The following description is for a typical shareholders agreement, but the mechanisms are often varied to some extent depending upon the client's preferences.

Pre-emptive rights explained

Pre-emptive rights are clauses in a shareholders agreement that require any shareholder who wishes to sell their shares to first offer those shares to the other existing shareholders before they can sell to a third party.

The price of the shares is either the price nominated by the selling shareholder or as determined by an independent valuer.

Usually, with a number of continuing shareholders, each of them can nominate how many shares they wish to purchase. If the offer is oversubscribed then the shares are allocated on a proportionate basis to the continuing shareholders in accordance with their existing proportionate shareholding, or as may otherwise be agreed between them.

If the acceptances from the continuing shareholders do not cover all of the shares put up by the outgoing shareholder then their offer is deemed to be rejected and they are free to sell to a third party for not less than the same price, and on the condition that:

- the new incoming shareholder is approved by the continuing shareholders (their consent not to be unreasonably withheld); and
- the new incoming shareholder agrees to become bound to the shareholders agreement.

Without pre-emptive rights, shareholders remaining in the business are at risk of being caught out by an outgoing shareholder selling to a third party who they don't know or haven't approved. You mightn't think this is a real risk but if the shareholders are not getting on with each other, people will look for alternatives and if the outgoing shareholder has a controlling interest then a third party might just be interested in buying.

Trigger events clause explained

A trigger event is an event that occurs in relation to a shareholder that makes their continued shareholding in the business problematic for the other shareholders and grants to the other shareholders an option to purchase the affected shareholder's shares in those circumstances.

Examples of trigger events include the following:

- the shareholder or their related principal is in breach of the shareholders agreement and fails to cure that breach within 30 days;
- the shareholder goes into liquidation or their related principal becomes bankrupt;
- the shareholder or their related principal becomes of unsound mind;
- the shareholder or their related principal dies or becomes permanently incapacitated. (Alternatively, such events can be dealt with by way of insurance backed "buy-sell" options. More on that below);
- the shareholder or their related principal who is working in the business becomes convicted of a serious criminal offence that, in the reasonable opinion of the other shareholders, would be likely to bring the business into disrepute; and
- the shareholder or their related principal who is working in the business is dismissed from their employment due to fraud or dishonesty.

The trigger events clause gives the other shareholders an option to buy-out the affected shareholder's shareholding for a price usually determined by valuation. Sometimes a bad leaver discount is applied such as where there has been fault on the part of the outgoing shareholder in bringing about the situation.

Drag along and tag along explained

A drag along clause covers the situation where one or more shareholders holding a defined percentage majority of the shares (e.g. 75%) wish to sell to a third party to realise value on their equity but the buyer requires 100% of the shares in order to proceed.

In those circumstances the majority can drag the minority not in favour of the deal along with the sale for the same price and on the same terms. Sometimes a first right of refusal is given to the minority not in favour of the deal, to buy the majority's shares at the same price and on the same terms as offered by the third party.

A tag along covers the same scenario where the defined majority wants to sell to a third party, but the buyer only needs a controlling interest and is happy to let the minority sit there as passive shareholders if they don't want to sell.

In those circumstances the minority can put up their hand and require that the majority procure that the purchaser buys their shares too at the same price so that they are not left behind. If the purchaser doesn't want to do this, then the sale will not proceed.

Majority approvals clause explained

The board of directors, not the shareholders, makes decisions regarding the operation of the business. Minority shareholders may not have representation on the board of directors.

A majority approvals clause is a list of defined types of decisions that must also be approved by shareholders collectively holding a defined percentage of the shares (for example, 75%).

Examples of majority approval matters include the following:

- the sale of the business;
- the acquisition of a new business;
- capital expenditure over a certain $ amount;
- the hiring of staff on a remuneration package over a certain $ amount;
- the issue of further shares (of any class) in the company;
- borrowing (over a defined $ amount) and the granting of security by the company;
- putting the company into external administration.
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This is a protective mechanism for shareholders, effectively granting them a right of veto over decisions of the board that a significant percentage of shareholders (by shareholding) consider are not in their best interests. This is particularly important where there are one or two directors on the Board who may have been appointed by the majority shareholder.

Insurance backed buy-sell options explained

If a shareholder (or their related principal) dies or becomes totally and permanently incapacitated (a buy-sell event), the continuing shareholders may not want to deal with the affected shareholder/principal's spouse in the position of controlling the affected shareholder, and the affected shareholder/principal's spouse may want the shares to be sold in order to obtain much needed cash for their spouse/ the estate.

Buy-sell options enable for the shares to be sold without the continuing shareholders having to find the money for the purchase price at short notice. This is where insurance comes in.

Each principal is required to take out an insurance policy on their life with cover equivalent to their related shareholder's percentage shareholding in the company, multiplied by the agreed business value.

If a buy-sell event occurs and an option to buy is exercised by the continuing shareholders, or a put option requiring the continuing shareholders to buy, is exercised by the affected shareholder/their estate then:

- the affected principal/their estate receives the insurance payout (which should be equal to their percentage share of the agreed business value); and
- the shares are transferred to the continuing shareholders who are deemed to have paid the price.

If there is a shortfall then clauses can deal with the payment of the shortfall over time by instalments, with or without interest and security.