Stockholder Agreements

Buy-Sell Agreements

One of the more important stockholder agreements that every family business should have is a Buy-Sell agreement that requires that the shares of stock be first offered to the company or another shareholder in the event that the shareholder is no longer interested in being a shareholder. In addition, it is also prudent that the agreement require a buy-sell in the event that one of the following events occur:

- The shareholder dies,
- The shareholder is declared mentally unfit,
- The shareholder becomes divorced,
- The shareholder files for bankruptcy protection, or
- The shareholder becomes separated from the business.

Why is this agreement so important? Because you will not want to have an adversarial party as a fellow shareholder. Because a lot of the information discussed amongst the ownership group is very confidential; stuff you don't want out in the general public. Because you don't want an uninformed or disinterested shareholder exercising his or her ownership rights.

In the case of the death of a shareholder, buying back shares of stock has the added benefit of helping the owner's estate to increase its liquidity. This in turn also helps the estate to make distributions to intended beneficiaries.

In the case of mentally unfit owners, the rationale behind this is pretty clear. However the challenge is with determining whether or not an owner is unfit. How does one do so without upsetting the owner? In the case of illnesses such as dementia, the symptoms are very mild at first and become increasingly debilitating as time goes by. When do you recognize that there is a problem?

In the event of a divorce, legal counsel for both spouses will usually make recommendations on asset splits, alimony, child support and other items of contention. The presiding court will consider the income and assets of both spouses and make a determination of how the marital estate will be divided. A buy-sell agreement will help to improve the shareholder's liquidity which then makes it easier to split the marital estate. For those of you with a prenuptial agreement, be aware that the court may choose to ignore that agreement if the asset distribution

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is considered to be unfair. A buy-sell agreement that includes divorce as a condition is a good idea.

If a shareholder declares bankruptcy, then a bankruptcy trustee or the bankruptcy court will have effective control over the shareholder's assets. In the case of a Chapter 13 reorganization, assets might be used to reduce debt in order to put a workable debt reorganization plan together. In the case of a Chapter 7 liquidation, assets will be liquidated in order to pay creditors. In either case, you run the risk of having an unknown party as a shareholder if you're not careful. Also, it's always a good idea for the company to file a notice with the bankruptcy trustee or the court advising them of the buy-sell agreement. That will help to insure that the shares of stock stay either with the company or with other owners.

Lastly, when a shareholder leaves the business, it's sometimes a good idea to buy his or her shares back. If the departure is for cause, then it's highly unlikely that they will be supportive of the business. So buy them out before they can cause any further damage.

Valuation of the shares of stock are always a matter of potential contention. I suggest discussing this question with your accountant or other financial professional. Nonetheless, many agreements use the company's net book value as a basis.

Voluntary/Discretionary Buy Back Program

Establishing a voluntary buy back program enables a company to address an issue that many multi-generational families have; too many stockholders. Why is that a problem? Well, ever try reaching consensus with a large group of people? Especially if some of them are very independent or entrepreneurial?

Consider the case of a third generation family business. Grandma and grandpa started the family's business and gave an equal interest to all six of their kids. Their kids in turn, had kids and many of them did the same thing and gave equal shares to their kids. So between the second and third generation there were now 47 owners. Trying to reach agreement with that many shareholders can be a monumental task.

A voluntary buy back program would help to reduce the number of shares held by everyone. For many shareholders who don't work in the business, owning an interest might not be that important to them. Given an opportunity, many will consider selling a portion of or all of their interests back to the company.

Voting

For family businesses that have several "branches" of owners, consideration should be given to having each branch designate one shareholder to speak for their branch of the family. Voting agreements help to reduce the number of shareholders who are involved in decision making. That helps to reduce the rhetoric, and make decision making more efficient and less frustrating for all.

Non-compete & Conflicts of Interest

Owners have a responsibility to each other as well as the company to always have the best interests of the company in mind. As such, it is important that shareholders not be involved with enterprises that compete with or take business away from the company. It is also very important that shareholders not be involved in decision making that benefits themselves, their family or friends and not the company.

A non-compete/conflict of interest agreement sets forth these expectations, and should be agreed to by all shareholders and key management personnel.

Confidentiality

Shareholders are privy to a lot of confidential information. They include the company's financial statements, business plans, compensation data, sales performance, etc. Release of this information could have a detrimental impact on the company's future successes. A confidentiality agreement will help to illustrate the seriousness of an owner's responsibility to safeguard such information.