

Drafting Shareholder Agreements

By Robert T. Smith

Agreements among owners of a business or professional practice come in many formats, whether styled as traditional corporate shareholder agreements, LLC operating agreements or partnership agreements. Unfortunately, these instruments are often the result of a poorly conceived “form” document, with too little attention paid to the specific considerations of each case. Significant differences exist, for example, between professional and non-professional companies, which affect everything from valuations to general governance issues. This article highlights several common drafting faults, along with important issues that should be considered in connection with preparing these types of agreements.

Poorly Conceived Valuation and Payout Provisions

Valuation provisions vary significantly ranging from fair market value determinations based on an appraisal to simple “net book value” computations focusing on hard assets and receivables, without giving impact to any intangible or goodwill value. Unfortunately, it is often the case that a shareholder agreement includes a valuation that is impractical for a particular firm. This is a common problem in dealing with professional service firms in which a sizeable portion of the firm’s intangible value may be lost upon the exit of a particular professional. It is important to review the appropriate valuation terms with the client and its financial advisors.

To compound the problem, unrealistic valuations may lead to strains on the corporation and its ability to continue as a going concern while servicing a mountain of buyout debt. Most shareholder agreements do not contemplate the impact of payouts to multiple shareholders who may exit in close proximity to one another. Because it is rare that the agreement requires individual shareholders to personally guarantee buyout obligations, the remaining shareholders may have less incentive to remain with the company. This can create a “race to the door” to determine who gets paid.

Valuation and payout procedures should be closely reviewed to ensure that they are appropriate for the particular company and

persons involved. This is a significant issue when representing a new professional entering an existing firm. If the agreement does not contain protective language, an analysis of the respective ages of the existing partners may indicate that the new shareholder could be left holding the bag when the line of retirement begins.

Enforcement Issues

Like any commercial contract, a shareholders agreement has value to the parties only if it is enforceable. Post-buyout noncompetition provisions are particularly important in this regard when dealing with professionals. The noncompete will be analyzed in the context of the general principles applicable to such agreements, requiring reasonableness in the term and scope of the restriction and that the company has a valid interest to protect. While enforcement of the noncompetition provision may more likely be enforceable when tied to the stock buyout, the terms employed must be considered against the general hesitancy of courts to enforce noncompetition covenants against many professionals. An approach that some state courts have approved involves using a liquidated damages provision as an alternative to a noncompetition covenant. The Arkansas Supreme Court, however, has indicated that the same public policy considerations applicable to noncompetition covenants would apply. *See Junkin v. Northeast Arkansas Internal Medicine Clinic, P.A.*, 344 Ark. 544 (2001).

Also remember to have each non-shareholder spouse provide written consent to the terms of the shareholder agreement. In *Cole v. Cole*, 82 Ark. App. 47 (2003), the Arkansas Court of Appeals determined that the non-shareholder spouse was not bound by a valuation provision where she had never consented to the terms of that agreement.

Dealing with Exit Strategies

While we generally may hope that clients will remain in business with one another for the long-term, the reality is that these relationships often must be unwound at some point, and shareholder agreements must be drafted with that fact in mind. Dissolving these relationships requires determining

the best manner in which to structure a buyout or otherwise separate the respective practices or businesses of the parties.

A common provision found in many agreements is a “take or pay” option. These provisions allow either party to offer a price at which it will either purchase the other party’s interest in the company or sell its interest to the other shareholder. This seems like a simple procedure to handle a separation, yet it is not necessarily ideal. For example, these provisions rarely contemplate situations in which the parties have personally guaranteed debt of the entity and whether a lender would also be willing to release the exiting shareholder as a guarantor. Nevertheless, it certainly provides a method to force action by the other party.

It is also important to consider cross-buyout triggers between related agreements. For example, it is common in many professional practices to have an operating entity (often a professional corporation) alongside an LLC or partnership holding real estate that is leased back to the operating company. These triggers are particularly important where a shareholder’s employment is involuntarily terminated, triggering a buyout on the operations side. Ideally, the real estate company’s agreement should contain provisions triggering a buy-out right with respect to that individual. This effectively assists the parties in severing all ties where the relationship has disintegrated.

Summary

These and many other factors should be considered in preparing an initial draft of a shareholder-type agreement, but the best advice is to first sit down with your clients to better understand their personalities, business and expectations. ■

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