Business Law & Business Litigation: Five Nightmares Prevented with a Shareholders' Agreement

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At inception, the owners of every business are faced with a daunting to-do list. Whether the founders of a new entity or the acquirors of a going concern, partners in a small business (be it a corporation, LLC or other entity, the principals of a small business tend to think of themselves as "partners") are occupied envisioning the how to make their enterprise a success. They are not focused on the road-map of disagreement, break-up, deadlock and withdrawal. This is the less than glamorous role of the business lawyer.

We often tell the principals of a business that we are paid pessimists, and we ask them to indulge us with a conversation about how they envision the continued success of their enterprise if they cease to get along or one of them wants out, voluntarily or through death or disability. This article seeks to succinctly set forth why partners should think about these issues and execute an agreement detailing what will happen if and/or when such events come to pass. We have couched the discussion through the medium of a shareholders' agreement, but the concepts are equally applicable to a limited liability company agreement or partnership agreement.

1. The Inadvertent Partner

In the event of the untimely death of a partner, the surviving partner is left owning a business with the decedent's heirs. Too often, this means seeking the input (or at least the consent) regarding key strategic, financial and operational decisions from the grieving heirs who have no expertise or experience running a business. From the perspective of the heirs, it also means being left with an illiquid, minority interest in the company, when what they may really need is cash. This issue can be easily addressed through cross-purchase rights granting each surviving partner a *pro rata* right and/or obligation to purchase the decedent's interest in the enterprise from the decedent's estate. The cross-purchase can be funded with company funded life insurance proceeds or with built-in deferred payment terms, making the buyout financially feasible for the survivors and infusing the decedent's heirs with an income stream going forward.

Key Man v. Cross-Purchase Insurance

When a company purchases insurance on the life of one or several of its principals, its purpose is ambiguous at best if there is no companion contract among the principals setting forth whether the insurance proceeds are intended to be used to buy out the decedent's interest or to fund the company's need to replace the decedent's services as a "key man." We recently represented a company after the untimely death of one of two principals, both of whom were very actively engaged in running the company. There was ample life insurance, the proceeds of which provided an influx of cash to the company. The company wanted to provide for the decedent's family by buying out his interest, but there was no executed shareholders' agreement addressing the issue of valuation, which lead to a protracted dispute. The central issue became whether the substantial life insurance proceeds should be included in a valuation of the company, or whether the proceeds were intended to be used as part of a cross-purchase. In the absence of an agreement establishing the value of the company, any independent valuation following the death of the principal had to include the insurance proceeds. If there had been an agreement establishing a value or method to value the shares and specifying that the proceeds were intended to fund that buy-out, relationships (and many dollars) would have been preserved.

Drag-Along Rights

As the name implies, a so-called "drag right" provides majority shareholders with a mechanism to force minority shareholders to sell their stock and otherwise consent to certain transactions, which the majority shareholders have decided to enter into. Transactions that trigger the drag right may include the sale of all or substantially all of the company's assets, the sale of the majority of the company's stock to an unaffiliated third party, or a statutory merger with and into a new company in which the current owners no longer hold a majority interest – what we typically think of as "Change of Control" events. For anyone who has tried to sell a company with a dissident shareholder, you likely already understand the countless ways, well beyond typical appraisal rights, in which that shareholder can interfere with a transaction. The client often ends up painstakingly negotiating two simultaneous transactions, the sale of the company and a buyout or settlement with the dissident shareholder, with the closing of the former being contingent upon the successful outcome of the latter. A well-crafted drag along right in the shareholders agreement providing that minority shareholders will take all required actions to close the transaction, including, where applicable, providing limited representations, warranties and indemnities in the transaction document, is a great way to save a lot of time, money and heartache.

Tag-Along Rights

The so-called "tag right" is the companion to the drag right – one goes, the other almost always follows. In the simplest terms, the tag right provides minority shareholders with a mechanism to assure that they will not be left behind when a liquidity event arises for the majority shareholders. For instance, with a typical provision in the shareholders agreement, faced with minority shareholders exercising tag rights, a purchaser of seventy-five (75%) of a company's commons stock will be faced with three options: (i) purchase 100 percent of the common stock, (ii) cancel the transaction, or (iii) purchase, on a *pro rata* basis, 75 percent of the common stock held by each shareholder of the company. The trigger for a tag is typically the sale of some percentage of the common stock in the company by the majority shareholders. Although the actual percentage can vary widely between shareholders' agreements, "control," defined as 51 percent of the common stock and/or the ability to elect the majority of the board, is common. A well-crafted tag provision suppresses the temptation of the majority shareholders to exit via a controlling interest stock deal at their first opportunity, leaving the minority shareholders behind, and ultimately avoids the resulting havoc such a transaction creates for the company.

Dispute Resolution

Many small businesses start with two people who each own one-half of the equity, and in most cases that equates to one-half of the voting rights or control. As a result, the partners must reach consensus on every important business decision. Framed another way, each partner possesses blocking or veto rights. Equally divided control works as long as the principals agree with one another, or one or the other is always willing to capitulate. As soon as the first truly controversial issue arises, however, growth and progress slow while the principals seethe over the deadlock. Rather than waste time and energy, a shareholders' agreement can at least lay out a pre-determined roadmap for how the partners want to address their differences. They can elect to name a trusted advisor to mediate the outcome, or ask that trusted advisor to appoint an impartial third party to serve in the role of "tie-breaker." They can alternatively elect an alternative dispute resolution method, such as commercial arbitration. While a dispute resolution provision will not prevent all discord, it will likely prevent the principals from becoming so mired in deadlock that there is no alternative but dissolution. At worst, it will fast track a buy out before the business has deteriorated in value and reputation due to the energy and time spent on the disagreement.

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