



GOVERNANCE AGREEMENTS & AND WHY YOU NEED ONE

The most common governance agreements include unit holders agreements (in a Unit Trust) and shareholders agreements (in a company).

Consider the following common situations:

A company, HINDSIGHT PTY LTD ACN 123 456 789, has 3 shareholders. Each of them has different areas of expertise necessary for the operation of the company's business. Each of them contributes \$100,000 and verbally agrees to stay with the company for a minimum of 5 years and that, after 5 years, any of them may stop working in the business. They have a business plan but no shareholders agreement.

- (a) After 1 year, the business is doing well but not as well as expected. Two of the shareholders agree to persevere believing that the business will ultimately succeed. The third wants to get out. The problem is that the other 2 do not have the resources to buy him/her out and they cannot afford to let him/her go as the company will fail without that expertise.
- (b) The third shareholder is consulting for a competitor, sells his/her shares to an unacceptable third party or simply decides that he/she won't bother turning up any more.
- (c) After 5 years, the third shareholder wants to stop working in the business and play golf. The other 2 don't have any difficulty with this, but they want to keep working and don't want the third to profit from their hard work.
- (d) Imagine the 3 shareholders are siblings. They have not discussed any governance issues thinking that they don't need to because they understand each other and assume they would be totally committed. One sibling subsequently marries, has children and is frequently absent. The other 2, while sympathetic, cannot manage without the third or don't want the third to profit from their hard work.
- (e) Imagine there are only 2 shareholders, a husband and wife, who have not discussed any governance issues because they thought that they didn't need to. After several years working together, they become involved in a messy divorce.
- (f) Imagine the company buys real estate. 2 shareholders provide all of the funds to acquire and develop the property while the 3rd has no money to contribute at the outset. After several years, the value of the property has increased substantially. The 2 who put all the money into the property are now faced with the 3rd being entitled to 1/3 of the net value of the property.

How are these problems avoided or resolved? None of the shareholders can be forced to resolve the dispute in a particular way without a shareholders agreement. Typically, when these sorts of conflicts arise, the point has already been reached at which none of the players wants to or is able to take a conciliatory approach. The only option is to let their lawyers have the argument with the attendant cost. The end result can be financially, emotionally and physically ruinous. It destroys relationships and, ultimately, the business.

The relationship which existed when the company was formed is irrelevant (ie these problems may arise whether the stakeholders are related or not). The Australian Financial Review in October 2005 suggested that married couples, particularly, should have a shareholders agreement when they form a company.

Nor does matter whether the company is involved in running a business, acts purely as a corporate trustee or simply has some passive investments.

Each of these people desperately needs a form of governance agreement . a shareholders agreement - at a time when it may be too late. While most people do not see the need for one when times are good, the point is that they are invaluable when conflicts arise. If the shareholders never need to refer to the agreement they are exceptionally lucky and rare creatures.

Good governance agreements are essential regardless of the size of the company, although these difficulties often occur more in small to medium sized enterprises. Most large companies have many different governance agreements in place. Probably the most common reason that small or medium sized enterprises lack proper governance agreements is that the stakeholders tend to be unwilling to spend the extra money on dealing with or preventing these problems before they arise. However, the cost of a governance agreement will seem insignificant compared to the financial and human cost of the disputes that will arise.

A good governance agreement is also just as significant for what it doesn't say as for what it does as the above examples illustrate. It will deal with any issues of importance to the stakeholders including:

- (a) the internal structure of the operating entity;
- (b) the obligations of the stakeholders and management to each other;
- (c) financial controls;
- (d) the determination of policy and management issues;
- (e) pre-emptive rights (the right for existing stakeholders to have first option to buy the interest being sold by another stakeholder);
- (f) the sale, transfer and allotment of stakeholder's interests;
- (g) the management of the business; and
- (h) dispute resolution.

The really great benefit of a governance agreement is that it focuses the parties' attention on those issues that each of them considers vital or important and generates discussion on how to deal with those issues and the problems that may arise. In doing so, one or more of the parties may decide that they do not want to be a part of the venture at all . that what seemed like a good idea, is not . or that the relationship must change to accommodate commercial reality.

Often, the process of preparing a governance agreement will present opportunities such as:

- (a) determining what should happen when expectations are not met. Most people don't consider that there might even be a down side let alone what happens when it transpires;
- (b) committing to paper what the parties real intentions are rather than relying on the subjective recollections of the stakeholders;
- (c) highlighting different intentions rather than assuming everyone else knows exactly what you mean when you say something;
- (d) eliminating ambiguity; and
- (e) raising real possibilities which have not been considered.

A governance agreement may not, at first glance, appear to be a document of vital importance, but ask any one who has been through a dispute, restructure, expansion or dissolution without one and you will find the same thing - wasted time, money and emotion. A governance agreement will give certainty and predicability to many situations which might otherwise result in time, money and effort wasting disputes or "management paralysis".

For further information or if you would like to discuss the need for a governance agreement, please call us on 1800 773 477.