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SHAREHOLDERS AGREEMENTS

A practical guide on Shareholders Agreements and why you might need one

1. INTRODUCTION

If you are going into business with others, you should consider putting a shareholders' agreement in place to protect both the business and your own investment in the company. A shareholders' agreement is an agreement between shareholders setting out rules for how shareholders will deal with each other and how the company will be run. A fully considered and well drafted shareholders' agreement can act as a safeguard, give shareholders more protection and help avoid a costly legal dispute.

Our guide sets out why you need to have a shareholders' agreement and what's in a typical shareholders' agreement.

2. WHY YOU NEED A SHAREHOLDERS AGREEMENT

The Companies Act 1993 (the "Act") governs companies, directors and shareholders in New Zealand. However, the Act only contains limited provisions which regulate the relationship between shareholders themselves and their rights and responsibilities to each other. For example, if you have no specific written shareholders' agreement or constitution:

- there is no duty to act fairly or in good faith between shareholders.
- other shareholders can sell their shares without your agreement and without giving you the first right to buy those shares.
- other shareholders can freely compete with the company, both while you are in business together and after if the business is sold.
- other than going to court, there is nothing to say how shareholder disputes are resolved.
- if you hold less than 50% of the shares:
  - you have no right to be a director;
  - even if you are a director, you can be removed as a director by the majority shareholder.
- if you hold less than 25% of the shares, you have even fewer rights and (for example) have no ability to stop the following:
  - the company selling all its assets, taking on major liabilities or other major transactions;
  - the constitution being changed; or
  - the company being liquidated.

3. A SHAREHOLDERS AGREEMENT

What is a shareholders' agreement?

A shareholders' agreement is an agreement between the shareholders of a company. It can be between all or, in some cases, only some of the shareholders. Its purpose is to protect the shareholders' investment in the company, to establish a fair relationship between the shareholders, and govern how the company is run.

A shareholders' agreement is usually formed at the beginning of a new business venture (but can be put in place at any time) and is a binding contractual arrangement between the shareholders that are party to it.

Am I required to have a shareholders' agreement?

No, legally you don't need a shareholders' agreement, but you should consider one if you have more than 1 shareholder (even if that shareholder is a family member).

When should a shareholders' agreement be put in place?

It's best to put a shareholders' agreement in place when the company is formed to ensure that all the shareholders agree on how the business will be run. At this stage, the shareholders should, as far as possible, agree about what they expect to offer and get from the company. If the investors can't agree how to run the company at this stage, it should ring warning bells about the nature of their future working relationship.

Sometimes shareholders may choose to defer discussing a shareholders' agreement because they want to get on with the important task of establishing the business. While they may have every intention of returning to it at a later date when there is more time, the appropriate opportunity may not arise and something else always takes priority.
Even if they do pick it up later, by then the shareholders' expectations and feelings towards the business may have diverged, making it more difficult for them to agree to the terms that should be included in the shareholders' agreement.

What is the difference between a shareholders' agreement and a constitution?

The purpose of the constitution is to regulate the internal management of the company. The constitution normally addresses the day-to-day mechanics of governing the company (like meeting the requirements etc.).

Importantly, a company constitution must be filed at the New Zealand Companies Office, unlike a shareholders' agreement which is a private document. For that reason, a shareholders' agreement normally deals with more sensitive, commercial matters between shareholders and a constitution is more mechanical.

4. WHY HAVE A SHAREHOLDERS AGREEMENT?

The key reasons to have a shareholders' agreement are as follows:

