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Shareholders' Agreements

Why Are They Important?

As business attorneys, all too often we find ourselves sitting across the table from clients telling stories of how their once great relationship with their partner or partners is now broken, or how a partner has become disabled or just simply wants to retire. After finishing, they all ask the same question, "How do we handle this?" Our response is always, "Did you and your partners sign a Shareholders' Agreement when you started your business?" More often than not, the business owner says they do not have a Shareholders' Agreement in place.

Also known as a Buy-Sell Agreement, the purpose of a Shareholders' Agreement is to help you and your business navigate life's challenges. Unfortunately, while you are focused on building your business, things happen that not only impact you, but your business. If not given the proper consideration early on, their consequences can be very damaging to your business (not to mention, costly). A Shareholders' Agreement takes on added significance when you are in a position of being a minority owner of a business. As a minority owner, a Shareholders' Agreement can provide you with certain protections that you would not otherwise be afforded under the law.

Typically, a Shareholders' Agreement will address many, if not all of the following issues:

- **Management and Control** - Who has day-to-day control and the power to execute contracts binding on the corporation (and are there limitations on a partner executing contracts having a value to the business over an agreed upon dollar amount); who can sign checks or access bank accounts; what are voting rights (for example, while votes on routine matters may require a majority vote, in certain circumstances, like admitting a new shareholder/partner; borrowing money; amending the business' organizational documents; selling company assets; borrowing money or substantial capital expenditures, approval by more than a majority may be required); partner obligations to invest additional funds in the business; and how the business deals with voting deadlocks.

- **Share Transfer** – Without any restriction to the contrary, you can walk into work one day and find out that a partner has sold his or her interest in the business to a third party whom you have never met before (or whom you have met, but do not like). Also, in the case of a subchapter "S" corporation, certain transfers of interests will terminate the "S" election (for example, corporations can not be shareholders of a subchapter "S" corporation). A Shareholders' Agreement will provide a roadmap of the process required to transfer a partner's interest (which can include transfers to relatives or for estate planning purposes). Typically, existing partners are given a “right of first refusal” to buy a partner’s shares at a designated price before any transfer to a third party can take place.

- **Valuation** – If a partner’s interest in the company is to be purchased, how will that interest be valued? While there is no one way to value a business, business owners can agree to use one of the following methods: independent third party appraisal; or valuation based upon a formula related to either assets, revenue or earnings. An important consideration is also how valuation is adjusted if a partner breaches a fiduciary obligation or commits a bad act.

- **Disability** - If a partner becomes disabled, either permanently or long-term, your business will undoubtedly suffer. Typically, a disabled partner’s interest is bought out. You must, however, consider how long the disability is in effect before the buyout; how is “disability” determined; and how the buyout will be funded.

- **Death** - As with disability, upon the death of a partner, his or her shares will typically be purchased by the company or remaining partners, since without this requirement, the deceased’s estate will usually inherit the deceased partner’s interest. Things to consider are how the buy-out will be funded (will there be insurance?) and the tax implications of a buy-out involving life insurance; and the period of time over which will payments be made in the buy-out.

- **Retirement** – How will the business provide for a retiring partner? Will the partner be bought out and if so, how will a buy-out be funded? Should retirement be triggered if a partner is not “pulling their weight”?

- **Divorce** – Without a Shareholders’ Agreement providing to the contrary, a partner’s interest in the business may be subject to property division along with his other personal assets. This can result in a spouse becoming a part owner in your business, which can cause an obvious strain on the business. Shareholders’ Agreements will typically provide for a buy-out to occur in the event of a divorce.

- **Payment** - When a buy-out occurs, an important part of the buy-out is how payment is to be made. Will it be all cash, part cash and part in a promissory note, or all in a note (if a note is involved, the parties must agree on the length of the payout, interest rate and scenarios when the payment under the note is accelerated, for example, on a sale of the business).

While your business is not obligated to have a Shareholders’ Agreement, the time to figure out how you and your partners will deal with certain matters is when the relationships are good, not when someone has died, has become disabled or simply wants out. Not having an agreement can lead to contentious litigation that could have a negative impact on the business you worked so hard to build.
