CORPORATE MATTERS:
SHAREHOLDER AGREEMENTS

Author
Simon H. Prisk

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Corporate Law
Shareholder Agreements

In the first issue of our publication, we discussed the need and relative ease of preparing and entering into an agreement between partners and the consequences of not doing so. We used the recent case of Gelman v. Buehler 2013 NY Slip OP 01991 (March 26, 2013) to illustrate the sometimes expensive consequences of not documenting the initial agreements between partners. Following up on that, we thought it might be helpful to outline in broad terms what one should look for in a shareholders agreement.

While we have stated that it is relatively simple to prepare a shareholders agreement. Careful consideration still must be given to the contents of such an agreement, and it should be tailored to meet the needs of the parties involved. No two shareholders agreements are alike, and one size definitely does not fit all.

When one thinks of a shareholders agreement it is typically in the context of a corporation. Many of the same issues arise between partners when drafting a partnership agreement and members in a limited liability company operating agreement.

SHAREHOLDERS

All of the shareholders should be correctly named and their percentage ownership in the entity set forth. All shareholders that are entities should be in good standing, and individuals should have their complete address inserted.

CAPITAL CONTRIBUTIONS

The amount of capital or the value of assets contributed should be clearly stated. If all of the capital is not to be contributed at signing, a time-line should be established with penalties for failure to contribute on a timely basis. If it is anticipated that additional capital may be required to fund the venture’s operations, it is necessary for the mechanism surrounding capital calls and payments of additional capital to be set out in the agreement. If a shareholder fails to make an additional capital contribution when required, the agreement may provide for the deficit to be made up by the non-defaulting shareholder(s) by way of a capital contribution in excess of their pro rata obligation, with a corresponding adjusting in the equity of the entity, or by loans to the entity by the non-defaulting shareholder(s).

MANAGEMENT

In a closely held entity, the shareholders may control the day-to-day management themselves. In any management structure, a shareholder will ideally have some control over major decisions. A super majority vote may be desired for certain corporate actions. The list could include any of the following:

- Issuance of further share capital;
- Decision to require additional capital contributions;
- Entry into other areas of business;
- Amendments to shareholders agreement;
- Any action relating to the merger, sale or reorganization of the entity;
- Incurrence of debt above a certain level;
- Appointment or removal of auditors;
- Approval of annual budget; or
- Any decision to distribute cash or other assets of the entity.

TRANSFER

A shareholder may request preemptive rights in the event the entity desires to issue more stock. The agreement will typically give a right of first refusal to other shareholders in the event of a proposed sale and may include drag-along rights[15] at the request of a major shareholder or tag-along rights[16] at the request of minority holders. With first refusal rights, any stock proposed to be sold by a shareholder must first be offered to existing shareholders on a pro rata basis. While this right allows shareholders to maintain their existing ownership percentages, it does slow down the process of selling shares and is not favored by certain investors when considering an investment.

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[15] This is a right that enables a majority shareholder to force a minority shareholder to join the sale of a company, provided that the minority shareholder receives the same terms as any other shareholder.

[16] This is the opposite of drag along rights and allows the minority shareholder to "tag along" or join the transaction.

NON-COMPETE

It may be important to prevent any shareholder from competing with the business of the entity and agreeing that the entity is the only vehicle through which any shareholder will conduct such a business.

DISPUTE RESOLUTION

Arbitration is typically a less expensive way to settle disputes that court proceedings. Consideration may also be given to a mediation clause where an individual agreeable to the parties is selected to settle disputes.

Shotgun Buy/Sell provisions are useful in the event of continued disputes between the parties. One party can make an offer to buy the entity, and the party receiving the offer can then elect to be a buyer or a seller on the terms offered. This clause favors the party with the deepest pockets.

DEATH OR DISABILITY

When a shareholder dies all shares owned become part of the deceased's estate, and therefore, will pass on to the deceased's heirs. In a closely held organization, it is probably not a good idea to end up with a partner's relatives as your business partners. Every shareholder agreement should include a clause allowing the buyout of a partner's estate. It is not necessary to provide for the purchase of all of the interest held by the deceased, as most individuals will want their estate to participate in the growth of the business after they die. Consider a provision that provides for the purchase of most, but not all, of the interest, say 75%, with the remaining shares converting to non-voting shares. The same principal applies to disability of a shareholder, and care should be given to how disability is defined.

"...non-U.S. shareholders should determine how their interest in the U.S. entity is treated (or taxed) in their home jurisdiction..."

TAX

As noted in our last issue,[17] in general, corporations are subject to an entity level of tax. To the extent dividends are paid, that shareholder will be subject to tax on the dividends received. In the case of a non-U.S. person, the tax may be withheld at the source but reduced by an applicable treaty. However, a Corporation may elect "S Corporation" status and "pass through" corporate income and losses to its shareholders. However, shareholders must be U.S. citizens or U.S. residents, among other limitations. Additionally, non-U.S. shareholders should determine how their interest in the U.S. entity is treated (or taxed) in their home jurisdiction and whether another type of entity (e.g., LLC or partnership) or another type of capital structure (e.g., debt v. equity), is a more appropriate conduit or a more efficient (tax) structure for their investment. As there may be competing interests amongst

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[17] See Insights, Vol. 1, No. 2.

shareholders, drafting a proper agreement, and/or agreeing to basic terms and structures, is essential for efficient corporate and tax planning.

CONCLUSION

As noted in our prior issue, a well drafted agreement may significantly reduce the chances and expenses of litigation in the case of a disagreement. Thus, importance should be placed on identifying issues and drafting them away at the start at the deal, transaction, business venture, or partnership. We are here to assist.