Shareholder Agreements
A Brief Primer

SHAREHOLDER AGREEMENTS ARE USED TO CONTROL WHEN AND HOW OWNERSHIP INTERESTS CAN BE TRANSFERRED, BY SALE, GIFT, OR DEATH, AMONG OWNERS. WHILE SIMPLE IN CONCEPT, THE NUANCES OF SHAREHOLDER AGREEMENT CAN DETERMINE WHETHER THE DOCUMENT WILL ALLOW FOR A SIMPLE UNWIND OF THE ENTITY, OR LEAD YOU INTO A PROTRACTED LEGAL BATTLE.

Basic Agreements

Shareholder agreements, also called Buy-sell agreements, are a contractual obligation entered into among the shareholders of a company or other entity (partnership, LLC, etc.) to govern ***when and how shares are transferred*** between and among shareholders. They may extend to include gifting and other donative transfers of shares or simply cover the dissolution of a company. These agreements can be created at any time by the shareholders of a company and can apply to all issued shares or just to those shares owned by parties to the agreement. There are significant tax considerations to redemptions that are beyond the scope of this initial discussion that should be considered as well.

CONSIDERATIONS

There are a number of considerations when drafting or negotiating a shareholder agreement, not limited to:

- **When is it effective?** What are the "trigger events" when the terms of the shareholder agreement become effective? Are there ongoing provisions that govern any sale or transfer of shares, including donations or gifts or does the agreement only apply to sales of shares to permitted shareholder and (perhaps with different notification provisions) to sales to non permitted shareholders? Are there situations when the sale or transfer process is triggered, perhaps involuntarily, by external events, forcing a shareholder to sell his or her shares?
- **How does it work**? What are the various processes for sale or transfer of shares? Is there a specific order by which events should take place? For example, are shares always retired or can the company hold the shares? Are there formal notice requirements to offer the shares to other shareholders, etc.?
- **Who is covered by the agreement**? Does the agreement govern *any* transfers of shares? Or only shares held by signatories of the agreement? Does the contract automatically apply to their successors (by gift or transfer, such as trustees of a trust or beneficiaries of a gift) or do the successors also have to sign the agreement?
- **When and how should the agreement be amended**? As with any contract, the terms by which it can be amended or revoked should be well established up front.
- **What is the duration or term of the agreement**? Is it perpetual or must it be automatically renewed every few years? What are the issues for the company and the shareholders if the agreement is not renewed?

- **Who are the permitted parties to a contract**? Shareholder agreements may go beyond simple "buy sell" arrangements to address issues of company ownership. Even if there are no company definitions, the agreement will often list the types of permitted shareholders who may be parties to the agreement, either outright or in trust. Are there informational barriers that should apply to differentiate information available broadly to all shareholders vs. parties to the agreement? Are there trust or other "holding" structures that should be created to allow economic but not voting transfer to impermissible shareholders? Is there a confidentiality provision with respect to terms of the agreement?

Types of Buy Sell Agreements:

There are three common types of "buy sell" agreement: (1) a **"cross purchase" agreement**, where shares are transferred between and among shareholders, (2) an "**entity purchase,"** where the company is purchaser of the shares, or (3) a **"hybrid purchase"** agreement, where the company and some (or all) of the shareholders purchase shares together.

CROSS PURCHASE AGREEMENTS: In a cross purchase agreement, a group of "permitted" shareholders may buy shares when offered by an existing shareholder or upon the occurrence of a pre-defined "trigger" event. The agreement will usually set forth the manner by which an offer is made to sell shares, procedures for notifying shareholders of the amount of shares and offering price. As an auction process can have significant ramifications for the company and the shareholders (impacting things like corporate debt covenants to individual estate plans), the shareholder agreement usually provides clear guidelines as to when and how the shares transferred are to be valued and how payment may be made (all cash, installment sales, etc.). The agreement will also set forth a timeframe for the sale. In closely held businesses, the agreement may also set forth a hierarchy for sales, allowing families or business affiliates to sell to a select group (e.g., to members of the same lineal family line or to other founders) before any notification or offer to the broader group. Other agreements may require that any offers to sell are made equally to all shareholders within set notification provisions; this latter approach can ensure fairness but can also create unwanted valuation issues if a bidding war is allowed to ensue over the shares.

