GALLAWAY COOK ALLAN LAWYERS

Why you should have a shareholders' agreement if starting a business

Wade Pearson

The Trusts Act 2019 introduced a new regime for how trustees are to manage trust affairs. In particular, the Act clarifies trustee obligations and includes an obligation to disclose certain information to beneficiaries. These changes necessitate a more proactive management of trusts in order to ensure that all trustees, including independent trustees, are fulfilling their legal obligations.

The changes are also likely to lead to an increase in litigation, with beneficiaries having greater access to information than previously. Alternative dispute resolution (**ADR**) mechanisms are provided for in the Act, which are intended to address trust related disputes in an effective and efficient manner, without parties having to go to Court.

Trustee Obligations

The Act clarifies a number of duties trustees are required to fulfil. There are both mandatory duties (which must be fulfilled) and default duties (which can be excluded or modified). For example, the mandatory duties require trustees to know the terms of the trust and to act in accordance with them. The default duties require the trustees to regularly and actively consider the exercise of their powers as a trustee. Trustees are also required to consider at reasonable intervals whether to provide information to beneficiaries.

These duties require trustees to be familiar with the trust and to regularly and proactively consider trust matters.

New one:

If you're starting or running a business with other co-founders, you've probably been told by someone to get a shareholders' agreement. But why is this important? What does a shareholders' agreement do? What can happen if you don't get one? In this article I'll explain why you need to have some hard conversations with co-founders, and we'll look at an interesting recent case with costly consequences.

What's a shareholders' agreement?

A shareholders' agreement is a contract where you agree how you're going to work together to run your business. Think of it like the ground rules for your business. A shareholders' agreement can cover things like:

- Ownership – what each person brings to the table, and what portion of the business each person gets in return.
- Shares – how each person can deal with their shares, and how the company can issue more shares.
- Decisions – how directors are appointed, and whether there are any decisions that require specific approvals.
- Exit – what happens if someone leaves the business, and whether they get to keep their shares (e.g. vesting).

There is no one-size-fits-all solution to any of these points. Each business is different, and each founder is different. So it's really helpful to agree on the rules that should apply early on, and review them as your business grows and changes.

Why should you talk through the issues early on?

It's kind of like a pre-nuptial agreement before you get married. If you can't have a sensible discussion with your significant other around things like money and what happens if you break up, then that might be a bit of a red flag.

I've seen businesses where the founders keep putting off a shareholders' agreement, as it's just "too hard" or "not a priority". If the business then fails, a messy end becomes even messier. However, even if those businesses had survived, they may still have had problems. By not laying the groundwork for how the business will run right at the start, you can potentially face large costs and lost opportunities down the line.

What if you don't want a shareholders' agreement?

It can be a bit daunting to engage with a lawyer in the early days of your business. There is also a cost to getting a shareholders' agreement drafted – depending on the lawyer, it's probably at least a few thousand dollars, or more. So, what can you do if you just can't afford the expense?

Well, the minimum effort here is really to talk through the issues with your co-founders. If issues arise, having nothing written down will make life more difficult. But if you have talked through the key issues, this should hopefully help avoid the risk of any problems arising – or allow you to work through problems before they become too big. If your business grows, then the problems can indeed become very big!

What can happen when things go wrong?

In one recent case, the majority owners of a business were missing a key clause in their shareholders' agreement. As a result, they had to pay an extra $2 million to the minority shareholder when they sold the business. How did this happen?

The majority shareholders (Dold and Jacobs) had agreed to sell the business for AUD$112 million. They then asked the minority shareholder (Murphy) to confirm his earlier approval of the sale, but Murphy wanted more money. He demanded $2 million extra for the deal to go ahead – even though he only held 6% of the company.

Unfortunately for Dold and Jacobs, Murphy was perfectly entitled to hold out for a better deal. So when Dold and Jacobs paid him, the Court said he was entitled to keep that extra money (even though some people might think that sounds like extortion). There's a bit more detail to the case, but the point here is that (in theory) a more appropriate shareholders' agreement could have prevented the whole drama.

What could they have done differently?

In principle, the shareholders could have agreed to include a "drag-along" provision in their shareholders' agreement. A drag-along provision would have required Murphy to sell his shares (at the same price as Dold and Jacobs). Murphy would still have received a substantial pay-out, but he wouldn't have had the leverage to hold up the entire sale for an extra fee.

In this case, there may also have been an underlying issue around whether Murphy deserved more shares based on how much work he had put in.

Trying to negotiate a shareholders' agreement earlier on may have allowed that issue to be resolved before it turned into a larger problem.

All in all, this is a timely reminder to sort out the ground rules for how you will work with your other shareholders – before it's too late.

Wade Pearson is a Senior Solicitor in the commercial team, at law firm Gallaway Cook Allan. This article is general in nature, so don't use it as a substitute for legal advice.