FAQS: SHAREHOLDERS AGREEMENTS

Together with your company's constitution, a shareholders agreement provides the foundation for the corporate governance of your startup and outlines what a shareholder can and can't do. It also sets out the shareholders' rights and obligations and their role in the management of the company.

The FAQs below address some of the commonly asked questions put to our Allens Accelerate team about shareholders agreements. A free copy of the Allens Accelerate A-Suite Shareholders Agreement, which includes guidance notes, is available for download here. If you have any other questions, please get in touch with our team.

WHAT IS A SHAREHOLDERS AGREEMENT?

A shareholders agreement is a binding contract between the shareholders of a company, which governs the relationship between the shareholders and specifies who controls the company, how the company will be owned and managed, how shareholders' rights may be protected and how shareholders can exit the company.

TIP

Your shareholders agreement should outline:

- the structure, management and direction of the business;
- how responsibilities will be divided between the directors and shareholders;
- how shareholders may acquire or dispose of shares;
- how the company will be funded; and
- what will happen if the relationship between shareholders comes to an end.

WHY DOES MY STARTUP NEED A SHAREHOLDERS AGREEMENT?

Even if your company is not planning to raise capital immediately, it is important that a shareholders agreement be implemented as soon as it appears that there may be more than one shareholder.

A robust shareholders agreement will:

- provide a framework for the transparent ownership and management of your startup. It will help to clarify how you intend to run the company and what you need to be mindful of in order to fulfil your obligations as a shareholder;
- signal to prospective investors that your company is well-managed and provide transparency over the company's ownership and management. This will help to reduce the likelihood that investors will require you to replace or negotiate the terms of your agreement with more investor-friendly terms; and
- outline how potential disputes between shareholders can be settled. While disputes might seem unlikely early on, it's helpful to agree on the resolution process from the outset so that at the very least there is an agreed framework in place that can kick in if (and when!) issues do arise.

WHAT HAPPENS IF THE SHAREHOLDERS WANT TO AMEND YOUR SHAREHOLDERS AGREEMENT IN THE FUTURE?

Because shareholders decide the content of the shareholders agreement, they can include a clause that outlines how the agreement can be amended in the future. Typically, such a clause would only allow for the agreement to be amended if all shareholders consent to that amendment.

WHAT HAPPENS IF A SHAREHOLDER BREACHES THE SHAREHOLDERS AGREEMENT?

A shareholders agreement enables an aggrieved shareholder to bring a cause of action against another shareholder that materially breaches one of their obligations under the agreement.

Material breaches will usually occur in the event of a failure by a shareholder to provide capital where required under law or the agreement, a failure to comply with any particular provision of the agreement or where a shareholder commits fraud. Of course, the nature of your business will determine whether it is important to customise your shareholders agreement to define any other event as a material breach (eg a breach of an employment agreement by an employee shareholder). It is important that you clearly define and list all circumstances you wish to consider material breaches.

If a material breach is not remedied, the shareholder at fault may be required to transfer his or her shares, pay compensation to other shareholders or may have their voting rights suspended.

WHO SHOULD SIGN THE SHAREHOLDERS AGREEMENT?

The shareholders agreement should be signed or executed by the company and each shareholder. Remember the legal requirements for a company and an individual to sign documents is different, so make sure that you review the execution blocks correctly and sign the right one!

TIP

Remember the legal requirements for a company and an individual to sign documents is different, so make sure that you review the execution blocks correctly and sign the right one.

If you're unsure of which execution block you or your company should be using, download our free A-Suite Shareholders Agreement and look for the guidance notes on the execution page.

GOVERNANCE: THE BUSINESS OF DOING BUSINESS

DOES THE SHAREHOLDERS AGREEMENT ALLOW SHAREHOLDERS TO MANAGE THE COMPANY?

A shareholder can participate, either directly or indirectly, in the management of the company by appointing directors to the board. A shareholder's right to appoint directors is provided for in the shareholders agreement. The shareholders agreement also sets out how the board operates, including when and how the board will meet and who must be present when it does.

TIP

Some companies limit the shareholders' rights to appoint directors, to ensure that this right is reserved for founding or substantial shareholders only. For example, the agreement may:

- require that only shareholders with a certain minimum percentage of shares can nominate directors;
- limit the size of the board based on the size of the company; and
- preserve a founder's right to nominate a director irrespective of any dilution of their shareholding.

SHOULD CERTAIN DECISIONS BE MADE BY SHAREHOLDERS OR DIRECTORS?

The shareholders agreement should set out matters that are reserved for the board and those matters that will require shareholder approval. It will also set out the level of majority required to pass a particular resolution.

Decisions reserved for the board typically relate to the day-to-day management of the company.