Some agreements (whether cross-purchase, entity, or hybrid) provide for a set date, minimum or maximum "size of sale" parameters and notification periods during which all sales may be made; all provisions that allow the company or shareholders obligated/expected to purchase shares to budget accordingly.

ENTITY PURCHASE AGREEMENTS: In an entity purchase agreement, the company (or LLC, partnership, etc.) is the purchaser of the shares. The purchase can be voluntary (e.g., a redemption offer) or involuntary (e.g., repurchase in the event of bankruptcy or other default). Whether the shares purchased by the company are retired (increasing the ownership percentages of remaining shareholders) or held as "treasury shares" (available for reissuance to permitted shareholders upon purchase), will depend on the

goals of the company and the shareholders. The retirement of shares can have income or estate tax consequences for other shareholders while the treasury shares can result in changes to ownership (and control) provisions that may be beneficial or harmful to the overall governance structures. Agreements providing for the retention of treasury shares should also address whether these shares would retain voting rights and if so, who might vote them.

When creating entity purchase agreements, many companies create a program for ongoing redemption of shares, which will include notification provisions (e.g., let us know by December 1st if you intend to redeem in the annual redemption date) and redemption parameters (e.g., redemptions are made on March 31st when notified in writing by December 1st of the prior year, up to $ X). Redemptions above a set amount or outside these parameters are often made at discretion of either the Board of Directors or some other group authorized to handle the redemption requests.

HYBRID PURCHASE AGREEMENTS: In a Hybrid purchase agreement, issues of timing, order of offer and notice period become paramount. Typically, the company is designated as the first purchaser and has a right of first refusal (ROFR) on the shares. The entity, or company, also as a right of first offer (ROFO), either to other shareholders (in a form and manner to be determined) or to selected buyers if the shares are able to be offered to non-shareholders (often among a permitted class or subject to Board approval if the shares are to be offered outside of a predetermined class of buyers). The company also often is given a right of last look, or right of last offer (ROLO or ROLL), under the agreement. This ROLO allows the company the ability to buy shares if they would otherwise be sold outside the company. The ROLO must be binding on all parties.

When creating hybrid purchase agreements, the timeframe for each step should be addressed clearly. For example, if a selling shareholder wishes to sell and notifies the company of its intention to sell, the company has the right of first refusal on the shares and then a set time frame (usually 30-60 days) to respond to the request to purchase shares. At that point, the company can exercise its right of first offer and trigger another thirty to sixty day window for shareholders to try to purchase the shares or to find an external buyer and then perhaps a final 30-60 day window to respond to a last look. This timeframe allows a company to seek outside financing or to negotiate terms of a multiple party purchase agreement over a 3-6 month period, at the end of which, the Company's offer, or lack thereof, is binding on all parties. In recent years, with the volatile credit markets, this time period may be extended or the agreement may provide for an extension to be triggered (e.g., if the market drops by more than 2% during the 30 day window or the Fed changes interest rates during this window, the period is extended by another 15 days). Other agreements may be tied to business days, allowing a slightly larger window and reflecting that financing deals may be harder to arrange around year-end or holiday periods.

TRIGGER EVENTS: When and how the agreement will come into action are important considerations for the negotiating parties. Likewise, determining the scope of the agreement and whether all provisions apply to all transfers are items that need to be clearly delineated in the document. For example, some shareholder agreements will apply to any transfer of shares (including gifts of shares or donations of

shares to charity) while others will only apply to the purchase and sale of shares by a shareholder, either to the Company or to another permitted shareholder. Shareholder Agreements may also contain trigger events at which point the Company can initiate a purchase of shares from a shareholder who may be obligated to sell to the Company at that time. Common mandatory trigger events can include death of a shareholder, divorce, bankruptcy, other creditor issues, criminal convictions, etc. The nature of the trigger provisions often reflects the involvement of the shareholders in the operations of the business or its financial affairs.

