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Shareholder Agreements

Planning for Certainty in Business Direction and Succession

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By nature, business ownership involves uncertainty. No matter how carefully a closely-held business owner plans for the future, surprises are bound to arise—especially in today's volatile economic climate. However, some types of potentially-crippling uncertainties can be contained or minimized with proper planning. Namely: unwanted changes in equity ownership, unexpected shifts in senior-level management, and finally: tax burdens and other disastrous financial consequences following the death, disability or retirement of a company's owner. With these aforementioned issues, a little extra preparatory legwork goes a long way, with the creation of properly-drafted comprehensive Shareholders Agreements. It is critical, however, that such agreements are drafted and executed well before life-altering events occur.

Changes in Ownership and Management

Family business owners often assume that the ownership and direction of the business will remain stable--at least until current owners retire and pass the baton to the next generation. This is *not* a safe assumption. Unless there are restrictions in a Shareholders Agreement, anyone who owns shares in a family business may sell those shares to other people--non-family members included, at any time. These shareholders may also vote to change the members of a company's board of directors. For these reasons, the cornerstone of a well-constructed Shareholders Agreement is a clause restricting the transfer of shares, which generally includes the following elements:

- The typical restriction is that no shareholder may transfer shares without the consent of the board of directors, or a majority or supermajority vote of the shareholders.
- Certain "permitted transfers" are usually carved out from the restriction. For example, transfers for estate planning purposes, to children or trusts, or to an entity controlled by the transferring shareholder, or to an existing shareholder.
- If the shareholders wish to create a degree of liquidity in the shares, transfers may also be permitted, subject to a right of first offer and/or right of first refusal. Under such an arrangement, if a shareholder wishes to sell shares to a potential purchaser, or alternatively, if he receives an offer from a potential purchaser, the shareholder must first offer to sell the shares to the other existing shareholders at the same price and terms as the third-party offer, before completing the third-party transaction.
- Another key element of a Shareholders Agreement: a mandate maintaining the membership of the board of directors. Since the board is responsible for high-level management of the company's business, and is empowered to appoint the President, CEO, and other executive employees, a voting agreement helps to ensure that the company's strategic direction remains on track.
- The Shareholders Agreement may specify the number of directors, and which shareholders are entitled to designate the occupants of certain board seats.
- The Shareholders Agreement may restrict the board's decision-making authority by requiring expenditures above a certain amount be submitted for shareholder approval. But must be handled carefully, however, as some state's restrictions on the board's

discretion may be legally unenforceable if they're not contained in the company's by-laws or in its certificate of incorporation documents.

It is important that the existence of all of these transfer restrictions are clearly noted in a legend printed on the reverse side of each stock certificate.

Buy-Sell Planning

The death, disability or retirement of key shareholders cannot be prevented. But the potentially staggering financial consequences, including tax consequences of such an event can be mitigated by incorporating appropriate buy-sell provisions into the Shareholders Agreement. The overriding objectives are to achieve (i) greater certainty (because the share transfer procedures, valuation methodology, and funding mechanism are spelled out in advance in the Shareholders Agreement) and (ii) greater fairness (because no one knows ahead of time if he will be the surviving shareholder or the deceased shareholder, and therefore everyone is inherently motivated to achieve a fair and reasonable result).

The first task is to determine which events will trigger the buy-sell action. Among the most commonly included triggering events are:

- Death
- Disability
- Retirement
- Termination of employment
- Divorce
- Bankruptcy

While the first three events are customarily included, the last three are somewhat unusual. Provisions for transfer upon divorce or bankruptcy--intended to keep shares out of the hands of ex-spouses and creditors, are subject to approval of divorce or bankruptcy courts, which may refuse to enforce provisions requiring the sale by an ex-spouse or creditor awarded shares in a legal proceeding. This can be alleviated in the divorce context by having each shareholder's spouse sign a joinder to the Shareholders Agreement, agreeing to abide by the buy-sell provisions.

A second crucial decision: whether the buy-sell will be optional or mandatory. This has a tremendous impact on who has leverage once a triggering event has occurred:

If the buy-sell is optional, the remaining shareholders have the luxury of deciding whether to purchase or decline purchasing shares of the departing shareholder. The remaining shareholders' leverage is maximized, often dramatically impacting the purchase price and payment terms, to the detriment of a grieving widow or widower, as the primary beneficiary of the deceased shareholder's estate.

If the buy-sell is mandatory, then the remaining shareholders are legally obligated to purchase the shares of the departing shareholder--typically at a price and terms determined under the buy-sell provisions. The leverage of the departing shareholder or his estate is maximized.

