The Proper Use of Shareholders' Agreements

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The time to determine whether or not a buy/sell agreement is complete and accurate is well before any dispute arises between the shareholders. By the time a dispute arises, and all of the various issues are revisited, it is usually, too late to determine what the "agreement of the parties" really was if it's not clearly spelled out. There are several issues with regard to Shareholders Agreements, also know as buy/sell agreements, which often must be discussed and reviewed in order to avoid problems in the future, and, just as important, to allow each of the parties to the agreement to fully understand their rights, responsibilities, obligations, and alternatives under various circumstances.

For this reason, it is always appropriate to consult with competent corporate counsel at the time the Shareholders' Agreement is being negotiated. While the parties themselves and other professionals can often add significantly to the calculus of thoughts that are needed, and the possible alternatives, reducing them to proper writing is certainly a task for an attorney.

Most frequently a buy/sell agreement is intended either to determine the methodology, terms and conditions under which a redemption will occur or be required or to provide for the "cost-purchase" of stock between multiple shareholders of the entity.

Generally, in a redemption agreement, the owners of the securities come to terms with the entity itself or the other shareholders regarding terms and conditions of the perspective redemption of the stock. While this may either occur due to circumstances beyond the control of either the shareholder or the entity (such as the death of the shareholder) or may be triggered by specific events in the agreement, the terms and methodologies will normally be outlined in detail. In certain circumstances, a redemption agreement may in fact be a "right of first refusal" for the corporation. The shareholder may be completely free to solicit the purchase of his stock; however, the corporation (or some other party) may have a "right of first refusal" at the stated price and under the identical terms to purchase the stock in lieu of the other proposed buyer.

Because of the complexity of negotiating terms with one perspective buyer, and then having that buyer know that the terms will be reviewed with someone else in the corporation, and the terms may then be matched by the corporation, it will generally all but obviate the opportunities for the shareholder to sell his stock to anyone but the corporation.

A typical cross-purchase agreement will, instead, require the other shareholder(s) to buy the stock from the shareholder desirous of selling; again, sometimes under specified terms and other times under more generally defined terms. The various triggering events that could occur may include (but not necessarily be limited to) the death of the shareholder, the disability of the shareholder, the petition for insolvency (bankruptcy) of the shareholder, the conviction of the shareholder of a felony (or in some cases a lesser crime), a planned or otherwise unplanned retirement or termination of the shareholder as an employee of the corporation, or other disagreements between the owners. In a litigation circumstance it will be difficult to determine what the terms of the sale were intended to be unless they are clearly spelled out. In certain circumstances the terms of the agreement will include a purchase price defined in the agreement. In many cases, the purchase price will either be a calculation that is spelled out, a methodology for determination of valuation, a requirement for multiple valuations, or some other method. In addition, the purchase price may be different under different circumstances.

If a repurchase agreement calls for a price of $2 Million if the shareholder/employee is terminated and $1 Million if the same employee/shareholder voluntarily terminates his/her employment, it may be difficult to determine whether someone was in fact fired or quit, or in fact was forced to quit, and this often will lead to litigation. In addition, the methodology for payment may differ, based on the triggering event, or it may simply be spelled out in the terms of the agreement. If the Shareholders' Agreement is silent on the payment terms, it may be assumed that payment would be simultaneous with the transfer of the stock back to the corporation or to the other shareholders. In fact, in some circumstances, it may be that the buyer does not have the funds to make immediate and full payment and payment terms may then need to be negotiated by the parties later on.

In addition, it is important to understand whether or not insurance is in place, which may pay for the purchase in the event of death or disability. The insurance may or may not be directly related to the buy/sell agreement, and may be covered under a separate agreement. It is important in negotiating buy/sell agreements that may be covered by insurance to discuss in advance how the insurance proceeds might work and the terms of payment. For instance, if the amount of the insurance is insufficient to pay the full amount of the purchase price, but that was the intention, how would the excess be paid? Would it be payable over a relatively long period of time as might be specified in the agreement if there was no insurance in place, or a much shorter period of time with the periodic payments to be the same as they would have been without insurance. Each of these items should be discussed clearly in advance. Likewise, if the amount of the insurance in place is in excess of the stated or calculated purchase price, does the excess amount go to the seller's estate or does it go to the owner of the policy/the corporation/the other shareholders?

