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a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

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SHAREHOLDER AGREEMENTS: What Co-owners Need to Consider

by Mary Hanson

When two or more individuals are co-owners of a closely held corporation, a shareholder agreement (also called a buyout agreement or buy/sell agreement) is often recommended.

A typical shareholder agreement is a contract among all the shareholders and the corporation for the purpose of restricting the shareholders from transferring stock except in accordance with the terms of the shareholder agreement.

In a small corporation, especially one where the individual owners are also key employees, it is often desirable to prevent shareholders from giving stock to family members or selling shares to an outsider without first offering the shares to the company or the other shareholders. In the same vein of thought, the company typically wants the right to buy back the shares of a shareholder who leaves the company to work elsewhere.

Without a shareholder agreement, each shareholder typically holds his or her stock without restrictions on transfer. Each shareholder is free to sell or give his or her shares to a spouse, a family member, or an outside third party. The other shareholders and the corporation typically have no right to buy back the stock, and no obligation to buy it back if the shareholder "wants out."

The most common provisions in a shareholder agreement are for the purchase of a deceased shareholder's stock in the event of death and a right of first refusal allowing the corporation or the other shareholders to purchase the stock of a shareholder who wishes to transfer his or her stock to an outsider.

Many other provisions can be included and should be considered, depending upon the circumstances of the business. For example, if a young company requires the active participation of all shareholders, it may be appropriate to have the buyout agreement provide for repurchase of the stock of any shareholder who ceases to work at a required level, or to perform his or her designated responsibilities.

Here are brief descriptions of some of the most common provisions of a shareholder agreement:

Restrictions on Transfer

A provision restricting transfer of stock prevents the shareholders from freely transferring shares. A shareholder agreement typically provides that shares cannot be transferred in any way except as permitted in the agreement. California law requires the stock certificates to be marked with a notice indicating that there are restrictions on transfer.

Right of First Refusal

To create a mechanism for a shareholder to sell his or her shares while still enabling the corporation to prevent a transfer to an outsider, most shareholder agreements contain a provision creating a right of first refusal. The provision permits a shareholder to sell shares to an outsider after giving the corporation and the other shareholders the opportunity to purchase the stock on the same terms as

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those offered by the outsider. The selling shareholder must comply with the steps set out in the agreement to give the other "insiders" the opportunity to prevent the sale to an outsider.

The right of first refusal is often in two or three steps, providing first an option for the corporation to buy the stock, and if the corporation does not buy all the stock the shareholder wishes to sell, then an option to the other shareholders to buy the stock not purchased by the corporation.

Mandatory Buyout in Event of Death

One of the key provisions in a shareholder agreement is usually the obligation of the corporation or the other shareholders to buy back the stock of a deceased shareholder.

Unlike other provisions of a shareholder agreement, the buyout in the event of death is often mandatory. Rather than providing an option for the corporation or other shareholders to buy shares, the agreement often requires the purchase of the deceased shareholder's shares.

Shareholders in an owner-operated business often do not want to be co-owners with the spouse or children or other heirs of a deceased shareholder. In addition, the spouse or children of a deceased shareholder often would receive no benefit from continuing ownership in a closely held business. Often no dividends are declared, no distributions are made to shareholders, and there is no market for the stock. A shareholder would likely not want to leave a bereaved spouse in the position of having to negotiate a buyout of the deceased shareholder's stock.

Where there are a number of unrelated shareholders, it may be most convenient to have the corporation bear the obligation to purchase the stock back in the event of a shareholder's death. When the corporation makes the purchase, the purchase price is paid by the corporation. The corporation can purchase life insurance on all the shareholders and have funds available for a purchase in the event of death.

Where shareholders are obligated to make a cross-purchase buyout, each shareholder would have to have adequate funds to make the mandatory purchase of shares from a deceased shareholder or have an insurance policy on the life of the deceased shareholder with the buying shareholder as a beneficiary. If the real source of funds for paying insurance premiums or for paying the purchase price for the stock is really the corporation, it may be beneficial to have the buyout structured so that the corporation holds the insurance policies and is obligated to make the purchase. An additional benefit of the corporate purchase structure is that each shareholder can monitor the corporation's purchase of life insurance and payment of premiums to make sure that insurance is maintained. In the event of a shareholder's death, it may be easier to seek the buyout from the corporation than to corral a number of other shareholders to complete a purchase of all the decedent's stock.

The various tax consequences of both the corporate buyout and the shareholder cross-purchase need to be considered. Insurance premiums are not tax deductible, whether paid by the corporation or the shareholders.

