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FINANCIAL PLANNING

Stockholders and Operating Agreements

A successful business should develop and maintain a succession plan

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A critical facet of any successful business is to make sure that it has agreements to protect the business if certain contingencies occur. New business owners focus on developing a business, finding a niche and making the business a success. Established business owners are busy expanding the business or maintaining its success and avoiding any problems. In the busy life of a business owner it is tough to take the time to develop and maintain a business succession plan. It is important for attorneys to address these issues with their clients. In fact, it is equally important for all law firms to focus on the issues themselves. Various topics to be covered by a stockholders or operating agreement include, the death of an owner, disability, termination of employment, lifetime sales and restrictive covenants.

For conciseness purposes, assume that we have an entity (either a corporation or a limited liability company), which has two equal owners. Further assume that the entity is an S corporation. Most of the points raised in this article are equally applicable to other business structures and multiple owners.

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Death

Death is probably one of the easiest topics. If there is a death of a stockholder, there should be a buy-out so that the surviving stockholder is not in business with the beneficiaries of the deceased stockholder's estate. The buy-out can take one of two forms: the corporation can purchase the stock or the surviving stockholder can buy the stock. Both methods have the effect of making the surviving stockholder the sole owner of the corporation. However, if the surviving stockholder is the acquirer, then his tax basis in the acquired stock will be increased by the amount of the purchase price, which is not the case if the corporation is the acquirer. Therefore, on a subsequent sale of the business, the surviving stockholder will have less capital gain (or increased capital loss). The purchase price will be based on a company's value, as discussed later in this article.

The buy-out is typically funded through life insurance. If there is sufficient life insurance, there will be no financial drain on the business. In the absence of life insurance (or if there is insufficient insurance coverage), the purchase price could be paid pursuant to a promissory note with interest at the lowest rate permitted by the IRS without imputation of interest. The problem with inadequate insurance coverage is that it could place the business in a cash flow crunch. It is beneficial for a trustee to own (and be the beneficiary of) any insurance used to fund a buy-out for several reasons. First, this protects the policy from the claims of a stockholder's creditors. In addition, the trustee will ensure that the proceeds will be used as intended — to fund the buy-out. Typically the trustee would be a professional (e.g., attorney, accountant) who represents the corporation.

Disability

As for a disability, there are a number of subtopics, which need to be covered:

How is a disability determined? It can be determined by the insurance company if there is a disability insurance policy. In the absence of such a policy, the subject stockholder can be examined by a physician selected by the corporation. If the subject stockholder disagrees with this determination, then he can be examined by a physician of his choice. If the two physicians disagree, then they can select a third physician whose determination would be binding.

There also needs to be a decision as

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to the time period during which compensation is paid to the disabled stockholder. A typical provision would be to provide for salary continuation for the first 12 months with offsets for any state benefits or disability insurance proceeds. The amount of such compensation could be based on the salary and bonus received by the disabled stockholder in the preceding year or could be tied to the compensation received by the remaining stockholder.

Upon the expiration of a period of time, it is generally recommended that there be a buy-out of the disabled stockholder's stock. There is disability buy-out insurance, which can be acquired to cover this contingency. In the absence of such insurance or if there is a shortfall in the coverage, then the purchase price would typically be paid over a longer period of time than the death time scenario so the company does not get suffocated with payments and the disabled stockholder can receive a stream of income.

As for management under a disability context, if one is physically disabled, then he can participate in management until there is a buy-out. If there is a mental disability, then he would normally not participate in day-to-day decisions. However, as for extraordinary decisions, he should be able to participate and that could be accomplished by having each stockholder unilaterally select an individual (and successors to that individual) to represent him as to such decisions.

Lifetime Transfers

As for lifetime sales, it would be highly unusual to permit a stockholder to sell his stock to an outside party. For a corporation, there cannot be a blanket provision against such a transfer since stock in a corporation is by law freely transferable. If there were such a prohibition, then that provision would be void against public policy and the stock would in effect be freely transferable. In a limited liability company, such a prohibition would be permissible.

Therefore, in a corporate context, it is recommended that if a stockholder wants to sell his stock, then he must receive a bona fide offer and that offer must be given to the corporation first and the remaining stockholder second. These parties would have the option to match the offer by paying the same price subject to the terms and conditions of the offer. In many circumstances, the corporation and the remaining stockholder may have the option of matching the offer price or using the agreed upon value so that they would have the better of the two prices. There may also be an option to pay the purchase price pursuant to the terms of the bona fide offer or perhaps utilizing a seven-year note with interest at the lowest rate of interest permitted by the IRS. Thus, the remaining stockholder gets the choice of the better of the terms as well.

If a stockholder loses ownership of his stock incident to a divorce or bankruptcy, sells the stock in violation of the agreement, transfers stock to someone not permitted to hold stock in an S corporation or stops work for a significant period of time (such as six consecutive weeks other than for a disability or attaining a normal retirement age), then there should be options in the corporation first and the remaining stockholder second to buy the stock. In these situations, the purchase price may be a percentage, such as 50-75 percent of the agreed upon value or what is actually paid for the stock (if there is a sale), whichever is lower. This reduction in price serves as a penalty. The terms could be a seven-year note or the terms of the purchase, if applicable, whichever the optionholder decides.

Other Issues to Consider

All stock certificates should be stamped with a legend indicating that the stock is subject to the terms of a stockholders agreement so that the outside world is on notice that there are restrictions imposed on the stock by the agreement.

Finally, there should be a provision in the agreement, which states that neither stockholder will compete with the business both while they are stockholders, and for a period of years thereafter, such as two to three years. The agreement should contain a geographic region for the noncompete. It should further state that they will not hire employees, deal with the company's customers, and will maintain the confidentiality of the business.

Another issue to consider is the impact of any personal guarantees by stockholders on corporate debt when an owner sells his stock. A possible solution is to have the corporation and/or the remaining stockholder indemnify the selling stockholder for liability on such obligation.

Valuation

A crucial aspect to any stockholders agreement is the provision regarding the valuation of the corporation for purposes of a buy-out. There are many different ways to value a company which can be incorporated in an agreement. Examples include book value, adjusted book value (for example, adding back the full value of any real estate), or a weighted formula taking into consideration the corporation's earnings. Another common approach to valuation is to have the stockholders agree annually on a corporate value for purposes of the stockholders agreement. If the stockholders fail to agree on a new valuation for a two-year period, the value could be determined based on a formula such as those described above or could be the most recent agreed upon value plus (or minus) any increase (or decrease) in the corporation's net worth since the date of the most recent agreed upon value.

Escrow Arrangement

Until full payment of the purchase price upon a sale of stock under the terms of a stockholder's agreement, the stock sold could be held by an escrow agent. This would ensure that there is an easy way to enforce the note if there is a default in making the payment obligations.

Once a stockholders agreement has been completed and signed, it is important that this document is revisited every few years to ensure that the decisions made with respect to the agreement are still appropriate. ■