

IMPORTANT MATTERS TO BE CONSIDERED BY PARTIES CONSIDERING JOINING TOGETHER TO COMMENCE A BUSINESS UNDERTAKING

This document sets out major provisions which should be considered for inclusion in shareholder deeds (agreements). It is intended to be used as a discussion document. Readers should refer to the important disclaimer located at the end of this document. Following consideration of the issues contained herein and the preparation of a Business Plan and accompanying financial projections (refer below) the understanding of the parties can be drafted as a shareholder deed or agreement.

Conditions Precedent

Is the operation of the Deed conditional on the happening of one or more events e.g. a contract being awarded? If so it/they should be understood and included in the deed.

Conditions Subsequent

For example: incorporation of company/partnership/joint venture, appointment of initial board members, chairman, managing director, secretary, opening of bank accounts, initial shareholder loans etc.

In cases where the company has not been incorporated where the company is to be domiciled needs to be stipulated.

Inconsistency between deed and company constitution (formerly a company memorandum and articles of incorporation)

The deed would normally include a statement ensuring the provisions of the Deed will prevail.

Clearly where there is any inconsistency between the deed and the relevant corporations' legislation, the provisions of the legislation/regulations will prevail.

The Business

Business objectives and business plan. This should include detailed financial projections covering the initial three to five years.

This is an extremely important inclusion which should be prepared, discussed in detail and agreed to before other shareholder agreement issues are decided. Once agreed upon, the business plan and supporting financial projections, including forecast cash flow statements, profit & loss reports and balance sheets will have a major impact on shareholder attitudes to many provisions in a shareholder deed.

A properly considered and prepared Business Plan will highlight many issues including, the scope of the business, projected growth targets, board, management and employee structure,

resource requirements including: equity capital, shareholder loans & external debt; long term assets including plant and equipment; profitability; potential for dividend payments; financial commitments both from the company and shareholders; liabilities and risks – both real and potential; timelines; etc. etc.

Equity Funding – Share Issues – Pre-emptive Rights

Mechanism for offering shares, unless unanimously agreed to by all shareholders, first to existing shareholders pro-rata with existing holdings (timing of offer/acceptance), then to other shareholders if one or more shareholders don't take up offer, and so on, then to third parties

Offer to third parties (must be on the same terms and conditions as offer to shareholders) usually needs to be conditional on the offeree agreeing to be bound to the deed

Circumstances where shareholders can object to an offer going to particular third parties eg. To a party who has previously suffered an insolvency event, previous or current unsatisfactory relationship with the objecting shareholder, conflict of interest with the objectives of the company, past criminal convictions etc.

The process is usually managed by the board

Share Dealings by Shareholders

Prohibition on the transfer or making any share the subject of any encumbrance unless in accord with the Deed

With the unanimous approval of shareholders encumbrance over shares can be permitted

Procedure to be followed where a shareholder wishes to transfer his shares

Deeds should allow for exemptions to the process being followed where all shareholders agree

Often the selling shareholder is required to notify the board of his intention to sell and the board then automatically takes control of the process.

There are different processes available. Many small companies opt for the valuation route – i.e. the board commissions a valuation and that sets the price by which the shares are offered for sale. The Deed should outline the rules applying to the appointment of the valuer(s)

Others allow for a (sensible) first step being a negotiation between the board and the selling shareholder to agree the price. Then there is the Russian-roulette clause where any shareholder can nominate a price and the remaining shareholder(s) can choose to sell his/their shares to that shareholder OR choose to acquire the shares of that shareholder for the price he nominated.

The Deed sets out the details of the chosen process e.g. time-line

Should this 'stage' of the process not produce a result the board would then set out to find one or more purchasers. (Given interested third parties may require minor/major changes to the sale price and conditions or to the status-quo the deed may offer a right of last refusal to remaining shareholders.)

Incoming shareholders should agree to be bound by the deed and the same rights to objection afforded existing shareholders referred to above will apply.

Restrictions applying to Shareholder Ownership and Control

'Up streaming' provisions should be included to protect against circumvention of share transfer provisions relating to corporate shareholders. These provisions should deal with changes in control as much as changes in ownership.

Debt Funding: Shareholder Loans and loans from External Sources.

These provisions should be constructed around the possible need for capital as projected in the business plan.

Ideally shareholders should provide, up-front, sufficient equity and loan capital necessary to see the company through to maintainable profitability as projected necessary by the business plan and related financials. Allowance should be made for delays in reaching maintainable profitability and for rates of growth exceeding the forecasts as 'growth' often requires funding at a higher rate than profitability. An alternative is for the company to issue partly paid shares.