Decisions reserved for resolution by shareholders typically relate to fundamental matters for the company. They include decisions relating to remunerating directors, issuing shares to third parties, borrowing or providing guarantees over a certain amount of money, commencing litigation, entering into any agreement between the company and one or more of its shareholders, major acquisitions and disposals and deciding to go to an initial public offering (***IPO***).

A resolution can be passed by shareholders through one of two mechanisms. Most decisions will be passed by way of ordinary resolution (ie. a resolution is passed where over 50 per cent of shareholders entitled to vote agree to the resolution). More significant decisions may require a special resolution (ie where at least 75 per cent – or such other number as the shareholders may decide – of shareholders entitled to vote agree to the resolution). Special resolutions are generally reserved for particularly sensitive matters, for example making investments/divestments of a very high value, amending the constitution, or deciding to go to an IPO.

TIP

Remember, it is up to the shareholders to decide the content of the shareholders agreement. However, as a general rule of thumb, the board should control the operation of the company, while shareholders determine matters that are fundamental to the company or that are particularly sensitive.

WHAT HAPPENS IF THERE ARE NEW SHAREHOLDERS?

IF THE COMPANY ISSUES NEW SHARES:

If the company issues *new* shares, a new party will need to enter into a 'Deed of Accession' with the company and all existing shareholders, so that the new party can be bound by the shareholders agreement, and the company can register the new party as a shareholder in the company's register.

A Deed of Accession is a deed made between the company, the new party and all existing shareholders under which the new party agrees to be bound by the shareholders agreement.

This means that, assuming the new shareholder is happy to be bound by the terms of the existing shareholders agreement, there will be no need to renegotiate the shareholders agreement. All that will be required is for the new shareholder to enter into the Deed of Accession.

But if the new shareholder wants to negotiate the existing shareholders agreement (for example, this is often the case where a new investor who is receiving substantial equity comes on board), all parties to the existing shareholders agreement will need to negotiate a new shareholders agreement with the new shareholder.

IF AN EXISTING SHAREHOLDER TRANSFERS THEIR SHARES TO A NEW SHAREHOLDER:

If a shareholder intends to transfer shares to a new party, the shareholders agreement will typically require the new party to enter into a Deed of Accession (as explained above) before the shares can be transferred and before the company can register the new party as a shareholder in the company's register. At the same time the new party agrees to be bound by the shareholders agreement, the transferor is released of its obligations under the agreement. This is a contractual equivalent of 'out with the old (shareholder), and in with the new (shareholder)'. The shareholders agreement will typically set out detailed provisions on how a shareholder may transfer its shares – see section 8.2 below for more details.

TIP

A shareholders agreement only imposes obligations, and grants rights, to shareholders that are actually a party to the agreement. So it's really important that all new shareholders enter into a Deed of Accession so that they are also bound by the shareholders agreement.

ISSUING AND DISPOSING OF SHARES

IF THE COMPANY ISSUES NEW SHARES, WILL THE SHARES BE DILUTED?

If the company wants to issue new shares, the shareholders agreement should include anti-dilution and pre-emptive rights provisions, to outline whether issuing new shares will dilute a shareholder's existing shareholding (ie reduce the shareholder's percentage ownership in the company).

For example, anti-dilution provisions may require that before issuing any new shares, the company must offer to sell to each shareholder a certain number of new shares, so that a shareholder can maintain their percentage ownership in the company.

But, if the company issues new shares and existing shareholders either don't have pre-emption rights or decide not to exercise them, then yes, the issue of new shares will dilute existing shareholders' ownership in the company.

CAN I SELL MY SHARES TO A THIRD PARTY?

1. Restrictions on the transfer or disposal of shares

The shareholders agreement outlines when, and under what conditions, a shareholder may transfer, sell or assign its shares to third parties. For example, a provision may require a shareholder to obtain prior written consent from all remaining shareholders before it can sell or transfer any or all of its shares. This protects existing shareholders from jointly owning a company with an unknown third party.

Shareholders agreements also often contain 'pre-emptive rights' clauses. These provisions can prevent third parties from purchasing shares in the company before the existing shareholders have had a chance to purchase those shares. This enables shareholders to ensure that the company is still owned and managed by the same group of shareholders.

2. Drag and tag

Shareholders agreements often also contain 'drag along' options and 'tag along' provisions (as outlined below). While these restrict the sale of shares to third parties, they may be relied upon to attract a higher purchase price for the shareholders.

Drag along options: If a majority shareholder wants to sell its shares to a third party, a 'drag along' provision enables the majority shareholder to force minority shareholders to also sell their shares at the same price and terms that the majority shareholder has negotiated with the proposed purchaser. This is a powerful tool for majority shareholders who may benefit from being able to 'deliver' the whole of the company to a third party, as the additional shares would typically attract a higher price (compared with if the sale was for only a part, or a smaller percentage, of the company). It is also a useful tool for prospective purchasers who know that as long as they can get the majority shareholder to sell, the minority shareholders can be 'dragged along' with it.

