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Understanding the pitfalls of shareholders' agreements

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An ounce of prevention is worth a pound of cure, or so the old adage goes. Shareholders' agreements, when drafted effectively and regularly updated, can prevent expensive litigation and disappointing results, but when they are poorly prepared or allowed to sit on a shelf collecting dust, disaster can occur.

What is a shareholders' agreement?

The owners of closely held corporations, where the owners are also the founders and principal employees, frequently enter into shareholders' agreements, also known as buy/sell agreements, or include buy/sell terms in the operating agreements of their limited liability companies. Shareholders' agreements typically include provisions (i) restricting the owners' right to sell their stock to outsiders; and (ii) requiring shareholders to sell their stock back to the company upon the occurrence of certain triggering events.

Owners' goals when entering into such agreements are to avoid being saddled with new partners not of their choosing, which could happen in the absence of a shareholders' agreement if an owner decided to sell to a stranger or died and left shares to a spouse or child in a will. To prevent the introduction of strangers to companies, shareholders' agreements will either require shareholders to sell their shares back to the company when they die or decide to cash-out or give the company the first option to buy the shares. The purchase price is often set by a formula that is favorable to the company (assigning a low value to shares) and is accompanied by payment terms allowing the company to pay over several years, essentially requiring the departing shareholder to finance his or her own buyout.

Shareholders' agreements are usually prepared when a company is formed, when the founders are young and ambitious and have no plans to cash out and risk of death is low. At that point, the founders' goals are aligned, and locking up their shares and providing for unfavorable exit scenarios are to everyone's advantage. For economic reasons, founders often hire a single lawyer to represent them collectively with respect to preparation of what can become a very important document a few years down the road when the company grows in value.

A well-crafted and well-maintained shareholders' agreement can help avoid an unpleasant and expensive legal battle when the unexpected happens, including circumstances involving disagreement among founders, or when one of the founders wants to pursue a different opportunity, needs to move away or even dies. However, the effectiveness of shareholders' agreements in preventing litigation often diminishes over time as the agreements stop reflecting current circumstances. Likewise, poor draftsmanship or one-sided provisions can similarly hinder the effectiveness of a shareholders' agreement in avoiding future litigation.

The tale of the stale agreement

Just as it is prudent to update estate planning as life circumstances change, it is also wise to revisit the terms of a shareholders' agreement from time to time as a company grows and changes.

A case recently litigated in Rochester involved a nine-owner company founded in 1990. Over time, seven of the nine founders decided to leave the company and sold their shares to one of the two remaining shareholders, who ultimately acquired 8/9ths ownership of the company, rendering him the majority shareholder. Upon the death of the majority shareholder, the minority shareholder owner insisted on buying the shares of the majority shareholder using a formula created 26 years earlier, setting the company's value as book value (i.e. the difference between assets and liabilities, or equity). The company was a professional services company that leased its office space and office equipment, so its assets were minimal but the cash flow generated from those assets was enormous. When the court decided to enforce the shareholders' agreement, the survivors of the majority shareholder received a pittance, while the minority shareholder owner got a windfall.

There is no guaranty that the minority shareholder would have agreed to amend the shareholders' agreement with the majority shareholder, but because of the majority shareholder's effective control over the company, he could have exerted financial pressure on his partner to revisit their agreement. Unfortunately for the family of the majority shareholder, he lost track of the shareholders' agreement and apparently never sought to amend it.

The risk of joint representation

Lawyers are expensive, and when founding a company the last thing initial investors want to do is spend precious resources planning for the day they have a falling out with their new partners or decide to leave the company. While a single lawyer can often competently prepare a shareholders' agreements that meets the needs and goals of all of a company's owners, especially where the owners are in equal positions, that may not always be the case, particularly where partners come to the company with different expectations or bargaining power.

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Another case recently litigated in Rochester involved two owners of a closely held corporation who relied on a single attorney to help form their company and prepare a shareholders' agreement. In that case, one owner had more equity in the new company than the other. The parties discussed the inclusion of a provision in their shareholders' agreement that would have required a shareholder to sell his shares back if he was terminated by the company. Because of the disparate equity positions, only one of the two shareholders, the minority shareholder, could ever be terminated. The minority shareholder instructed the lawyer not to include his termination as an event that would trigger his buyout. While the ultimate agreement signed by the parties did not list termination as a triggering event, a draftsman's error resulted in the inclusion of the concept of termination in the language regarding the buy-out valuation formula. That language added ambiguity to the agreement resulting in litigation. Had the founders hired separate counsel, the error may have been caught and fixed before the minority shareholder signed the agreement.

It is rarely too soon or too late to plan for the future. Shareholders' agreements are a great planning tool, but they require careful preparation and review and should be updated from time to time as circumstances change.

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