

Business Succession Planning: The Impact of a Shareholder Agreement

Christopher J. Skufca , William J. Keating Jr.

January 12, 2002

In representing family businesses over the years, we have experienced situations where owners have entered into a Shareholder Agreement not fully understanding the impact the Agreement has on them. By the time they seek advice of counsel, the damage is done. A Shareholder Agreement both protects and restricts your rights as a shareholder. These Agreements can also permit or prohibit members of your family from becoming (or remaining) shareholders.

The purpose of this article is to give you a few things to consider before adopting or amending your Shareholder Agreement.

Restrictions on Sale. A typical Shareholder Agreement will restrict a shareholder's right to sell his stock. A shareholder may be required to first offer his stock to the other shareholders and the company before he can sell his stock to a third party. This right of first refusal can grant any one or more of the other shareholders or the company the right to purchase the stock at the same price and on the same terms as contained in the third party offer.

However, it could provide the other shareholders the right to purchase the stock at a different price or on different terms. Before deciding that such terms would benefit your company, you should consider that some day you may be a selling shareholder. If you are the majority shareholder and similar restrictions apply to you, you cannot sell your stock without first offering it to the other shareholders or the company, and depending on how the restrictions apply, you may be limited as to the price you receive and when you receive it.

Purchase Requirements. A Shareholder Agreement can have a mandatory or optional requirement that a shareholder sell and the remaining shareholders (or the company) buy the stock in the event of a shareholder's death, disability, retirement, termination of employment or bankruptcy.

If it is mandatory, you are required to sell your stock upon a triggering event. As such, you cannot pass your stock on to a family member who wants to continue in the family business. This provision could apply differently to each shareholder and triggering event.

Valuation. A Shareholder Agreement should set forth a price, formula or method for determining a purchase price for the stock. The price or formula can be the same or different in the event of a shareholder's death, disability, retirement, termination of employment or bankruptcy, and can impact the selling shareholder's estate.

For example, you decide to use a low price to keep the value of your stock low for estate tax purposes. You enter into an agreement that says at your death, the company will buy your stock for book value. You die, the IRS audits your estate and determines that the true value is 1.5 times book value. If the IRS wins, your estate pays the tax on 1.5 times book. To make matters worse, your estate receives sales proceeds based on book value.

Since the company's operations can change over time, the method of valuation used today may not be appropriate in the future. You need to determine whether the price, formula or method is appropriate at different sales and earnings levels.

Business Succession Planning: The Impact of a Shareholder Agreement (Continued)

Buyout Payment Terms. A purchase at death or disability can be funded with insurance. For other triggering events, the price can be paid over time. However, if the terms of the buyout financially strap the company, the remaining shareholders may need to sell the company or some of its assets. Another consideration is your beneficiaries who may need the sale proceeds to pay estate expenses, taxes and cover living expenses.

Duration of the Agreement. A Shareholder Agreement can apply to current shareholders, future shareholders or a combination of both. If you enter into an agreement with your children which provides for mandatory purchase at death, the family of the last surviving child ends up with the company.

The Agreement you sign today may impact your children and grandchildren tomorrow in ways you did not envision. You need to see how the Agreement affects your children and grandchildren.

Amending the Agreement. Unless it provides otherwise, the consent or agreement of all the shareholders is required to amend the Agreement. This means, a shareholder with one share of stock has as much power as the shareholder with 100 shares. You can provide that a majority of the shareholders can amend the Agreement or vest the right to amend in a committee or just one person. Because times and situations change, you will need the flexibility to amend the Agreement to adapt to changing times. The amendment clause is the most overlooked provision in a Shareholder Agreement, and yet it can be one of the most important clauses.

Points to Remember. What you should remember from this article:

1. A Shareholder Agreement both protects and restricts your rights as a shareholder.
2. A Shareholder Agreement can apply to any, some or all of the shareholders.
3. Each term of a Shareholder Agreement can apply differently to each shareholder.
4. Review the amendment clause.
5. Is the valuation formula appropriate in changing situations?
6. Take the Agreement for a test drive. Put pen to paper, and before you sign it, see how the Agreement applies to you, the other shareholders, future shareholders and the company.