Tag along options: The reverse of a 'drag along' where, if a shareholder wants to sell its shares to a third party, a 'tag along' provision gives the other shareholders a right to join or 'tag along' with the deal and sell their shares on the same terms and conditions negotiated by the shareholder with the proposed purchaser. This is a powerful tool for minority shareholders as it means that they can cash in on any great deal negotiated by another shareholder. It also prevents shareholders from being forced to remain in incompatible or undesirable arrangements with the proposed purchaser, and protects shareholders from becoming devalued if the proposed purchaser purchases a controlling interest.

WHAT IS AN EXIT EVENT AND WHAT DOES THAT MEAN FOR MY SHARES?

Shareholders agreements contain provisions about how the relationship between shareholders may come to an end, and how and when shares can be transferred. Sometimes, this relationship may come to an end because an 'exit event' occurs.

Common exit events include: where the company sells a substantial number of shares or assets, merges with, or is acquired by, another company, goes into liquidation (where the company stops operating and its assets are sold) and if there is an IPO (ie where the company's shares are listed on the stock exchange).

The shareholders agreement will typically address how an exit event can occur, what this means for shareholders, and how to determine the price of shares if there is a transfer or an IPO.

I ALWAYS HEAR ABOUT SHARES 'VESTING'. WHAT DOES THAT MEAN?

The term 'vesting' is used where a person is allocated shares incrementally rather than being provided with all their shares at once. For example, if a shareholder meets certain 'vesting criteria' (eg an employee shareholder is employed for a certain number of years), they will be allocated shares on an incremental basis to incentivise them to stay with the company for the duration of their employment. If the shareholder doesn't meet the criteria (eg they quit working for the company before the specified 'vesting date'), they will not be allocated the shares. Startups are often interested in establishing vesting arrangements with employee shareholders, because it rewards employees who commit and contribute to the productivity of the business over the course of its lifecycle.

Vesting does not exclusively apply where a shareholder is employed or engaged by the company – the company could impose other criteria under which shares will vest to shareholders (provided that such criteria are easily, and objectively, measurable). For example, the criteria may be associated with certain milestones in the lifecycle of the company (eg next funding round, certain number of users etc.), or certain revenue, profit or other financial benchmarks.

Keep in mind that a financial investor will typically seek an equity interest that is not subject to vesting criteria.

WHY WOULD I WANT TO SET UP AN OPTIONS POOL FOR EMPLOYEES? HOW DO I DO THAT?

You might have heard employees talking about their 'options' or the company discussing the 'option pool'. An option is a right, granted to key employees or other persons, to purchase shares in the company at some point in the future if certain conditions are met. This means that individuals who are instrumental to the success of your business can benefit from the increase in the company's value over time.

Startups commonly use options for two reasons.

- While a startup may lack cash flow in its early stages, granting options is a great way to attract and retain talent without having to offer high salaries or cash bonuses.
- Options help to ensure the employee and company have the same objectives – which encourages employees to perform at a higher level.

The shareholders agreement outlines how and when the company may establish an 'options pool'. The 'options pool' consists of a certain percentage of share capital (usually about 10-20 per cent) reserved for option holders to claim at a later date. Companies can determine the size of the pool at their discretion, but should keep in mind that the larger the pool, the greater the dilution in value for the founders of the company.

WHAT HAPPENS WHEN AN EMPLOYEE SHAREHOLDER CEASES TO BE EMPLOYED BY THE COMPANY? DO THEIR SHAREHOLDER RIGHTS AND OBLIGATIONS CHANGE?

If an employee shareholder stops working for the company, the shareholders agreement will typically provide that his or her shares must be sold back to the company. The price paid by the company for those shares typically depends on whether the employee is a 'good leaver' or a 'bad leaver'. Generally, a good leaver will be paid the fair market value for their shares. Bad leavers might receive only a nominal amount, as low as $1 per share.

TIP

Our free A-Suite Shareholders Agreement includes common good and bad leaver provisions in line with market practice. However, depending on the nature of the company, you may need to include other provisions for good or bad leavers in your shareholders agreement. If so, consider whether there is anything in particular that would make a leaver either good or bad (eg an employee resigning to work for a competitor might be considered a 'bad leaver', and an employee resigning after 20 years of service might be a 'good leaver'), and also how the buy-back value of the leaver's shares should be calculated.

ALLENS ACCELERATE

Allens Accelerate is a legal practice dedicated to supporting the Australian startup community and providing expert legal advice to startups, investors, and corporates and government agencies responding to disruption and investing in innovation. Contact our team for more information.

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