

FACTORS TO CONSIDER IN A PARTNERSHIP OR SHAREHOLDERS AGREEMENT

INTRODUCTION

This guide has been prepared to assist CPA Australia members who hold a public practice certificate and who may be considering entering into a partnership structure.

The guide highlights some relevant matters when considering having a Partnership or Shareholders Agreement prepared for an entity running a business. While CPA Australia members may have expert input and advice into these types of agreements, it is recommended that any final documentation be drafted and settled by a registered legal practitioner. This guide is not intended to be exhaustive, nor complete. The following is provided for information and reference purposes only. This guide considers legislation relevant to Australian corporate entities. Members practising outside of Australia must comply with the specific requirements of local laws and/or regulations.

A Shareholders' Agreement is a written agreement between the shareholders or partners of a business.

A Shareholders Agreement is best prepared at the start of a business when all parties are enthusiastic and there have been no disputes or disagreements over the running of the business.

A Shareholders / Partnership Agreement covers the funding, structure, management and direction of the business. It outlines the responsibilities and obligations of the business owners. It is designed to deal with the issues that may arise during the life of a business, by determining in advance, how such issues should be dealt with. The process of developing a Partnership/Shareholders Agreement and the content included will differ between each entity after discussion and input involving all the relevant partners/shareholders and their relevant advisers.

PARTNERSHIPS

A partnership is an association of persons who have agreed to pursue a business objective for their mutual benefit. Accordingly, a partnership allows two or more people or entities to come together to operate a business and share the profits, the responsibilities, and the risks of the business.

In general terms, a partnership is created at law by an agreement or deed, whereas a company is a registered incorporated entity with the Australian Securities and Investments Commission (**ASIC**) under the Corporations

Act. A partnership may also be a limited partnership which requires registration with a State authority or an incorporated limited partnership which requires registration with ASIC (any questions about either of these vehicles should be raised with a legal practitioner).

While the Partnership Act sets out the rules for partnerships, it is important to have a Partnership Agreement in place. A Partnership Agreement establishes guidelines in writing, for how the business will run and what will happen in the event of certain situations. Where no Partnership Agreement exists, the shares of the partnership may be inferred under the Partnership Act based on a course of dealing and for this reason alone, a written agreement is crucial.

SHAREHOLDER AGREEMENTS

A shareholder is someone who owns one or more shares of stock in a company. They get to benefit from the company's earning and assets but they also share liability if the company owes money or goes bankrupt.

While the Corporations Act does not require companies to have a Shareholders Agreement, having one can be beneficial for setting ground rules about issues that affect shareholders, such as one shareholder deciding to sell their share later, where the conditions for doing so, have already been worked out in a signed Shareholder Agreement.

Seek appropriate professional assistance and advice prior to finalizing any documentation. Each partner / shareholder should seek their own personal independent legal advice before entering into any such agreement as the legal practitioner retained by the entity to draw the relevant documentation, will generally only be capable of acting for one party, either the partnership or the company as the case may be.

The preferred agreements are those that have clear drafting and operate to resolve issues quickly with certainty and finality and may include provisions which address the following key areas.

COMMON FEATURES

Admitting or terminating partners/directors/shareholders

It is important to clarify how persons can join or leave a partnership or company and whether such decisions are to be unanimous or (especially in larger entities) by majority or special resolution. A special resolution may operate by way of a set percentage of partners/shareholders voting or permit only one dissenting vote. Practitioners should be alert to the inclusion of veto powers in any such provisions as they may be used for personal motives as between individuals which may fall outside the objects or purposes of the entity. In addition, there is no reason why admission/ termination requirements need be similar or identical under these clauses.

Decisions requiring unanimous resolution

An agreement may provide that some decisions by an entity such as mergers or acquisitions may require special rules or provisions whereas by contrast day-to-day decisions may be either delegated (for example to the board of directors of a company) or be determined by a majority vote.

Procedure for delegating decisions to individuals or committees

All delegations should be clearly and expressly formalised. It is not uncommon for an agreement to specify the extent and limitations of each individual partner's power and authority or in the case of a company, the authority of the board of directors. There may be general limitations, for example, those requiring two partners/directors to sign cheque or specific limitations, such as prohibiting a particular individual from dealing with specified activities. Rules regarding the hiring/firing of staff or other personnel should also be clear. Disputes as to authority commonly arise where provisions under this heading are not clear or are uncertain.