Parties to the agreement can have tremendous latitude in selecting trigger provisions as well as whether a trigger event will force merely a review of the situation or a mandatory redemption or other action. For example, death of a shareholder may not require a mandatory redemption but may provide that other financing options will become available to the estate (hence why these are often called "shareholder" agreements, rather than just "buy-sell" arrangements, as the circumstances when the provisions will apply may vary). Another example might be a divorce, where the divorced shareholder may no longer be a permitted shareholder but there is a desire to retain the shares for estate planning or other reasons. At this point the company can require the use of various trust structures to hold the shares, set a redemption program to be implemented over time or require the departing or selling shareholder to enter into a voting agreement with respect to the shares. A similar result may occur in a bankruptcy or creditor issue, where the company will buy the shares and provide the selling shareholder with an option to repurchase the shares from the treasury for a set period of time. Care must be taken with this type of arrangement to prevent the company from becoming the lender of choice for shareholders who are temporarily short on cash, unless this is a desired outcome.

These agreements can also contain provisions that preclude a selling shareholder from seeking third party bids on company shares until all or some of the time periods under the ROFR or ROFO have passed. The selling shareholder may only sell if and when all prior rights are refused. These types of provisions obviously limit the marketability of the shares while in force by increasing the timeframe for any deal as well as increasing the uncertainty of a successful transaction to a non-shareholder third party looking to purchase shares. This lack of marketability can have implications for gift tax and estate tax purposes. It also often results in a better value if and when the shares are sold to a third party since the company ahs a right of last look or last offer, and can match the offer (whether the company can, at this point, invite its own third parties into the deal is often implied by the ROLO provisions but should be addressed specifically in the document).

Valuation Methods

Most shareholder agreements contain detailed valuation provisions for company shares. If the company has a history of setting the valuation and the shareholders agree on this approach, the agreement can simply begin by stating that that valuation will be the starting point for all purchases (this is usually the case when the agreement is entered into by an operating company – vs. a start up – and may be the fixed price method, discussed below). However, the purpose of a shareholder agreement is to anticipate situations where there may be dissent among shareholders, particularly if the sale is involuntary. As such,

it is prudent to provide for dispute resolution provisions that will apply in the event the existing valuation is challenged by a selling shareholder.

There are a number of valuation methods commonly used in these agreements, each of which has positive attributes as well as some considerations, and bear further examination. The common forms of valuations include (1) fixed price valuations, (2) formula valuations, and (3) shotgun valuations.

FIXED PRICE VALUATIONS set a price for shares at the time the agreement is entered into; they may also provide to have the price reset annually and provide the mechanism for the annual calculation. Fixed price valuations are easy to understand and negotiate, hence they are often favored because they can be inexpensive to create. The main drawback of the valuation is that the value can be unfairly depressed by events that are of short duration (e.g., large capital charge depresses valuation in a year) or may not accurately reflect the facts of the situation (e.g., in a partnership where one partner's involvement represents significant goodwill to the company). Fixed price valuations can have unanticipated consequences; it can pull the focus off of growing a business since there is little incentive to add value to a fixed price. The valuations usually can become quite contentious if there is no mechanism to reset or revalue the price or dispute mechanisms to challenge the valuation in an orderly process. However, in larger organizations, fixed price valuations, with appropriate metrics for setting and re-evaluating are often the easiest, if only for their clarity and simplicity. Where there is an outside, or disinterested party, approval process (such as a board of directors with outside directors), this can be the valuation method of choice for widely held family businesses.

FORMULA VALUATIONS are an agreement simply on the way to set the price. This forward-looking approach also relies on trigger events, at which time the price will be set at which sales will occur. When agreeing to a formula, it can be one formula or an average of formulas. Usually formula valuation clauses will also include a sample calculation using values as of the date of the shareholder agreement and guidelines on how the formulas are calculated (one appraiser picked today, each party gets an appraiser, third appraiser as a tie-breaker, etc.). Understanding the formula, and reviewing the formula on a periodic basis is also important. For example, the value may be a multiple of book value or earnings, or an average value employing a number of different formulas; reviewing the formula at pre-set intervals, before a trigger event, can highlight whether the business has shifted so as to warrant a review of the formula used or calculation methods.

