



SHAREHOLDER AGREEMENTS

NEW BUSINESS

New business ventures usually kick off with passion and a fair amount of excitement about the business opportunity. Not surprisingly, the business partners are not keen to talk about the downside, the risk of failure, exit strategies, anti-compete obligations and so on. How many “about to be marrieds”, want to work through a prenuptial agreement regulating what might happen if the marriage breaks down. It comes as no surprise that only a minority of new business ventures are regulated by properly documented shareholder agreements.

FUTURE INEVITABILITY

One thing is certain – change is inevitable. Business partners will experience changing circumstances, health issues, diverging priorities, varied outlooks, good and bad market conditions, negative performance issues, deadlocks, retirement considerations and other possibilities. Without pre-planning, these issues can, and often do, lead to bitter and destructive disputes.

THE FALLACY OF “TRUST”

So often partners say that they have implicit “trust” in one another and do not need an agreement. On the contrary, that is exactly why they should have an agreement. Trust amongst family, friends and business partners can turn to dust, not because of dishonesty but rather because of different expectations which are not adequately explored and recorded at the outset. So often one’s “trusted” business partner seems to let you down.

Often, this is not a breach of trust, but rather a failure to recognise differences which were always present but remained undiscovered. The only safe approach is a business agreement which sets out the rules and looks ahead to deal with future eventualities. Only after such an arrangement is documented and filed away can business partners safely “trust” each other.

WHAT SHOULD YOUR SHAREHOLDER AGREEMENT COVER?

There is no ‘one size fits all’. Every situation is different although there are many common features. Here are some suggestions for your Shareholder Agreement:

* Expectations

Identify the expectations that each party has about the business venture. What do they intend? What will the business do? What is the business plan and what is the budget?

What do the parties expect of each other. What will each partner do. They may contribute capital, inventions or services – each may have a different role.

* Finance

Consider the financial needs of the business, both immediate and in the future. Borrowings and future obligations of the parties to contribute, as well as the intentions of the parties to reinvest or distribute future earnings should be explored and recorded.

What about issuing new shares to raise more money or to make acquisitions. This may result in your having a smaller piece of a bigger cake, but with less control.

* Management

Who will serve as directors. How many directors. How will directors make decisions. Will unanimity be required or will a simple majority suffice.

Who will be employed in the business and on what terms and conditions. What performance criteria will apply.

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* **Minority Protection**

In most situations a simple majority vote is sufficient. However, these are usually important issues where the parties want to be protected by a special majority or even a unanimous resolution. Examples of this include making acquisitions, share issues, diversification, the sale of the business, or large borrowings.

* **Exits**

There are so many possibilities that they cannot all be listed here, but the parties should think about their exit strategies and future expectations:

- share transfers to each other and outsiders should be dealt with. (Preemptive rights provision are almost always included but are not always a practical solution because it is usually difficult to sell a minority stake in a private business to an outsider);
- what happens if one party dies or becomes disabled or wishes to retire;
- what if one party wants to work part-time or to play golf once a week;
- how should you react to an offer by an external purchaser – some form of “drag along/tag along” arrangement is necessary;
- should the company buy back the Shares if a partner wants to sell or leave;
- what values should be applied and how should buy-outs be funded;
- should there be mutual insurance to facilitate payment.

The possibilities are many and varied but it is well worthwhile exploring them.

* **Deadlocks and Russian Roulette**

Deadlocks, particularly in 2 person equal partnerships present a particular problem, and frequently arise. Often the only solution is to liquidate the business and to kill the goose that laid the golden egg.

One possibility where the parties are deadlocked is a form of a “russian roulette “ – along these lines:

- one party calls for a valuation;
- either party can then offer to buy out the other based on the valuation;
- the other then has the right to accept the offer, ie to sell or instead to buy out the original offeror.

This is a robust approach and may not always work or even be suitable, but it represents one possible solution instead of winding up.

* **Protect the Business**

Provisions to protect the business are essential. The parties should commit to keeping sensitive business information confidential and should recognise that all intellectual property will belong to the business.

The parties need to look ahead in case one of them leaves and needs to be restrained from competing with the business.

* **Disputes**

Ending up in court is always the worst outcome. Usually there are better and less expensive alternatives including mediation, arbitration and expert determination. These should be considered and provided for.

NOT TOO LATE

Even where the business has been running without a shareholder agreement, as is often the case, it is not too late to deal with these important considerations. In fact, the participants may be better placed to think through the issues than they were as “newly marrieds”. The only time that it is too late is when a serious dispute has broken out, or a major issue like death or retirement or ill health arises, and the partners do not have an effective working solution in place.

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