- A shareholders agreement is private - A shareholders agreement is a private document, and there is generally no requirement to file it at Companies Office, meaning its content can be kept confidential.
- A shareholders agreement plugs gaps in the law –The law leaves you vulnerable to disputes and disagreements; a shareholder's agreement can fill the gaps in the law and sets out what will happen if things go wrong. Having a shareholders' agreement provides you with the opportunity to tailor a contract to your needs. Otherwise you will just have to work within broad legal principles which may or may not work to your advantage.
- A shareholders' agreement can help improve company governance – A shareholders' agreement can have a useful secondary purpose of helping company governance, operation and business planning, because it can divide governance and management functions and spell out rights,obligations, and delegations.
- A shareholders' agreement prevents disputes - Having a shareholders' agreement prevents disputes and helps dispute resolution. Disputes often arise when shareholders wish to sell or exit, or if the company is doing particularly badly or even particularly well. It doesn't matter how well you know the person you're doing business with, conflict is extremely common. Trying to agree a process of resolution when you are already in dispute is almost impossible. It is easier to formalise the approach that will be taken if the relationship does turn sour in an agreement at the outset, rather than to risk waiting until differences of opinion become entrenched. If disputes do occur, there can be specific provisions in a shareholders' agreement for dealing with disputes. These could include at what stage there would be a referral to mediation, or how an arbitrator would be chosen.

- A shareholders' agreement can save costs - The initial fees in setting-up a shareholders' agreement are often minor compared to the costs of disputes or the uncertainties involved in having no written agreement.
- A shareholders' agreement can control the transfer of shares - A shareholders' agreement can provide a mechanism which effectively gives the other shareholders a "right of first refusal" where one shareholder wishes to sell their shares. This can be used to try and restrict who may or may not acquire shares in the company.
- A shareholders' agreement can offer protection for minority shareholders - A shareholders' agreement can provide protection for minority shareholders, for example, by providing the minority a veto right over certain decisions (such as the ability for the company to issue further shares or entering into significant transactions). The shareholders' agreement may also contain "tag along" provisions, which enables a minority shareholder to "tag on" to a majority shareholder in a share sale situation where the majority try to sell only their shares rather than seeking to find a buyer for all the shareholders.
- A shareholders' agreement can offer protection for majority shareholders - A shareholders' agreement can provide protection for majority shareholders – and prevent the "tail wagging the dog". For example, a shareholders' agreement may contain "drag along" provisions, which operate where an offer is received to buy all of the shares in a company and the majority shareholders wish to accept that offer. This allows the majority to force the remaining shareholders to accept the offer on the same terms so that they do not scupper the deal.

- A shareholders' agreement can include non-competition restrictions - If a shareholder seeks to exit the company, the remaining shareholders might want to restrict the exiting shareholders' ability to set up or work in a competing business. These restrictions can be stricter than may exist in any employment contract and can be very valuable in protecting the interests of the company moving forward.
- A shareholders' agreement can include an exit strategy - Very few things last forever. Most shareholders would regard their participation in a company and its business as an investment, and like all investments there will come a time where it is desirable that it can be cashed up. There are many possibilities here, and discussion with legal and accounting advisors can help identify provisions that might suit the individuals concerned.

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5. WHAT IS TYPICALLY COVERED IN A SHAREHOLDERS AGREEMENT?

A shareholders' agreement will usually cover the following matters:

- The nature of the business.
- The role, rights and responsibilities of each shareholder.
- How are distributions to be calculated and when they will be paid.
- Frequency of board meetings and quorum requirements.
- How many directors the company will have, and who can appoint and remove them.
- How important decisions will be made.
- How funding will be arranged and secured (including shareholder loans).
- How new shareholders are admitted and new shares issued.
- Transfer of shares – including pre-emptive rights, drag along and tag along provisions, call and put options. The agreement can set out the process for valuing shares in the event of any transfer by the shareholders.
- What happens to shares on the death of a shareholder.
- Removing a shareholder/director – under what circumstances can a director or shareholder be removed – e.g. breach of the shareholders' agreement, ceasing employment or acting dishonestly.
- What insurance must the company take out, for example, life insurance for shareholders so that each shareholder's shares can be purchased by the other shareholders if one of them dies.
- Non-competition provisions which prevent a shareholder from competing with the company.
- What happens when shareholders cannot agree and how disputes will be resolved.
- What happens if a dispute cannot be resolved.

6. NEED A SHAREHOLDERS AGREEMENT?

A free, automated non-binding term sheet for a 50:50 shareholders' agreement is available online at advisme. This can help you understand the content of a basic 50:50 shareholders' agreement.

For more information on shareholders' agreements, or if you want us to help you prepare a shareholders' agreement, please contact the advisme team.

DISCLAIMER

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