When using formula earnings, it is a good idea to engage a valuation specialist to review the formula clauses, as they will bring a practical bent to the language, often highlighting interpretive issues that might not be addressed by the attorney drafting the agreement. It is also important to have a goals or values clause, to set forth the overall goal of the parties at the time of the agreement. Bear in mind that this "goal" exercise can also create an issue – fair market value may mean the book value of the company or it may mean the book value less any applicable minority discounts on the shares. Formula agreements are usually easy to understand and negotiate so there is less legal documentation at inception. The major drawback is that no one formula is appropriate for all businesses, all the time. While value might be determined by a multiple of book types earnings, how measure earnings (EBITA, EBIDA) can result in

wildly different outcomes. When using formula valuations or when planning to use an outside appraiser, agreeing on the process by which the appraiser is selected, or their minimum credentials, is recommended.

SHOTGUN VALUATIONS, also known as *Roulette* valuations, are a process by which both parties submit a valuation and agree that one will buy and one will sell at the offered price. These are more common in two member partnerships and can inflate the price over the actual value in an effort to win the "roulette". Shotgun valuations have fallen out of favor and are rarely used but may appear as a "last step" in a valuation process.

WHAT IS "VALUE"? The term "value" is a rather elastic one in legal and particularly tax situations. Simple terms like "book value" or "fair market value" are often thrown around in negotiations yet can yield unintended results. For example, "fair market value" defined as the price that a willing buyer would pay a willing seller. Yet in the context of a shareholder agreement and the redemption or purchase of shares, the seller or buyer may not be "willing." Likewise, the "auction" type of free market negotiation that is presumed by the definition of "fair market value" may not exist because of limitations on permitted shareholders, the desire to control the valuation process to preserve confidentiality or to prevent unwanted estate or gift tax consequences to other shareholders. Finally, "fair market value" may imply discounts for lack of marketability or premiums for controlling stakes that are antithetical to the overall interests of the shareholders. Stating that value is an uncertain term does not imply that a valuation will be false or misleading but simply means to emphasize the process by which value is to be determined is usually the centerpiece of most shareholder agreements and bears careful consideration.

Simply using a set valuation, like "book value" for a company may not be a bad result in some instances. Book value is often used for investment purposes, where shareholders are not actively engaged in the business operations and where the value must extend across a number of parties. Book value may not be an appropriate valuation method in all circumstances; it may not be appropriate because of current distortions to value that may not be true reflections of the shares' worth. Cash reserves held for taxes, loss carry forwards, depreciation deductions, one-time charges, capital expenditures, and the goodwill value represented by the selling shareholder can all skew the "real" value of the shares sold. In general, all usual costs of operation can all effect valuation.

The agreement should set forth the method by which value is determined, as well as when and how shareholders are informed of the value of the shares, changes to the valuation and how company operations may affect the ongoing valuation of the shares. It can be helpful to set out what financial statements will be used by the appraisers (e.g., most recent audited statements vs. trailing 12 months) as well as the "as of" date, or the time that the valuation will be effective to prevent older valuations or subsequent events from affecting a valuation.

Choosing an appraiser

Even shareholder agreements that do not anticipate using outside appraisers are strengthened by setting the terms by which appraisers will be used, how they are chosen and how many can be involved (as well as who will pay the costs of the appraisers (company or the selling shareholder – which can be an additional deterrent to a sale and an incentive for the company to provide fair value) as well as addressing the standard of valuation (FVM, Book value as well as definitions of those terms), the level of valuation (pro rata, reflecting control or minority discounts), the date of valuation, the process by which appraisers are selected, the standards to which the appraisal must adhere and payment for the appraiser should all be addressed.

Final Thoughts

When negotiating the parameters of a shareholders agreement, bear the following in mind. ***Someone will buy shares and someone will sell shares – but exactly who will buy and who will sell is unknown.*** The process needs to work whether you are the buyer or the seller. Furthermore, the process articulated in the agreement must protect the families of the buyer or seller (whether they are also shareholders or not). Finally, the process needs to work for the corporation. While the process can seem arduous and often costly, the time spent on thoughtful preparation will avoid significant costs if the agreement was successfully challenged at a later date because of oversights today.

WORKING WITH US: Wealthaven's independent views and deep expertise across business, investments, estate and tax planning can be an invaluable resource for business owners considering succession or transfer issues for operating businesses and/or complex assets. By supplying technical knowledge and an objective voice, we can support your legal and financial advisors and ensure that the implications for your broader wealth picture, such as tax or estate planning considerations are properly addressed.