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WHY YOU NEED A SHAREHOLDERS' AGREEMENT / LLC OPERATING AGREEMENT

(THE BENEFITS OF WORKING OUT YOUR DEAL UP FRONT)

By Steven M. Shishko

The formation of a business, like a marriage, is usually intended at the outset to be a long-term relationship. But at the beginning of a new relationship it is often difficult to foresee a scenario in which the partners would fall out, or find difficulty in making decisions. It may also be difficult to envision the possibility that someone may need to exit the partnership, even amicably, before originally intended. Like a marriage, the partners in a new business are often certain that they have the kind of relationship that can weather everything, feel strongly about their ability to "cross that bridge" when they come to it and don't want to dampen the excitement of the new relationship with a pessimistic outlook.

However, despite the partners' best intentions, views among them may diverge, circumstances can change and resentment can lead to captious disagreements. Reaching agreement on many of the decisions facing a business relationship is not easily accomplished after the relationship has turned sour and after the partners have committed time, effort and, especially, finances for the long term. It is much easier to address the difficult issues at the start of the relationship when the partners have optimism and harmony working in their favor.

If the company does not have a written shareholders' agreement, the owners' rights and responsibilities are governed by the applicable the state statute. These statutes set up the basic outline for company governance, portions of which owners are free to modify with written agreements.

Even though the law does not require shareholder agreements, every privately held corporation with more than one shareholder and every privately held limited liability company ("LLC") with more than one member is well advised to have a formal "partnership" agreement, preferably implemented at the onset of the business before the critical issues arise. (The issues addressed in this Article relate equally to shareholders of corporations and members of LLCs; for simplicity, I have used the term "shareholders' agreement" to also mean LLC operating agreement, and the term "shareholders" to also refer to the members of an LLC.)

Shareholder agreements force the shareholders to discuss the issues which could arise prior to facing those issues and help to reduce the damage that could be caused by such issues. Once the agreement is in place, the ground rules for the relationship among the shareholders, including the rights and obligations of the shareholders, are established and the shareholders can run the business knowing that if an issue arises, the resolution of the issue, or at least the procedure for resolving the issue, has already been determined. Consequently, the potential for shareholder conflict is reduced and the company has a greater opportunity for success.

The terms of shareholder agreements will vary depending on the particular needs of the shareholders and of the company. In general though, shareholder agreements will typically address the following:

- Restriction on Transfers (*control who owns your company*). General corporate and LLC law allows for owners to freely transfer their equity. However, shareholders in a privately held company are not random and unknown to each other; the shareholders have typically elected to go into business with the other shareholders for a reason. As a result, most shareholder agreements impose restrictions on the transfer of shares primarily because the shareholders want (and need) to control those with whom they are in business. A shareholders' agreement can provide a mechanism whereby a shareholder who wishes to sell their shares pursuant to a bona fide third party offer gives the other shareholders and/or the company a "right of first refusal" to purchase those shares. This enables the non-selling shareholders to preempt a sale to someone they do not wish to have as a business partner, while still providing a selling shareholder with an exit strategy.

- Regulation of Management (*control over decision making*). Ordinarily, the high-level decisions of a corporation are made by the board of directors and the execution of those decisions is carried out by the corporate officers. Though an LLC can create a board of directors and elect officers, the management is often through one or more managers. However, there may be certain decisions that should not be left to the discretion of the directors or managers but instead made subject to shareholder/member approval. A shareholders' agreement can provide that key issues, that would otherwise be determined by the directors or the managers, instead be decided by the shareholders, such as, a sale of the company, borrowing money, buying real property, or instituting or settling litigation. The power of directors or managers is thus restricted by the decisions of the owners. A shareholder's agreement is therefore important to fully determine the basis for important decision making, to restrict the power of the directors or managers where necessary and to provide protection for the parties involved in the ownership of the company against the actions of the others.

