

ISSUES RELEVANT TO THE PREPARATION OF A SHAREHOLDERS' AGREEMENT

There are a number of legal vehicles which a group of Chartered Accountants may adopt to carry on an Accounting Practice. An Accounting Practice Company is a commonly adopted vehicle as it has the advantages of continuity, limitation of liability in certain circumstances, the ability to provide more attractive superannuation and fringe benefits to the Principals of the Practice and, subject to relevant ethical rules, the ability to share income from the Practice with family members.

A Shareholders' Agreement is important because it deals with many issues relating to the conduct of an Accounting Practice Company and the rights of Shareholders which are not dealt with in the Constitution of the Company.

The Shareholders' Agreement should be drafted in the form of a Deed. A Deed has the advantage of overcoming any problem which may arise relating to the absence of consideration.

The terms of a Shareholders' Agreement for an Accounting Practice Company will vary according to the requirements of the Shareholders. In each particular case it is suggested that the Shareholders' Agreement should make provision in respect of the following:

1. Parties

The Practice Company and each Director and Shareholder of the Accounting Practice Company should be parties to the Agreement. Accordingly the full name, address and where relevant, the ACN, of each party should be included. Where a Shareholder is not one of the individual Chartered Accountants who are the Principals of the Practice, such as a family member, family company or family trust of a Principal, then consideration should be given as to whether the Principal concerned should give a guarantee in respect of the obligations of that Shareholder under the Shareholders' Agreement.

2. Recitals

The recitals are that part of the Deed which set out the scope of the ensuing Agreement. Consequently it is necessary to state any relevant circumstances leading up to the establishment of the Practice Company.

3. Type of practice

The Agreement should describe the type of Accounting Practice to be carried on by the Company. This is important for the following reasons:

- (a) some areas of practice, such as audit, can only be carried on by individuals;
- (b) the Shareholders' Agreement represents an agreement amongst the Shareholders on the scope of the Practice;
- (c) such a provision will help the Shareholders to determine what income derived by a Shareholder personally (e.g. Directors' fees) will be considered as Practice Company income;
- (d) the scope of the Practice will determine the nature of the goodwill owned by the Practice Company, which is relevant to determine the nature of any restrictive covenants which might be applied to Directors/Shareholders who leave the Practice Company.

4. Profits

The share of each Shareholder in the profits of the Practice Company should be stated. If a Shareholder is to receive additional remuneration for abnormal efforts, e.g. if he or she plays a larger role in the management of the Practice, then provision for this extra remuneration should be included in the Shareholders' Agreement.

Many Accounting Practices incorporate the Lock-Step system of sharing profits. The advantages of this system compared to a system based on equal profit shares and payment for the purchase of 'goodwill' by an incoming Shareholder should be considered.

The Lock-Step system involves a new Shareholder receiving a smaller profit share than the other Shareholders for the first few years. For example, the lock-step to a full profit share might occur over 5 years so that in the first year the New Shareholder receives 50% of a full profit share, 60% of a full profit share in the second year and so on by incremental 10% increases each year so that from the sixth year the new Shareholder is on 100% of a full profit share or an equal share of profits with all the other 'full share' Shareholders.

The entitlement of a Shareholder to profits whilst on maternity or paternity leave should also be addressed.

Most Shareholders will wish to receive their profit share by way of a combination of salary, superannuation contributions, dividends and fringe benefits and accordingly the Shareholders' Agreement should make provision for these various profit share options.

5. Incoming shareholders

A mechanism may be established to allow for incoming Shareholders. In such a case consideration will need to be given to the treatment of the following:

- (a) Debts owing to the Company and Work in Progress generated prior to the admission of the new Shareholder.
- (b) Provision as to appropriation of accounts paid by clients after the admission of the new Shareholder where clients owe money for services rendered both before and after the date of admission of the new Shareholder.
- (c) Payment of any agreed price for the purchase of an interest in the goodwill of the Practice. Provision needs to be made as to how the price is to be paid and the payment of interest on any unpaid part of the price.

