



SHAREHOLDERS' AGREEMENTS: ARE THE MEMBERS OF YOUR COMPANY IN AGREEMENT?

Business owners often fail to recognise the risks associated with failing to properly document agreements and understandings between them. Ironically, this question of 'what is the real agreement between the owners of the business' is a fundamental one because it can easily lead to – often catastrophic – dispute.

Business entities are all unique. They have unique external (regulatory) and internal restrictions. For this reason the sort of documentation appropriate to clarify arrangements will differ between entities. As the title suggests we are, here, focussing on the agreement between the owners of a company i.e. its shareholders.

In truth, most privately-owned companies (including family companies) would benefit from having an agreement of this nature. How comprehensive the agreement ought to be depends on a range of factors including the size of the company, the business of the company, the business structure which incorporates the company and the number of members, their relationship to one another and the existing legal arrangements in place affecting those relationships e.g. wills, etc.

WHEN SHOULD YOU PREPARE A SHAREHOLDERS' AGREEMENT?

The intention, when preparing a shareholders' agreement, is to create certainty with respect to arrangements and understandings between the shareholders. You would expect to see a record of the shareholders' aims and objectives for the company and provisions about the operation and administration of the company.

Whilst it is preferable to put shareholders' agreements in place at the outset, when the company is being established, it is *never* too late to clarify the arrangements between members. In doing so it is quite common to find that there are issues that the parties have not actually turned their minds to or that there wasn't, in truth, agreement on an issue even though the members had themselves previously believed that there was. Often, if identified early, an issue of disagreement can be resolved quickly through negotiation because the issue is still a hypothetical one. It is much easier to negotiate the terms of a default provision *before* there's been a default by one of the parties!

Take the time now to consider your company structure. What companies are involved? Who are the shareholders? Do you have written shareholders' agreements amongst those shareholders? With reference to our checklist overpage, ask yourself:

1. When establishing the company did the shareholders consider these issues?
2. Did the shareholders *actually* agree on these issues and, if so, did they document the agreement?

If you answered no to either of these questions you have now identified a significant risk factor that should be addressed.

Some of these issues may have inadvertently been addressed in the company's constitution. In most instances the shareholders aren't involved in stipulating the terms of the constitution when a company is established. For that reason the constitution may not actually reflect the agreement between the parties.

HOW TO GET THE RIGHT LEGAL ADVICE

When getting advice about a shareholders' agreement remember to bring in all documents that are fundamental to your business' structure and operations e.g. constitution of the company, shareholders' details, any relevant business plans, etc.

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We would ensure that, when drafting your agreement, we advise you on legislative provisions, such as the Corporations Law, that could impact on your agreed terms. The company's constitution also needs to be considered and, if necessary, to avoid conflicting provisions, changes made to the constitution using proper procedures to give legal effect to the change.

Having agreed on this it is important to follow through the steps needed to make the agreement work in practice. We would also advise you on the prudent steps you should take before the agreement is signed. For example: The members may decide to give one another a 'first right of refusal' (*on agreed terms*) in relation to the purchase of shares in the event of death. To give this clause practical effect it may be necessary to obtain mutual "key-man" insurance policies to fund that buy-out. Not only should the funding of these insurances be addressed in the agreement but the insurance itself needs to be put into effect before the agreement takes place.

CHECKLIST – SOME ISSUES THAT CAN CAUSE CONFLICT

- | | |
|--|--|
| <input type="checkbox"/> Board of Directors – appointment/removal of board (including chairman), board voting, regularity of board meetings, etc | <input type="checkbox"/> Restraints – e.g. non-competition with company business |
| <input type="checkbox"/> Decision-making – of board & shareholders in general meetings | <input type="checkbox"/> Trademarks – clarification as to ownership & usage |
| <input type="checkbox"/> Day-to-day management | <input type="checkbox"/> Confidentiality – of company information |
| <input type="checkbox"/> Financial reporting and accounts | <input type="checkbox"/> Dispute resolution procedures – if a dispute arises |
| <input type="checkbox"/> Funding arrangements for the company | <input type="checkbox"/> Default of the agreement – rights available to parties |
| <input type="checkbox"/> Transferring shares – transferring to related entities, right of first refusal, etc | <input type="checkbox"/> Termination provisions |

FORREST V APPELYARD & ORS: HOW THINGS WENT WRONG FOR SHAREHOLDERS WHO FAILED TO FOLLOW THEIR OWN AGREEMENT

A recent decision of the NSW Supreme Court¹ illustrates the importance of actually following your shareholders' agreement once the agreement has been concluded.