Frequency and timing of partners/directors meetings

The scheduling of regular partners/directors/shareholders meetings and the level of attendance expected should be expressly clear under any such provision.

Expectations of a partner/director (or principle of a shareholder) within the practice and managing outside interests and obligations

A broad range of issues may be covered under this heading including but not limited to the following:

- whether any specific roles and responsibilities are assigned to an individual partner/director for each to perform on behalf of the practice (e.g. acting in the capacity as the CEO, carrying out marketing activities, interviewing/employing staff)
- productivity levels (e.g. billing hours) expected from each partner/director/principal
- the level, if any, of non-chargeable work allowed for a partner/director to fulfil voluntary activities during work hours (e.g. professional bodies, pro bono work and charities)
- whether approval needs to be provided by all partners/directors/shareholders for an individual to accept positions on external boards as directors. This is due to the potential impact on the entity in relation to the legal and fiduciary responsibilities of directors and the need for addressing any potential conflict of interest issues.

Dividend/Drawing policy & loan accounts within an entity

It is desirable for agreements to include a policy about the timing and method used to determine amounts to be paid as dividends or drawings as well for dealing with any loan accounts of any individual partners or shareholders. Disputes may potentially arise in the case of a director resigning but remaining as a shareholder with a personal liability remaining for payment on account of his/her loan account.

Consequences in the event of death or permanent/temporary disability of partners/directors/principal

In the event of death, agreements should expressly address both the amount and the timing of payments to a deceased partner's/shareholder's estate. Provision should also be made for "key man" insurance arrangements to be put in place as well as formally documenting such arrangements. Care is needed when clarifying who is the appropriate owner of any such policies. An agreement should also have express provisions dealing with who has responsibility for any other insurance arrangements. Many entities require partners/directors (or principal) to personally take out temporary/ permanent disability cover for periods of disability in excess of three months.

Compulsory retirement age

Care needs to be exercised in relation to any express compulsory retirement age provisions in light of the operation of various Australian Commonwealth, State and Territory anti-discrimination legislation. As a general rule, these do not apply to equity arrangements. However, where the business is carried on through a separate

legal entity, i.e. a company or trust with a corporate trustee, employment relationships may usually be created. Care needs to be exercised and it is especially important to obtain independent legal advice in respect of the compulsory retirement of a salaried partner/director as it may contravene current law.

Determining goodwill calculations on entry and exit

Agreements need to cover in what circumstances a goodwill payment is made and how any such payment is to be calculated. It is important to have a transparent and effective mechanism of establishing the value for the transfer of goodwill between incoming and outgoing partners/shareholders. When all partners/shareholders agree to the valuation model and the succession planning strategy as part of their agreement it eases the administrative process and provides a more certain outcome. When a new partner/shareholder is either admitted to the entity or retired, each party should have a clear understanding of how much consideration he/she may be expected to pay/receive and the basis on how such calculation was arrived at.

Factors to be taken into consideration when a partner/director retires

If a goodwill payment is being made, care needs to be taken with appropriate restraint clauses on departure.

If a partner/director (or principal) is not retiring but establishing a business on his/her own, the agreement should be specific about a number of relevant areas including but not limited to the value of fees taken, how this affects the value of goodwill of the entity, engagement of staff and access to resources such as files, client lists and premises. The procedure for resolving disputes in relation to these areas should also be spelt out in detail. Where a partner/director is retiring from his/her position and is not proposing to compete with the entity or carry on a similar business, provision may be made for consulting arrangements usually for a mutually agreed period.

Restraint requirements and notice period on retirement

Care needs to be taken to ensure that any restraint requirements set out under an agreement are enforceable, and do not invalidate the whole agreement. The law in relation to the enforcement of restraint clauses is complex and seeks to strike a balance between protecting the rights of an entity with the rights of an exiting party to ply his/ her business, profession or trade. The courts are generally reluctant to impose restraint periods in excess of 12 months and sometimes lesser periods are preferred. If the retiree is to compete with the entity, longer periods of notice may sometimes be required. Again, it is recommended to seek independent legal advice in relation to the preparation of any such restraint clauses.

