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Benefits of Shareholders' Agreements

If you are in business with another person and you think that you do not need a Shareholders’ Agreement—or, if you are doing business as a limited liability company, an Operating Agreement dealing with the same issues—you should reconsider. A properly designed Shareholders’ Agreement will enhance the stability of a closely held business by (i) providing for continuity in the ownership and management of the company, (ii) establishing certain restrictions as to the disposition of a shareholder’s shares while he or she is living, (iii) establishing a procedure for the redemption of a shareholder’s shares upon an involuntary transfer of a shareholder’s shares, (iv) establishing a procedure for the redemption of a shareholder’s shares upon the termination of his or her employment by the company, (v) establishing a procedure for the redemption or purchase of a shareholder’s shares upon the permanent and total disability of that shareholder, and (vi) establishing a procedure for the redemption or purchase of a shareholder’s shares upon the death of that shareholder.

One of the most important aspects of a Shareholders’ Agreement is that it will typically determine the price to be paid for the shares while the shareholders have a good and working relationship with each other. There is no right or wrong way to determine the value of a business, but depending on the type of business, there may well be some industry standards that would be appropriate to use. Some of the various possibilities are:

- Book value;
- Gross profit;
- Net income before income taxes;
- Cash flow (generally a weighted cash flow);
- A combination of one or more of gross profit, net income before taxes and cash flow;

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Mareta Smith
816.559.2475
msmith@shb.com

- Value as agreed to by the shareholders at least once each year; or
- Appraised value.

Sometimes the shareholders will also want to provide for either a minority discount (recognizing that a minority shareholder has less control over the company than a majority shareholder) or a majority premium (recognizing that a majority shareholder has more control over the company than a minority shareholder).

Other situations that are often dealt with in a Shareholders' Agreement would include whether a majority shareholder can force a minority shareholder to participate in a sale to an outside third party or whether a minority shareholder can force the majority shareholder to include the minority shareholder in a sale to an outside third party. (The first situation is called drag along rights; the second situation is called tag along rights.)

If the company is an S-Corporation for income tax purposes, then it is also important to deal with the consequences of a share transfer mid-year. Generally, you would want to make sure that the company pays to the shareholder whose shares are being redeemed or purchased the amount of any income allocated to such shareholder for the period in question.

By having a well-drafted Shareholders' Agreement in place, the shareholders are much more likely to avoid costly conflict when the business relationship ends.