The items that most frequently occur with regard to litigating a purchase agreement are whether or not it has been triggered, what the price is, what the terms of payment are, and what, if any, additional rights the seller (or any existing shareholder) may have during the period of payment.

Shareholders' Agreements, especially in terms that relate to litigation, always need to be read and considered in connection with any existing employment agreements and any other agreements that may have been negotiated and/or executed essentially simultaneously with the purchase agreement. In fact, not infrequently, multiple agreements are executed simultaneously, and subsequently Joinder Agreements may be signed to allow/require additional parties to conform to the terms of the existing agreements.

One of the areas that may be disputed is when a Shareholders' Agreement exists and, at a substantive point in time, a new or revised employment agreement (or some other agreement that may involve insurance policies) is written without conforming it completely to the underlying Shareholders' Agreement.

In addition, there have been circumstances where a Shareholders' Agreement may contain terms which restrict in some way the transfer that may be pursuant to a divorce or other matrimonial discord. If such a circumstance exists, the areas for potential litigation include not only the various original parties to the agreement, but potentially the soon to be ex-spouse. For this reason, many legal counsel will recommend that any agreement that calls for some special treatment in the case of divorce be counter-signed by any spouse that exists at the time the agreement is negotiated, and may even call for the subsequent signature of any subsequent spouse to the shareholders. The actual failure to obtain such a signature of a future spouse may in fact be part of the cause for litigation.

Valuation issues in a Purchase Agreement, if they're not clearly spelled out, can often lead to litigation. So any Shareholders' Agreement that is silent with regard to the purchase price is an invitation, at a later date, for attorneys and valuation experts to become involved, and the only ones who then benefit are the outside professionals. When valuation methodologies are put in place, unless they are clearly spelled out and use terms acceptable in the valuation profession, they also can lead to litigation with allegations of misuse of the financial statement information, other historical information, comparable company information, and/or other financial data used in the valuation process.

Even the use of what might be deemed common terms such as income, net income or earnings may be problematic in valuation methodologies in a Shareholders' Agreement. None of those terms are commonly utilized in valuation methodologies, nor are they uniquely understood. Specific categories of earnings are used in valuation methodologies (such as earnings before interest, taxes, depreciation, and amortization -EBITDA) or specific numbers from a tax return may also be utilized. In addition to the terminology, the understanding of the portion of the practice or business that's being purchased and the methodology to be used for allocating value to that portion may become very important.

If a 20% shareholder under a Shareholders' Agreement is being bought out at "fair market value" it is important to understand whether that includes the traditional valuation discounts for minority interest and lack of marketability. Unfortunately for the parties that may be involved later, state law dictating how ambiguities are to be resolved may work against one party or another (usually against the party who actually drafted the agreement) and may cause the valuation result to be other than that was truly contemplated by the parties. Likewise, such a relatively vague set of terms may work against the selling party if it is determined under applicable law that all applicable discounts are to be used when, in fact the parties may have intended a 20% shareholder to simply obtain 1/5 of the full value of the entity in the event of a triggering event under the Shareholders' Agreement.

Other clauses within a Shareholders' Agreement and/or a related employment agreement may also cause litigation or other disputes. The simple determination of what is being treated as "equal" among shareholders who own the same percentage of the stock and/or pro rata among all shareholders may become a matter of dispute. Different shareholder/employees may be getting different salaries, different perks, different reimbursement for other expenses, may have other aspects of their financial lives being treated differently, and unless all these are spelled out in the Shareholders' Agreement and/or the employment agreement, these, too, may give rise to a dispute.

In understanding the agreements, the terms and the thoughts expressed above, sometimes disputes can be avoided, and other times it will allow legal counsel to focus on the issues and the language to resolve the dispute most favorably to their client.