Leave entitlements

There should be no ambiguity in any agreement about a partner's/director's/principal's entitlements in respect of leave entitlements including annual, special, sick, long service, carer's or maternity leave. Where an employment relationship is created between the entity and an individual partner/director/principal then relevant legislation or contractual provisions may apply. However, where this is not the case, the absence of rules and records as to an individual's leave entitlements may be a cause of disharmony or dispute.

Requirement for capital on the happening of a defined event or procedure

Agreements ideally should provide for a procedure or mechanism for capital injections into the entity in periods of declining business growth or insufficient economic activity. This usually takes the form of a loan account from the relevant partner or shareholder of the entity. Uncertainty as to a partner's or shareholder's obligations under the express terms of an agreement during such periods may give rise to confusion and the need for external dispute resolution.

Specifying events/conduct which may result in automatic expulsion or a lower voting threshold on exit/termination

Discussing and defining the boundaries of non-acceptable behaviour of a partner/director (or principal) should ultimately find expression under any such agreement. The prevention of any such non-acceptable behaviour is one of the primary objects of any such clause in an agreement and it is important to note that these rules may often exist and operate in parallel with the entity's other internal operational documentation e.g. workplace relations manual.

Clarification of voting/decision making power

There is no golden rule under the heading of whether voting or decision-making power should be based on an equity holding or on a per partner/director/principal basis. This will need to be agreed upon by a process of discussion and deliberation between the relevant parties within an entity. However, irrespective of the ultimate decision in relation to the rules relating to voting/decision making power, certainty and clarity of the terms of any such agreement assist in the prevention and avoidance of disputes.

Voting/information entitlements for fixed profit share/non-equity partners/directors/shareholders

There is no golden rule under this heading. However, irrespective of the decision ultimately adopted by the entity, express provisions under an agreement will provide certainty and assist in reducing the potential for disputes.

Alternative dispute resolution

Generally, decisions relating to a business' operations will be decided by agreement between the parties. However, issues will arise from time to time which cannot be decided or resolved informally. Accordingly, it is prudent for any agreement to contain alternative dispute resolution (ADR) processes, such as mediation, arbitration or conciliation. It is important to note, however, that a provision in an agreement to resolve disputes through ADR cannot completely oust the jurisdiction of the courts, but, when carefully drafted, they can make court proceedings a last resort.

Selling or winding up the business

In the event that majority partners/shareholders wish to sell their shares in the business (or the business as a whole in the case of a partnership), a 'drag-along' clause may be appropriate to provide the selling partners/shareholders the right to compel (or drag-along) the other parties in a sale to a third party. Drag along rights are generally given to majority interest holders although this is not always the case. Similarly, it may be appropriate to include a 'tag-along' clause in a shareholder agreement to impose a restriction on the majority shareholders from selling their shares without first procuring the outsider to make an offer for the shares of the minority shareholders on the same terms. It is recommended that you seek independent legal advice in relation to the preparation of any such clauses.

CHECKLIST

In addition to the provisions in paragraphs 1 – 18 above, a good Partnership / Shareholder Agreement will address the following:

PARTNERSHIP AGREEMENT	SHAREHOLDERS AGREEMENT
Name and address of the business and its purpose	The share split and the types of shares
Name and addresses of partners	The rights of shareholders in relation to the type / percentage of shares they own
Duties and responsibilities of each partner	The division of dividends (taking salary payments into account)
The process for making decisions and authority of partners	The voting rights of shareholders (depending on the type / percentage of shares they own)
The amount of money (capital) each partner will contribute	Actions that require the consent of shareholders
Bank accounts and accounting details	What happens when voting is deadlocked
The names of consultants – lawyer, accountant	Whether shareholders can also be company employees
Provisions for proper accounts and their audits	Pre-emptive rights for the transfer of shares
Details about how profits and losses will be shared	How new shares are allocated
Details about the payment of salaries / income to partners	The valuation of shares
Provisions regarding interest on capital including arrangements as to interest on advances and drawings	The liability of shareholders when the company is in debt
Tax and stamp duty issues	Confidentiality
How to dissolve the partnership, including valuing and distributing assets	

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