Where there is a need for additional capital deeds usually provide for additional debt and equity capital to be called upon in the same proportions as each shareholder's holding in the company. They will also outline rules where a shareholder is either unwilling or unable to provide his share of the necessary funds. Again, there are many options here: the shareholders providing the funds could then have the option to provide the additional funds as additional shareholder loans (at a higher interest rate), as equity or as quasi-equity e.g. convertible bonds. The Deed would need to lay out the rules to be followed in these circumstances e.g. how the share issue price or interest rate applicable is to be calculated etc.

Terms relating to the repayment of shareholder loans need to be considered particularly in relation to the payment of dividends. Where shareholder loans have been advanced other than in proportion to shareholdings often Deeds will provide repayment of shareholder loans is made first to loans exceeding shareholding proportions.

The Deed may provide for security be offered over the company's assets to the shareholders sufficient to cover the shareholder loans from time to time outstanding.

To provide for instances where external debt funding is sought the Deed should consider obligations on shareholders and directors to provide guarantees to third party lenders and offer their shares in the Company as security for any such loans.

Board of Directors

Issues to be considered and provided for in the Deed include:

Minimum and maximum number of directors on the board

Entitlement to board seats – perhaps any shareholder with 15% or more

Appointment and selection of external or independent directors. In many instances Deeds require the appointment of an independent chairman

Rules relating to the appointment of alternative directors e.g. similar to those automatic incoming shareholder exclusions referred to above.

The appointment of the initial chairman and provisions dealing with the appointment of future chairmen. Terms of appointment provisions will be included

Does the Chairman have a deciding or casting vote?

Remuneration of shareholder directors is usually an issue covered in the Deed and for independent directors an issue for the board

Will the Company appoint a managing director and if so, on what terms?

Board Meetings

Issues to be considered and provided for in the Deed include:

Any director can call a meeting

Stipulation of a quorum

Some deeds permit voting to be determined by a poll i.e. when demanded by at least one director, each director's vote carries the same weight as his appointing shareholder shareholding would carry in a meeting of shareholders.

Again, some deeds provide for directors to discuss and disclose board minutes, management accounts, items tabled etc. to his appointing shareholder. Non-disclosure declarations would be required from said shareholders.

Shareholder Meetings

Usually 'boiler-plate' provisions including stipulation of quorums, who can call meetings, notice periods, proxy rules etc.

Dividends

Rules should be determined having regard to the business plan. Issues include, shareholder attitudes to external debt, company retention of profits to fund expansion & CAPEX and general balance sheet strength. Some deeds specify a dividend payout policy in the form of a percentage of after tax profits to be paid out in dividends each year. For example a provision imposing a 40% dividend payout ratio. Similarly, deeds sometimes provide for zero dividends whilst there remains any shareholder loans outstanding.

In start-up situations it is quite common for deeds to include a prohibition on the declaration of dividends for a period of time following commencement of business. Two and three year periods are common.

Accounts, Audit and Reports

The deed should stipulate who is to prepare the annual financial statements. It is common for the deed to provide for the appointment of external accountants, the firm being selected by the shareholders in general meeting.

Whether or not the financial statements are to be audited should be included in the deed.

Some deeds provide for shorter periods between financial year-end and the dates for distribution of financial statements and EGM than the corporations legislation and company constitutions allow.

Other deeds provide for the inspection of company records, including the books of accounts, by shareholders at any time during the year. Where this provision is made it is common for the deed to also allow shareholders to require a set of (year-to-date) accounts be prepared and supplied to said shareholder. (The requesting shareholder would need to pay for the report.) Some deeds even provide for the provision of monthly, quarterly or half-yearly management accounts be provided to shareholders.

Decision Making

Deeds will usually stipulate decisions made by the Board or by shareholders in general meeting will be made by ordinary resolution unless otherwise required by the deed, the constitution or relevant legislation.

It is common for deeds to incorporate a table listing decisions requiring different levels of consent by directors (in board meetings) and shareholders (in general meetings) and indeed

which decisions are to be made at board level. Some deeds, where the decision is to be made by the Board, require unanimous approval otherwise the decision is referred to the shareholders. Such decisions can include:

- The entering into of material contracts
- Material changes to the Business Plan or change in the nature of the business
- Significant CAPEX decisions
- Share issues
- Calls on shares
- Related party transactions
- Debt funding
- Appointment of external accountants and auditors
- Winding up of the business or material segment of the business
- Appointment of board members and senior employees
- Any dealings by the company other than in the ordinary course of business
- others

Boiler Plate Sections

- Where the deed is made and under what laws is it bound by
- Background
- Definitions and interpretation
- Confidentiality
- Termination
- Conflict resolution
- Post transfer shareholder obligations
- Representations & Warranties
- Notices
- GST
- Amendments
- Entire Agreement

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