

April 2006

SHAREHOLDER AGREEMENTS – HOW DO THEY WORK

Use of Shareholder Agreements

The scope of these agreements is wide and varied, dealing with corporate control, share issues, exit provisions and share sales, financing, board representation, management and the resolution of disputes and deadlocks (to name a few examples).

This paper examines the connection between the company's Constitution, the Corporations Act and the Shareholder Agreement.

The Statutory Contract

The Corporations Act provides (in section 140) that the company's Constitution has effect as a "contract":
between the company and each member;
between the company and each director and company secretary; and
between a member and each other member,
under which each person agrees to observe and perform the Constitution and rules so far as they apply to that person.

Put simply, the Constitution of the company is a "statutory contract" or, more precisely, it is a number of statutory contracts between the various different parties (members, directors, company secretary and the company itself) who are referred to in the legislation.

The importance of the Constitution and its role in Corporate Governance cannot be overstated. It is the foundation and basis upon which the company's constituent parts are regulated.

Contradictory Provisions

Often, the company's Constitution and the negotiated Shareholders Agreement cover the same ground, often with contradictory requirements. A simple example is a clause conferring a casting vote on the Chairman at meetings of directors, when the corresponding Shareholder Agreement often provides for the Chairman to have no casting vote.

It is common for Shareholder Agreements to provide that the Shareholder Agreement is to prevail in the event of a conflict between the Shareholder Agreement and the Company's Constitution. Frequently, this is complimented by a further provision that the relevant provisions of the Shareholder Agreement must be incorporated into the company's Constitution – the purpose being to remove the conflict and to ensure that the relevant parties are governed by only one set of rules.

All too often however the conflicting provisions persist and go unnoticed until an issue arises necessitating legal analysis. In the example of the Chairman's casting vote, the directors are bound by the Constitution and the terms of the Shareholder Agreement are irrelevant to the conduct of directors' meetings and the manner in which their votes are taken. The directors have no choice but to act according to the Constitution, and to ignore the conflicting Shareholder Agreement.



Share Issues

In most companies (and this is usually supported by the Constitution) the business of the company is managed by its directors who are given the power to allot and issue shares on terms determined by them. Usually the director decisions require nothing more than a simple majority vote of the directors. Directors are not normally part to the Shareholders Agreement. However, it is common to find "minority protection" clauses in Shareholders Agreements listing activities which require more than a vote of the directors, and may for example, require approval by the shareholders (in addition to the directors). A typical example of this, is for the issue of additional shares. What is the position where the Constitution authorises the directors, by simple majority to make share issues, but the Shareholders Agreement requires 80% Shareholder approval as well.

Arguably, the directors are entitled, probably obliged, to ignore the Shareholder Agreement and to comply not only with the statutory contract in the Constitution, but also with their duties as directors to issue additional shares, disregarding the conflicting provision of the Shareholder Agreement particularly where the company's financial wellbeing requires them to act in this way. This may be the case even if it disregards the wishes of some shareholders who may rely on their Shareholder Agreement.

New Shareholders

The solution is to ensure that the provisions of the Shareholder Agreement are incorporated into the Constitution and that any conflicting provisions are removed. There is another compelling reason for incorporating the Shareholders Agreement into the company's Constitution. Although the Shareholders Agreement is binding as between the parties to it, the agreement would not bind new shareholders who do not expressly agree to be bound. The way to ensure that the shareholder provisions bind all shareholders (present and future) is to have them embodied in the company's Constitution.

Privacy

Why not simply incorporate all relevant provisions into the company's Constitution? This may well be the answer in some cases including the examples mentioned. However there are circumstances when arrangements (private or otherwise), are more appropriately dealt with in private Shareholder Agreements and not embodied into Constitutional documents which will potentially be open to public scrutiny. A typical example is the financing arrangements between shareholders.

Modifications to the "Contract"

Once provisions are incorporated into a Shareholders Agreement, it is not always easy to modify them. Modification of the contract will usually require agreement by all parties. On the other hand, modification of a company's Constitution (a statutory contract) can be more easily achieved by a special resolution, that is a three quarter majority of those voting. But even that is subject to qualifications, two of which, in particular are worth mentioning.



In general, the Corporations Act permits the company's Constitution to be modified by special resolution. However the Act expressly permits the Constitution to have "a further requirement specified" which must be met before a modification can take effect. For example, the modification may require the consent of a particular party, and until this is obtained, the modification would not be effective.

The second qualification is interesting. The legislation provides that a modification to the Constitution which imposes or increases restrictions on the right to transfer shares will not bind a member unless the member "agrees in writing to be bound". Shareholders may for example resolve, by special resolution to incorporate a first refusal provision into the Constitution, restricting share transfers. The Constitution may be modified to give effect to the special resolution. However even if the vote is passed unanimously, it seems that shareholders will not be bound by these restrictions unless they have actually agreed "in writing to be bound". In this case, it is vital to ensure the incorporation of the relevant provisions into a Shareholder Agreement to which each of the members agrees in writing to be bound. The writer believes that this is an anachronism – and is frequently ignored – probably because, in most cases the parties involved are not even aware of this statutory requirement.

Summary

In summary:

- both the Shareholder Agreement and the Constitution are important Corporate Governance tools;
- each has a distinct, sometimes overlapping purpose;
- it is unsafe to allow inconsistencies to remain, and a clause giving the Shareholder Agreement priority, without more, may not always be enough to remove the conflict;
- some constitutional amendments do not bind shareholders until they agree in writing to be bound;
- company directors may have to conform with the Constitution – even where it conflicts with the Shareholder Agreement.

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