- Minority Shareholder Protection (*avoid unfair dominance*). In many closely held companies, ownership of the shares is not equal. This means that not all shareholders have the same voting control. For many decisions, this is how it should be; one share one vote, and those with more shares have greater voting control. However, there are company decisions that can be unfairly adverse to minority shareholders and, without a shareholders' agreement to establish the requirement for unanimous approval of certain issues, the majority shareholders have the ability to force issues that may be in opposition to minority shareholders. For example, the majority shareholders may refuse to declare dividends or distributions when the company is profitable or they may divert earnings to the majority owners through excessive compensation. A shareholders' agreement can prohibit the majority from taking any such actions.

  A shareholders' agreement may also contain a so-called "tag along" provision, which enables a minority shareholder to be able to sell his or her shares along with a majority shareholder in a sale where the majority attempt to sell only their shares rather than seeking to find a buyer for all of the company's outstanding shares.

- Majority Shareholder Protection (*avoid unfair obstruction*). A shareholder agreement can also provide protection to majority owners. For example, as a corollary to the "tag along" provision, the agreement can provide a so called "drag along" provision which enables the majority shareholders to force the minority shareholders to also sell their shares if the majority shareholders find a buyer who wants to acquire the company by purchasing *all* of the outstanding shares. If it's in the best interests of the company to sell the business, one minority dissenting voice should not necessarily be able to stop the deal.

- Employment Termination and other Significant Events (*establish what happens when an active owner disengages*). Often shares in a company are held by directors, employees and others who are active in the business. If they were to leave the business, whether due to resignation or termination of employment (under favorable or unfavorable circumstances), or death, disability or retirement, such exiting shareholders would remain entitled to participate in voting, receive dividends and share in any increase in the value of the business generated by the remaining shareholders. In some cases, that may be justified. However, in many cases, the remaining shareholders would want to have the ability to repurchase the shares from an exiting shareholder. A shareholders' agreement establishes the method by which the remaining shareholders and/or the company may repurchase the shares and the method by which such shares are valued, which could go further and include different valuation mechanisms depending on the circumstances under which the exiting shareholder left the company.

- Restrictive Covenants (*protect the company's assets*). During the time that a party owns stock, and also for some period of time after stockholder status concludes, the remaining shareholders may want to prevent the exiting shareholder from competing with the business, disclosing confidential information, and soliciting the company's clients and personnel. Even if such shareholder has an existing agreement with non-competition covenants (such as an employment agreement), a shareholders' agreement can provide for greater restrictions and help protect the interests of the company.

- Dispute Resolution (*addressing conflicts*). As in any partnership, disputes can occur. A shareholders' agreement can provide the shareholders with a pre-determined mechanism for resolving the disputes, such as an escalating process starting with an informal meeting between the disputing parties, then, if the dispute is still unresolved, formal mediation and then, ultimately, arbitration for final resolution. Without such resolution procedures, the parties are often compelled to litigate, which is costly and time consuming, takes the focus away from the business and typically ends in an irreconcilable and public split.

- LLC Distributions (*payments to owners*). In a corporation, all shareholders of the same class of shares must receive dividends equally (based on their respective ownership percentage). However, members of an LLC may be treated differently (even within the same class of membership interests) and there are often many reasons to do so. For example, only one member may have provided investment funds and the members agree that such member should recoup his or her investment from the company before other members are entitled to any distributions. An LLC operating agreement can provide for priority distributions among members.

Without a comprehensive shareholders' agreement, a business is vulnerable to many conflicts which could jeopardize the company's operations, profitability or even existence. The short-term sacrifice of addressing the issues at the start of a business relationship before they arise can ultimately provide the company with the long-term benefits of providing a sense of fairness among owners, avoiding costly distractions and enabling the company to focus on building a successful business.

If you would like additional information, please contact Atty. Steven M. Shishko (by email at *SShishko@BeaconLawGroup.com* or by phone at 617-235-8600).