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Shareholders' agreements – the key concepts

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If you're in business with other people (like co-founders or investors), it's important to have a shareholders' agreement. Today we'll look at some of the key concepts to include in a shareholders' agreement – or constitution, which is a similar document. Most shareholders' agreements will have "pre-emptive rights" on transferring or issuing shares. There are also some concepts that change for each business, including who can appoint directors, how decisions are made, and what shareholders can't do.

Two common features of a shareholders' agreement

Most shareholders' agreements will restrict how the company can issue new shares, and how shareholders can transfer their existing shares.

A company may want to issue new shares to raise more money, or to pay and incentivise its workers. But most shareholders want some limits on this. If the company can issue shares however it likes, a shareholder can end up with less ownership of the company than they intended (i.e. their shareholding is "diluted"). There's also the risk that the company issues shares cheaply, which is unfair to other shareholders. Generally a shareholders' agreement will provide that the company must offer any new shares to existing shareholders first – unless a majority of shareholders approve otherwise. These are called "pre-emptive" rights, as you essentially get an early chance to get more shares before outsiders can invest.

We usually see a similar position for transfers. When you're in business with someone, you don't necessarily want them to leave the business and have someone new come in to make decisions. Often each shareholder will agree they need to offer their shares to the other shareholders first – before selling shares to anyone else. Somewhat confusingly, these are also often called "pre-emptive rights". There might be some permitted exceptions, like transferring your shares into a trust or to a relative.

Without these standard clauses, you can end up stuck in a business with someone you don't get on with. Or you can end up owning far less of a company than you expected to. This can also negatively impact on the business itself – at its worst it can be the death of a business entirely. It's important to check whether your shareholders' agreement (and constitution) has pre-emptive rights on issuing and transferring shares.

Adapting clauses for your business

Half of a shareholders' agreement might be somewhat "standard" wording, but the other half is for you to customise. These decisions will depend on what the business does, how many shareholders there are, and what your growth plans are. A good starting point is deciding how directors are appointed.

How directors are appointed

Directors direct how the company is run, and the standard position is that shareholders appoint directors by majority vote. However, a shareholders' agreement could allow a major shareholder to appoint a director to represent their interests. This could be for a shareholder with as low as a 5% shareholding, or as high as 25%. If you don't get this right, you risk being shut out of decision-making – or you might have too many cooks in the kitchen.

How decisions are made

A shareholders' agreement can also change how decisions are made. The standard position is that directors make most decisions by majority vote, with only four key decisions reserved to shareholders under company law. You can however require specific approval thresholds for different decisions, by agreeing them in the shareholders' agreement. For example, you might say that unbudgeted purchases above $10,000 require unanimous director approval, or that the issue of new shares requires 75% shareholder approval. If you're raising capital from an external investor, the investor might require a veto right over some decisions. The key with this process is making sure you balance flexibility with protections, to avoid extra administration burden.

Restrictions

If you are receiving investment, an investor may want further restrictions on the founders. It's common to prevent the founders from selling their shares for 1-3 years (to keep them committed to the business). You may also see a restraint of trade. A restraint of trade can prevent a founder from competing with the business, or hiring away employees – even after they leave the business.

A restraint of trade is a key area to review closely, with good legal advice. In particular, it's worth considering how wide any restraint is. We've seen restraints that would stop you from being able to earn a living, which is often unreasonable. On the other hand, we've seen companies with weak restraints of trade that therefore have a serious risk to their business. Even if nothing bad happens, an issue here can turn away potential investors, or reduce the value of the business.

Understand the key concepts

Unless you're the sole shareholder and director of your company, you should probably have a shareholders' agreement – or at least a robust discussion on the issues. Issues most often arise later on in the life of a business, particularly when a business doing really well or really poorly. At that point it can be too late to do anything if you don't have a good shareholders' agreement. At the very least, try to understand the key concepts in your shareholders' agreement and ensure they work for you and your business from day one.

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