Constitutions

When people go into business together, it is common for them to enter into a Shareholders' Agreements to govern how they will own and administer their company. Our preference is to use a company's **Constitution** as the primary instrument to regulate the affairs of a company. Our reasons for this include:

Simplicity

A Constitution provides a **single source of rules** about the company – which makes it easier for all members to use, including members who may not be experienced in interpreting multiple, and sometimes conflicting, documents.

Consistency

If all the provisions are contained in the one document there is **less chance of a dispute** as to which document takes precedence. Although most Shareholders' Agreements override a Constitution to the extent of any inconsistency, it is not always clear when an 'inconsistency' exists. For example, does an **additional** requirement in one document amount to an inconsistency with the other document?

Transfers and succession

When a new member joins the company by subscribing for or acquiring shares they are **automatically bound by the Constitution**, without having to sign a further document, which is not the case with a Shareholders' Agreement. As a practical matter, a Shareholders' Agreement rarely gets signed by all the members and can be overlooked when new members are admitted. Becoming automatically bound to the terms of the Constitution is also particularly important when shares are transferred on the death of a member – when the recipient is receiving the shares as a 'right' under a Will, rather than 'negotiating' to become a member. It is also relevant when a member becomes insolvent, as the terms of the Constitution will automatically bind the external administrator.

Modification

A Constitution, or certain provisions within a Constitution, can be **modified** by less than a unanimous agreement between members. A change to a Shareholders' Agreement generally requires unanimous consent – even a very small change. Whilst it is possible to incorporate attorney provisions to get around this, these are complex and dispute prone.

Statutory contract

A Constitution acts as a **statutory contract** between the company and its directors, and between the company and its members, not just as a contract between the members.

This is important for directors who may be required to act in accordance with a Shareholders' Agreement that would ordinarily be inconsistent with their duties as a director. If the requirements are contained in the Constitution, then the director is not subject to this conflict.

Replaceable Rules

A provision in a constitution will **displace a 'replaceable rule'** under the *Corporations Act*, whereas a provision in a Shareholders' Agreement will not automatically displace a replaceable rule. Accordingly, acting in accordance with a Shareholders' Agreement may cause an inadvertent breach of a replaceable rule in the *Corporations Act*.

Embedded rights

When **valuing** a share in the company, the rights and obligations under the Constitution must be taken into account, as they form part of the 'interest' of the member in the company. On the other hand, rights and obligations under a Shareholders' Agreement are more akin to an 'encumbrance' against the interest, or a separate 'collateral agreement' having its own value.

This can be relevant if a shareholder becomes insolvent, because an external administrator holding shares would ordinarily be able to void the Shareholders' Agreement but must take the shares subject to the rights in the Constitution.

Why would you want a Shareholders' Agreement?

There are reasons why a separate Shareholders' Agreement may be used in preference (or more accurately, in addition) to a Constitution, including:

Privacy

For a public company, the Constitution must be lodged with ASIC, and therefore becomes a public document, whereas, the provisions of a Shareholders' Agreement may be kept private (at least initially). That said, Shareholders' Agreements are rarely used in the context of public companies. The Constitution of a private company does not need to be lodged with ASIC.

Amendments

It is only possible to amend a Constitution by means of a special resolution passed by a 75% majority vote. (We note that it is also possible to include in the constitution a higher threshold, e.g., unanimity.) Arguably, a Shareholders' Agreement can contain a mechanism to achieve an amendment with a lower majority. However, this is not simple to achieve and is rarely used.

Inconsistency with Corporations Act

Any provision of a Constitution that is inconsistent with the *Corporations Act* will be invalid. It is arguable that a Shareholders' Agreement may contain provisions that are inconsistent with the *Corporations Act* and yet still be valid itself. However, in practice, while the Shareholders' Agreement may not itself be invalid, any exercise of those powers will likely cause a similar breach of the *Corporations Act*, and therefore either be invalid or give rise to remedies.

Accordingly, on balance, we prefer the use of appropriately drafted Constitutions in place of Shareholders' Agreements.

What next?

If you would like to speak to someone about putting in place a Constitution, call us on 1300 654 590 or email us at wehelp@adlvlaw.com.au.

Further information can also be found on our website at www.adlvlaw.com.au.