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Shareholder Agreements: Parting Ways

Can you name two types of agreements that can be divisive when you create them, but reduce problems when things fall apart? Yes, despite the advertised benefits of setting the terms by which shareholders hold and transfer their stock, many family businesses still lack shareholder agreements. I find them to be among the two most discussed, but perhaps most difficult to implement, documents in the family business world.

Though simple in concept and intent, shareholder agreements raise issues that can be terribly complicated and emotionally challenging. Many families will not even discuss them. So, they miss out on a key way to protect their businesses and reduce future family friction.

In this article, I seek to demystify these agreements and provide some insights to help your family face up to underlying issues that get in the way of implementation.

Despite their legal structures, family and other closely held businesses are like partnerships. Partners typically choose their partners. For example, my brother married his wife; I did not. Although I like her, I do not necessarily want my sister-in-law as a partner if she inherits my brother's stock when he dies.

A shareholder agreement is a contract governing the ownership and transfer of shares. Like other contracts, it can contain or omit almost anything to which the parties agree. Most commonly, the agreement restricts stock transfers and the types of people who may own shares. Ah ha! you exclaim. This is how I make sure that my 26-year-old throw-back-to-the-60's son-in-law can't coerce my daughter to transfer her stock to the Save the Hungarian Whales Foundation!

Unfortunately, it's not that easy. Corporate law typically does not allow a total prohibition against stock transfers. So, while a shareholder agreement might prohibit transfers, it must address what happens if a shareholder violates the terms. The most common result is that the offender (or the receiving party) becomes obligated to sell the shares that were improperly transferred. Therefore, shareholder agreements are often called buy/sell agreements.

Permitted Transferees

The agreement should define persons to whom stock may be transferred without triggering any implications. They often include:

- Descendants of current owners,
- For post-first generation businesses, descendants of the business founder (permits a childless owner to transfer to siblings, nieces and nephews, etc.),
- Trusts for the benefit of the above persons, and
- Partnerships or other entities that are owned solely by permitted transferees.

Here's the first touchy issue. Should shareholders spouses (aka my sister-in-law) be permitted transferees? If not, my brother may have to pay estate tax to pass his stock to his children. So, we might include marital trusts as permitted transferees, which in turn allows the estate tax to be deferred until his wife dies. As a compromise, we could require that only permitted transferees may be a) trustees and b) residual beneficiaries at the in-law's death.

Triggering Events

Next, the agreement should specify events that can trigger consequences. Obviously, transferring the stock to someone other than a permitted transferee should trigger the agreement's wrath. Other examples might include:

- Pledging the stock as collateral for a loan,
- The shareholder's insolvency or bankruptcy,
- Retirement, disability or termination of employment for any reason (although these tend to be uncommon triggering events for family owned businesses),
- The owner's death unless the stock is transferred to a permitted transferee, and
- Distribution from a trust or other entity to a non-permitted transferee.

Consequences

What happens when a triggering event occurs? The typical consequences are one or more of the following:

- The violator or the resulting non-permitted owner is required to sell the stock,
- The company either has the option or is required to buy the stock (a redemptive agreement), and/or
- The other shareholders either have the option or are required to buy the stock (a cross-purchase agreement).

Agreements typically require the violator or non-permitted transferee to sell, but give the company or remaining shareholders the option to buy. This might be another touchy issue. If you think you might want to cash in your stock one day, you'd like the right to force the company or other shareholders to buy your stock. Conversely, if you want your family members to continue to own the stock or you're not sure that you'll have the money, you'll naturally want the flexibility of having an option, not an obligation, to buy.

Needing Dough

Where does the buyer get the money? Life insurance folks have the answer. But, there are several problems with that solution:

- Life insurance can fund only one of the possible triggering events (death).
- The insurance might be needed to pay estate tax, not to buy back stock from your son's special friend who inherited it.
- You need to make sure that the right person owns and is the beneficiary of the insurance. The company must receive the proceeds for a redemptive agreement. Each shareholder must own insurance on all other shareholders lives for a cross-purchase, which gets rather complicated.

The more common approach is to provide very generous (from the buyer's standpoint) payout terms. For example, the agreement might specify a 10% down payment, with the balance payable over 10 years at the lowest interest rate allowed by the tax law.

Buy/sell agreements create order when shareholders split because they set the terms of the business divorce. In the meantime, did you think of the other type of agreement that can be divisive at the start and create order at the end? Yep, prenuptial agreements probably are the toughest for family business owners to discuss and adopt.

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