The buy-sell must also specify whether the share purchase will be undertaken by the company (i.e., a "redemption" of the shares) or directly by the other shareholders (i.e., a "cross-purchase"). Exactly which approach is preferable depends on a myriad of factors. For example, the number of shareholders comes in to play, as too many shareholders could make a cross-purchase unwieldy, where redemptions are preferable. A second factor is the tax treatment of the transaction, which is sometimes more favorable for a cross-purchase than for a redemption. The Shareholders Agreement may combine these two procedures into a hybrid approach, where the company has the first option to redeem shares and, if the company declines, remaining shareholders may elect to engage in a cross-purchase, or they may even me mandated to do so.

Funding payments under the buy-sell often presents challenges for a family business. Life insurance is generally the best source of funding when the triggering event is the death of a shareholder, as it automatically provides funds for the purchasing parties to purchase a deceased shareholder's shares. However, the cost of such insurance may be prohibitive, or a shareholder may uninsurable, depending upon the age, health, and number of shareholders. Disability insurance is also available, but may be even more costly. If life insurance is purchased, certain steps must be taken to ensure that unexpected tax and other consequences are avoided:

- There must be a policy on the life of each shareholder.
- The owner and beneficiary must be the *other* shareholder(s) (for a cross-purchase) or the company (for a redemption). If the insured is mistakenly-listed as the owner or beneficiary, the buy-sell arrangement will be fatally undermined, which can lead to disastrous estate tax liability consequences.
- The Shareholders Agreement should contain provisions listing the policies and requiring them to be maintained and the premiums paid by the company or the shareholders.
- The insurance coverages should be reviewed and updated periodically, or at least annually, to ensure there's no mismatch between the amount of insurance and the fair market value of the company. The greatest risk here is that the company increases in value, but the amount of insurance is not increased, so upon the death of a shareholder there's a purchase obligation but insufficient insurance proceeds to fully fund the buy-out. If the buy-sell calls for a mandatory purchase in a lump-sum payment, this could put the purchasing party under enormous financial pressure, which could jeopardize the survival of the company.
- Generally, if life insurance is not purchased, or if there is an insurance shortfall, the remaining purchase price is paid under a promissory note. The proceeds generated by business operations are usually the source of the note payments, so it's important to structure the transaction with a realistic term of years and interest rate so the cash flow is sufficient to cover the note payments. The note is often secured with a pledge of the stock transferred in the buy-sell transaction.
- Finally, the buy-sell must contain a mechanism for determining the purchase price. The most common approaches are:
    - a formula (e.g., a multiple of the company's EBITDA).
    - a certificate of agreed value, whereby the shareholders confer and mutually determine the fair market value of the company. This should be done on an annual basis, to avoid a "stale" certificate that does not reflect current fair market value upon the occurrence of a triggering event, and can unexpectedly lead to a windfall for one party (typically the purchaser) at the expense of the other.
    - one or more independent professional appraisals.

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Estate and Gift Tax Considerations
In a family business where the shareholders are related parties, estate and gift tax concerns are of paramount importance. The Internal Revenue Code establishes a general presumption that any contractual price established between family members will be disregarded in determining a deceased shareholder's estate tax liability or, in the case of a gift, a shareholder's gift tax liability. The requirements for overcoming this presumption and having the contractual price respected are difficult to meet, and the burden of proof is on the taxpayer or his estate. At a minimum, the taxpayer or his estate must establish that the Shareholders Agreement:

- Reflects a bona fide business arrangement.
- Is not a device to transfer property for less than full and adequate consideration.
- Is comparable to similar arm's-length transactions.
- If the IRS decides that a buy-sell price is below its determination of fair market value, it will require tax to be paid on the higher fair market value. But this IRS determination does not invalidate the Shareholders Agreement for contract law purposes, and therefore the selling party will only be entitled to receive the lower buy-sell price set forth in the Shareholders Agreement, despite the fact that estate or gift tax is owed on a potentially much higher value. This mismatch can destroy an estate plan--especially if the amount received by the seller is insufficient even to cover the estate taxes imposed by the IRS--much less to provide fair payment on the transferred shares, which may represent a lifetime of hard work by the seller in the family business. Therefore, it is vitally important that the Shareholders Agreement be drafted by an experienced practitioner – and that its requirements are strictly adhered to, with periodic updating – to increase the likelihood that the buy-sell price is respected by the IRS.

Moving Forward
Family business owners can take significant steps toward achieving certainty in business direction and succession by implementing and maintaining a Shareholders Agreement. A well-crafted agreement can alleviate the uncertainty arising from changes in ownership and senior management, as well as the financial and tax risks associated with the death, disability or retirement of a shareholder. Although a Shareholders Agreement cannot eliminate the uncertainty inherent in owning and running a family business, it can mitigate negative consequences and protect against a devastating blow to the business.

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