The case involved four parties carrying on a civil engineering consulting business (*"the owners"* for ease of reference). A shareholders' & unitholders' agreement, dated 1 September 1995, existed between the owners. This agreement regulated the retirement of shareholders and the transfer of their shares.

Mr Forrest, one of the owners, sought to retire from practice however, in doing so, did not follow the steps set out in the agreement. The remaining directors entered into discussions with Mr Forrest rather than requiring him to comply with the procedures set out in the agreement.

The ultimate outcome of the case was that the remaining shareholders could no longer enforce a provision in the shareholders' agreement that permitted them a discount in the purchase price due to Mr Forrest's early retirement. To this end the Court concluded that the 'negotiation' process that had occurred overrode certain terms of the shareholders' agreement. It was also found that Mr Forrest had acted in reliance on representations made in the negotiation process such that the remaining partners were 'estopped' from relying on terms in the shareholders' agreement as against those representations.

The fallout for this business was considerable. Not only were the remaining partners (who were unsuccessful in the case) landed with Mr Forrest's legal costs (which would have been substantial) but, before the hearing of the case, a second director sought to retire in circumstances where there was still dispute as to how much was owed to Mr Forrest for his shares and whether there was an legal obligation on him to actually acquire those shares.

On a broader perspective this case clearly demonstrates the need for business owners to recognise that, whilst they are working together in a business and have common objectives with co-owners, decisions about individual goals and ideals can easily put their interests at odds with the interests of other members. Having a properly prepared shareholders' agreement and then actually following the agreement will substantially reduce the risk of a difference in personal objectives turning into a protracted dispute.

¹ *Forrest v Appleyard & 2 Ors* [2006] NSWSC 281 (13 April 2006)

EXPERTISE

BUSINESS SNIPPETS

RECENT ATO RULING AFFECTING SERVICE TRUSTS

The ATO has released Taxation Ruling TR 2006/2 which relates to the deductibility of service fees paid to associated service entities. This ruling may affect your business if you are structured so that one entity supplies services to another related entity for a fee. If your service trust arrangement is found not to be legitimate it will affect your ability to deduct expenses paid to the service trust and could result in significant additional tax being payable along with penalties. If you think your business could be affected you should consult your accountant to determine whether the ruling applies. We can then work with your accountant to assess what (if any) business restructuring would be prudent in order to comply with the ATO ruling.

MACGILLIVRAYS APPOINTED BY INTERNATIONAL MERCHANT BANK

The Corporate & Business Group has recently received instructions from one of the largest merchant banks in the world, based in the UK to act for it in a specific project in Queensland.

The firm has once again demonstrated the capacity and flexibility to respond to off shore client needs in their investment strategies in Australia.

FEDERAL GOVERNMENT INITIATIVES TO CUT RED TAPE FOR SMALL BUSINESS

In a media release issued on 15 August 2006 the Federal Government announced its response to the Banks Report on red tape. According to its media release the Government has agreed in full or in part to 158 of the 171 recommendations made in the Banks Report.

Key initiatives include:

- tougher rules for making new regulation
- promoting greater national consistency on OHS regulations
- better alignment of training, licensing and small business definitions
- greater cooperation on providing education and advice for business
- establishing a strengthened Office of Best Practice Regulation to replace the Office of Regulation Review
- developing a Business Consultation Portal through www.business.gov.au
- reviewing all regulation at least every five years.

MACGILLIVRAYS PREFERRED SUPPLIER TO THE BUS INDUSTRY

Co-ordinated from Brisbane and working through MacGillivrays' offices around Australia, the Corporate & Business Group is now one of the leading legal specialists for the transport industry.

PLEASE NOTE: This newsletter is not legal advice and our comments are of a general nature only. This document is not to be relied on as substitution for proper detailed advice. If you would like to be removed from, or added to our mailing or emailing list, contact Meredith Clarke on (07) 3221 4550 or meredithc@macgillivrays.com.au