6. Retirement

Provision should be made for the retirement of Directors and Shareholders. The following matters should be considered:

- (a) a compulsory retirement age and whether relevant Anti-Discrimination Legislation prohibits age discrimination;
- (b) period of notice of intention to retire;
- (c) a compulsory purchase of the shares of a retiring Shareholder by the remaining Shareholders, including:
 - (i) the price or method of determining the price, including the basis of valuing goodwill; and
 - (ii) the terms of payment of the price and interest payable on any part of the price which remains unpaid.
- (d) provision for the introduction by a retiring Shareholder of his or her clients to the remaining Shareholders.

7. Death of a shareholder

Consideration should be given to the following:

- (a) The compulsory purchase by the surviving Shareholders of the shares of the deceased Shareholder and if so:
 - (i) the price or method of determining the price, including the basis of valuing goodwill; and
 - (ii) the terms of payment of the price and interest payable on any part of the price which remains unpaid.
- (b) The method of financing the payment to the estate of the deceased Shareholder.

8. Expulsion

It is normal to provide for the right of Shareholders to expel a Shareholder in limited circumstances e.g. bankruptcy, repeated breach of the Shareholders' Agreement and serious professional misconduct.

9. Sickness

Consideration must be given as to what will happen in the event that a Shareholder is sick for a short or long period.

(a) Short Periods

What period of sick leave is to be allowed? Is the sick Shareholder to suffer any pro rata loss of profits and after what time period? Is there an obligation on Shareholders to take out sickness and accident insurance? Who pays the premiums and owns the policy - the Practice Company or each Shareholder?

(b) Long Periods

Can the other Shareholders exclude the sick Shareholder from the Practice Company and, if so, on what terms e.g. same terms as apply in the event of the death of a Shareholder? What period of absence from the Practice is to elapse before such a provision can be invoked?

10. Restrictive covenant

The Shareholders should consider whether a clause is to be inserted in the Shareholders' Agreement which restricts the future practice of an ex- Shareholder/Director. The clause should address the following issues:

- (a) Is the restriction to be a total prohibition from practising in a particular geographical area and/or in relation to clients of the Practice?
- (b) What is to be the duration of the restriction?

11. Management

In the absence of a provision to the contrary in the Shareholders' Agreement, the management of the Practice Company's business would normally be vested in the hands of the Directors who would make management decisions by majority vote in accordance with the Practice Company's Constitution. Consideration should be given as to whether a majority greater than a simple majority is required in relation to decisions by the Directors. In a large Practice consideration should be given to setting up a streamlined management structure to conduct the day to day running of the Practice. Some of the issues which need to be addressed either in the Shareholders' Agreement or at an administrative level are as follows:

- (a) Payment of expenses.
- (b) Banking arrangements. Who is to sign cheques?
- (c) Keeping of financial records.
- (d) Yearly, half yearly or other periodical accounts.
- (e) Division of profits and periodical payments on account of profits.
- (f) Motor cars of Shareholders. Are they to be a Practice Company expense or the responsibility of each Shareholder?
- (g) Professional indemnity insurance.
- (h) Leave provisions including:
 - (i) Annual or other periodical recreational leave. Length of time, when and how to be taken. Whether recreation leave is to be allowed to accumulate.

- (ii) Extended or sabbatical leave for overseas travel, holidays, post-graduate studies and for local post-graduate studies. Length of time, when it may be taken, who has first choice and the interval to elapse between the return of one Shareholder and the next Shareholder to take leave. Financial arrangements whilst a Shareholder is on leave.
- (iii) Maternity and Paternity Leave.
- (iv) Provision for the manner in which notices are to be given to Shareholders for the purposes of the Shareholders' Agreement.

12. Arbitration and alternative dispute resolution

Shareholders' Agreements relating to professionals quite often provide that any dispute between the Shareholders is to be referred to a private arbitrator to preserve confidentiality, rather than have the dispute heard in public by a Court. Other methods of alternative dispute resolution such as mediation and conciliation also have the advantage of avoiding publicity and can often lead to a quicker and less costly resolution of disputes.

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