Under certain circumstances the IRS may challenge a corporate purchase of a shareholder's stock and seek to tax the transaction as a dividend (taxable as income, with no tax basis) rather than a purchase (where the excess over the tax basis would often be taxed at long term capital gain rates). When structuring a shareholder agreement, the possibility of such a tax challenge needs to be weighed against the benefits of a

corporate purchase. The dividend treatment challenge arises most often in family businesses where shareholders are related, because the IRS will for some purposes treat the stock of one family member as the stock of another. Such attribution rules make it difficult for a shareholder being bought out to meet the requirement that he or she retains no interest in the corporation. Particular steps must be carefully taken to avoid dividend treatment in a family owned business.

Another landmine in the field of corporate redemption is the "insolvency" restriction under California law. The California Corporations Code prohibits distributions (including payment of a purchase price) to a shareholder if the retained earnings do not cover the amount of the distribution (the payment) or the distribution reduces the corporation's assets below the total of its liabilities.

The shareholder agreement needs to provide that the surviving shareholders will purchase any stock that the corporation is unable to buy in order to address the possibility that the corporation has inadequate profit and retained earnings to make the purchase in compliance with the code.

In addition, the agreement should anticipate that the amount of life insurance may be too little to cover the entire purchase price, and that the life insurance proceeds may exceed the purchase price. The purchaser of the deceased shareholder's stock should be required to cover the excess purchase price with a promissory note in the event the insurance proceeds are inadequate and the agreement should make clear that the estate of the deceased shareholder will get no more than the purchase price of the stock, even if the purchaser receives life insurance proceeds in a higher amount.

Trusts and Conflicting Estate Plans

A key feature of a typical shareholder agreement, the mandatory buyout of stock in the event of a shareholder's death, is intended to prevent the heirs of a shareholder from becoming shareholders. It is important to note that this intention is directly contrary to the consequences of trust ownership.

First, a trust cannot die, so that, without more specific treatment of the issue, the mandatory buyout in the event of death would never be triggered for stock owned by a trust.

In addition, the typical trust document provides for assets held by the trust, such as stock, to be distributed to heirs according to the trust document.

In order to allow a shareholder to hold shares through a trust and yet give effect to the restrictions of the agreement, the shareholder agreement must contain a number of provisions requiring a trust shareholder to be bound to the same consequences as if the original individual shareholder were still the shareholder. The mandatory buyback of stock needs to be triggered by the death of the original owner, notwithstanding trust ownership.

Optional Buyout in Certain Events

Typically, a shareholder agreement sets out bases for an optional buyout by the corporation or other shareholders. The agreement has to set out the events that trigger the option, and, like any option, the provision must provide the timeframe for exercise of the option and the method for determining the price.

The events that trigger an option to buy are typically financial circumstances such as a shareholder's bankruptcy, divorce of a shareholder, and a shareholder's failure to participate in the business.

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Publisher's Note

It is also possible to place restrictions on transfer in the articles of incorporation or the bylaws of a corporation, but such an approach is much more limited than a separate agreement executed by the shareholders and the corporation.

A shareholder agreement can also provide a "put" or "cash out" option. The beauty of a shareholder agreement is that it can cover whatever the shareholders wish to cover in a negotiated agreement. The challenge is often to come up with an agreement that is feasible and actually works to solve the problems encountered by the company or the shareholders under various circumstances.

A buyout agreement is often contained in an LLC operating agreement, a partnership agreement, and in agreements for other types of entities with a number of owners. The issues are usually the same, although the mechanisms and details may differ because of variations in the applicable laws and tax treatment.

Shareholders should anticipate updating these provisions every few years. As circumstances change, and hopefully as the business grows, the involvement of particular shareholders and restrictions on transfer may become less important.

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Method of Buyout

The agreement must set out a method of determining the price of the shares to be purchased and the payment terms.

Typically the most accurate valuation method is an appraisal by an experienced and qualified business appraiser. The use of a formula is not uncommon, but there is a serious risk of the calculation being so far off (high or low) that it invites a dispute.

Typical payment terms include a 20% down payment and payment of the balance over 48 months or more. The terms of the buyout have to be realistic. The business needs to survive in order to make the payments.

Noncompetition

Under California law, a shareholder may be bound by an enforceable covenant not to compete with the corporation after a buyout. This is an exception to typical California law prohibiting non-compete agreements. A covenant not to compete should be part of most buyout agreements.

Consent of Spouse

In a community property state the agreement also needs the consent of shareholders' spouses to make clear that each spouse agrees to give up his or her community property interest in the event of a buyout of stock under the agreement.

Rather than having each shareholder's spouse sign the agreement, a separate "Consent of Spouse" is often attached to the agreement in which each spouse states that he or she understands the agreement and agrees that his or her community property right in the shareholder's stock will be transferred with any transfer of the stock by the shareholder under the agreement. BA