Shares to that third party) to cause that third party to purchase the Tag Along Shares on the same terms (including as to price) as the purchase of the Selling Shareholder's Shares by that third party; and

ii. the Selling Shareholder must not sell its Shares if that third party for any reason fails to purchase all of the Tag Along Shares on the same terms (including as to price) and to complete that purchase of the Tag Along Shares at the same time as the completion of the sale of the Selling Shareholder's Shares to that third party.

(ii) *Drag Along Rights*

(a) If at any time:

i. an offer on arm's length terms is made by an independent third party (Drag Along Buyer) to one or more Shareholders that hold 50% or more of the Shares (Drag Along Shareholder) to purchase all of the Shares on issue at that time at not less than the market value of Shares, for a cash price per Share, on the same price and terms for each Share (Drag Along Offer); and

ii. the Drag Along Shareholder wishes to accept the Drag Along Offer,

then after compliance with clauses # to #, if Offers and re-offers with respect to some of the Sale Shares have been rejected by all Shareholders the Drag Along Shareholder may, accept the Drag Along Offer and by notice to the remaining Shareholders, require the remaining Shareholders to accept the Drag Along Offer and those remaining Shareholders must upon receipt of that notice, do so.

(b) If any remaining Shareholder does not accept the Drag Along Offer when required to do so in accordance with clause # prior to expiry of the Drag Along Offer, that person:

i. will be deemed to have accepted the Drag Along Offer immediately prior to expiry of the Drag Along Offer;

ii. must do all things necessary to complete the sale of its Shares resulting from acceptance of the Drag Along Offer in accordance with terms of the Drag Along Offer; and

iii. must transfer all of its Shares to the Drag Along Buyer free from any Encumbrances, in accordance with the terms of the Drag Along Offer.

(c) Where a remaining Shareholder, when reasonable required to do so, has failed to sign such documents or take such actions to effect the transfer of Shares referred to in this clause #, that remaining Shareholder is deemed to have appointed the Drag Along Shareholder as its attorney to complete and execute (under hand or under seal) all documents and take all actions on its behalf to effect the transfer of all such Shares to the Drag Along Buyer in accordance with the terms of the Drag Along Offer. The remaining Shareholder agrees to ratify and confirm whatever the attorney lawfully does, or causes to be done under the appointment pursuant to this clause #.

5.3 Detailed financial reporting obligations

What is included in these clauses is entirely a matter for negotiation between the parties. Usually, shareholders are restricted as to what type of financial information they can access, and how often. Part 2F.3 of the Corporations Act governs shareholders limited legal rights to inspect books of the company (Sections 247A to 247D inclusive).

Where the shareholders are sophisticated and an exit is proposed by way of an IPO, the parties are likely to require financial reporting that would meet the due diligence requirements of an ASIC approved prospectus. Set out below is an example of a clause we used in a Shareholder Agreement that was connected with a share purchase agreement with a proposed IPO exit.

(i) *Financial Year*

Each financial year of the Company will end on 30 June.

(ii) Auditors

The Shareholders must procure that the Company will cause the consolidated profit and loss account and balance sheet of the Company to be audited by the Auditors.

(iii) Books and Records

All books, records, accounts and other documents relating to the Company or the Business must be kept at the registered office of the Company.

(iv) Accounting Policies

The Shareholders must procure that the Company prepare and maintain its books, records, accounts and other documents on an accrual basis in accordance with the Accounting Standards.

(v) Annual Accounts

The Shareholders must procure that the Company provides to each Director and to each Shareholder as soon as available, and in any event within 120 days after the end of each Financial Year, a copy of the audited balance sheet of the Company as at the end of that Financial Year and a copy of the audited profit and loss account of the Company for the period ending on 30 June in that Financial Year.

(vi) Half Yearly Accounts

The Shareholders must procure that the Company provides to each Director and to each Shareholder as soon as available and in any event by 31 January in each Financial Year copies of the unaudited balance sheet of the Company as at 31 December in that Financial Year and a copy of the unaudited profit and loss account of the Company for the six months ending on 31 December in that Financial Year.

(vii) Monthly Management Accounts

The Shareholders must procure that the Company furnishes to each Director and to each Shareholder within 25 days after the end of each month unaudited management accounts covering the operations of the Company for the preceding month.

(viii) Other Financial Information

The Shareholders must procure that the Company furnishes to each Director and to each Shareholder as soon as available all other financial accounts, projections, budgets and reports that may be approved by the Board from time to time.

5.4 Other clauses

There are numerous other matters which can be incorporates into Shareholder Agreements. The include but are not limited to:

- Share buy-outs using put and call option deeds
- Pre-agreeing division of assets on termination of Shareholder Agreement
- Incorporating director's employment terms (as an alternative to having a separate agreement)
- Specific clauses dealing with agreements between the company and shareholders
- Detailed clauses relating to funding for projects to be undertaken by the company

6. New Shareholders, Accession and Amending the Shareholder Agreement

Well drafted Shareholder Agreements commonly have provisions which make it a condition of an approved share transfer that the incoming shareholder signs an Accession Deed to the effect that they agree to be bound by the provisions of the existing Shareholder Agreement.

It is essential to have a formal method to make the incoming shareholder a party to the existing Shareholder Agreement, because, unlike the Constitution which is imposed on the shareholder as a condition of their shareholding, the Shareholder Agreement operates a private contract between the signatories. If a party doesn't sign it then, usually, it will not be capable of being enforced against them.

The ability to amend a Shareholder Agreement, subject to the overarching effect of the Corporations Act and the protections it affords to minority shareholders, will depend on what provisions for amendment are allowed for in the Agreement. Unless the mechanism for amendment is pre-agreed, any dispute about the proposed amendment will lead to some form of deadlock or dispute resolution.

7. Conclusion

A Shareholder Agreement is a contract between the members of a company that, together with its Constitution and the overriding application of the Corporations Act, provides an enforceable framework for the orderly operation of a company.

For the Shareholder Agreement to be effective, it needs to be customised to take into account the essence of the shareholder's agreement. Depending on the business experience of the parties, the lawyer's role will legitimately be to guide the parties through the process and invite them to talk through subjects and issues they have not considered. Clear and concise drafting of that agreement should follow.

I hope this paper assists you to more effectively play that role and to produce, or contribute to the drafting, of more effective and practical Shareholder Agreements.

Peter English
Director
Surry Partners Lawyers
19 March 2014