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AN OVERVIEW OF SHAREHOLDER AGREEMENTS AND CLOSELY HELD COMPANIES

BY ERIC M. MENCHER



Most shareholders in a company, especially at the inception of the company's existence, believe that they share one vision with respect to the interaction of the shareholders and the future of the company. However, it often becomes clear in the process of drafting shareholder agreements for clients that they had not given thought to all of the potential issues they might face and which often should be addressed in shareholder agreements. The clients are often surprised at the number and complexity of certain issues, and might resist addressing them up-front. As tedious as the process might become, it is always better to address the issues when the mood is mostly positive and the issue at hand has not yet come to pass. There is a greater chance of obtaining reasonable compromises on issues at the outset rather than when action on such issues is required.

This article will discuss the main issues that are generally involved in the drafting of shareholder agreements. Certain of these issues impact each other and should not be viewed in isolation (for example, valuation issues and put and call provisions). These same issues are involved in the drafting

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of a limited liability company operating agreement, which agreement, in concept, is basically a combined by-laws and shareholder agreement with certain additional provisions addressing the partnership tax nature of the entity.

Transfer of Stock

Often, but not always, shareholders in a closely held company know each other (or at least know of each other or know people in common). They often take some comfort in that knowledge. This leads to the issue of restrictions on transfer of stock by the shareholders. The easiest, but least flexible, resolution is to require consent of the non-transferring shareholders prior to transfer. The question then is whether unanimity, majority or supermajority voting is required regarding consent to transfer stock. A variation allows for transfers to family members by way of trusts with certain limitations (which facilitates estate planning), but otherwise also requires consent.

Allowing for a right of first refusal is a common compromise, which allows a shareholder to attempt to liquidate his interest in the company while allowing the non-transferring shareholders some control over who their partners will be. Here, a selling shareholder may obtain a bona fide third party offer to purchase his shares, but then must offer the shares to the other shareholders before selling to the third party. Tension may arise as to the cost of the purchase if the right is exercised. Usually the right of first refusal requires the exercising sharehold-

ers to match the offer from the third party. Often, however, especially if certain shareholders feel that their ability to obtain necessary funding is suspect, the shareholder agreement may call for the purchase price to be the lower of the offer or some other valuation (e.g. book value, appraised value, and original buy-in cost). Additional variations of this right allow other shareholders to piggy-back on a sale of shares by a shareholder ("tag-along rights") and allow selling majority shareholders to force minority shareholders to join in on a sale ("drag-along rights"), each of which variation is useful in the right circumstances but often meets with resistance from clients.

The standard buy-sell agreement provides for transfer of shares upon a share holder's death. This calls for the surviving shareholders or the company to purchase the shares from the deceased shareholder's estate, often utilizing life insurance proceeds to fund the buy-out. An issue may arise here when a shareholder wants certain family members to continue with the business after his death and/or views the company as his legacy. Even if the concept of a buy-out is agreed to, the valuation of the company for purchase price purposes may be problematic. Especially in closely held companies, the calculation of net income and net worth might not reflect the real cash flow value to the shareholders. Different valuation methods are discussed below.

Other circumstances which arise in

the course of the life cycle of a business and which require consideration of transfer issues are disability of a shareholder (whether or not such shareholder is also an employee) and termination of the employment of a shareholder/employee. Either of these scenarios might allow for a put (where the shareholder may force the company or the other shareholders to purchase his shares) and/or a call (where the company or the other shareholders may require the shareholder to sell his shares).

Management/Employment

Management involves different levels (shareholder voting, board of directors and officers of the company) and different types of issues (overall company purposes and principles on the one hand, and day to day operations on the other).

Most shareholder agreements denote who the directors will be and all shareholders agree to vote for them. Sometimes, the offices to be held by shareholders are likewise stated. More involved is the type of vote required to take certain action. Often there is a listing of actions (either by the board or by the shareholders) which require a unanimous vote (usually the most material actions, such as selling the assets of the company and requiring additional capital contributions), a separate list of actions that require a supermajority vote, and a third list for those that require only a majority vote (or a catch-all that "all other actions require majority vote").

If the company also employs the shareholders, or certain of them, there are issues regarding compensation, expenses, job descriptions and, most importantly, accountability. Some shareholder agreements call for employment as long as the employee remains a shareholder, but problems arise if a shareholder no longer fulfills (or is no longer able to fulfill) his duties in an acceptable manner. On the other hand, most shareholders are uncomfortable allowing the other shareholders to decide, in their sole discretion, whether he or she should be able to remain employed. Certain supermajority voting

requirements in connection with certain general "bad-guy" actions may be drafted allowing for termination of employment in the most egregious circumstances, to protect the company and the other shareholders, while eliminating absolute discretion of the other shareholders and vague performance standards, to protect the shareholder/employee. Additionally, the salaries are often tied together, either by amounts or formulas, or a base salary is established and bonuses may be voted on by supermajority to reward performance, to allow flexibility while providing some comfort to all involved.

Valuation/Payout

One of the most common methods of valuing a closely held company is for the shareholders to agree, at the time of the shareholder agreement execution and then, usually, annually thereafter, upon a valuation dollar amount. A certificate is signed at each valuation date by the shareholders. Often, when there are life insurance funded buyout provisions, the amount corresponds to the amount of the insurance. The problem arises when there is no annual revaluation, or shareholders attempt to do so, but cannot agree on a value. In those circumstances, the shareholder agreement often provides for an appraisal mechanism to determine value when a situation arises calling for the sale of shares by a shareholder.

The most common other method of valuation is valuing the company at the time of a sale, utilizing an appraisal mechanism or a formula (e.g. a multiple of EBIT, net worth of the company or book value). A shareholder agreement usually includes different payout schemes for different scenarios. There is usually a general payout (e.g. 20 percent down, the remainder over five years). However, if there are life insurance funded buy-outs, the down payment may be larger and the payout over a shorter period. There may be circumstances set forth in the agreement in which the down payment may be smaller and the payout over a longer period. Some clients, however, prefer the simplicity of one scheme for all situations.

Restrictive Covenants

There is usually no disagreement with

respect to a confidentiality provision in a shareholder agreement, restricting disclosure and use of the company's confidential information.

However, reaching an accord on non-compete and non-solicitation provisions may prove to be more difficult. This is especially true if certain shareholders are employed by the company or involved in the industry while other shareholders are not. Drafting the restrictions in a narrow, well-defined manner will not only improve the chances of approval, but will also make it more likely that the restrictive covenants will be enforceable.

Most shareholder agreements also address the issue of conflicts of interest (and corporate opportunity) on the part of the shareholders, and whether or not the shareholders and/or entities in which they have an interest may have transactions with the company.

Conclusion

The purpose of this article is to provide a general overview of the main issues that arise in shareholder agreements, especially in connection with closely held companies, and some possible resolutions of the issues. Space does not allow a discussion of all of the issues, nor an in depth discussion of any of the issues. However, it is hoped that this article provides a useful guide for a practitioner in preparation for meeting with his or her clients and in drafting the kind of agreement which will enable clients to have an agreed upon roadmap for the amicable resolution of those issues and circumstances which inevitably arise during the life cycle of a company.



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