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SHAREHOLDERS’ AGREEMENT IN A FAMILY OPERATED BUSINESS

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Like families, no two family operated businesses are alike. However, many families strive to achieve harmony and prosperity for current and future generations. Family shareholders’ agreements are an excellent opportunity to safeguard against risk, conflict, and the associated costs.

While some clients generally contemplate and implement shareholders’ agreements at the start of their family business, you should consider reviewing your agreement on a periodic basis to determine whether your shareholders’ agreement effectively addresses the evolving dynamics and concerns of your individual family circumstances.

For example, you should consider:

Death and Disability

When a key individual of the company suddenly dies or becomes disabled and is no longer able to perform their duties, insurance can provide a useful solution.

In the case of death, life insurance proceeds provide liquidity to the company for repayment of shareholder’s loans to the deceased, payment of taxes, or to enable a buy out of the beneficiaries of the deceased’s estate.

However, the value of the life insurance proceeds from the initial policy may no longer accurately reflect the cash flow needed in the event of a death (e.g., for payment of taxes). As a result, it is important to consider what other options may exist if additional life insurance is not available or is cost-ineffective.

In the case of incapacity, long time disability insurance is also useful in providing liquidity, for the disabled individual, their family and the company.

However, you should further consider whether or not an Enduring Power of Attorney specifically for your corporate affairs is appropriate (for example, appointing your business partner), which would be separate from your general Enduring Power of Attorney for the rest of you financial affairs (for example, appointing

your spouse).

Careful disability planning can minimize disruption to business operations, avoid deadlocks in decision-making, and set out adequate compensation for those assuming the incapacitated individual’s role.

Direction

In the context of a lone family operated business, some clients may have a child who will continue to operate the business, while the other children do not to participate. Planning may be easier if the direction for each child is clear, but directions may change.

Where two or more unrelated business partners operate a single business, the family of a retiring, incapable, or deceased shareholder may not want to continue participating in the company, or the families of the immediate shareholders may want the business to continue, but do not want to work with each other.

While shareholders’ agreement may include buyout (“shotgun”) clause or other exit provisions, you should still consider whether the timing of the exit provisions are appropriate in your present circumstances. There should be a definitive, realistic timeline so the parties can plan their affairs accordingly.

Exasperation and frustration often mount simply because parties have differing expectations on the speed at which the other party operates or matters are addressed.

Expectations and Side Letters

You should also consider the nature of your business and its assets (and liabilities), and the expectations of your heirs and successors. While many clients strive to act fairly towards their family, it is more difficult to reach equality if assets are not easy to divide.

A shareholders’ agreement may be able to ensure relatively equal value between shareholders at the time of separation. However, such value may not necessarily reflect equal opportunity in growth.

If the separation requires a significant amount of time to complete, and the growth of each asset is different, then the value of the assets each party receives may fail to line up at the end of the day. This may result in conflict among the family members regarding the equality and fairness.

In order to avoid this issue, you may also consider the use of side letters in conjunction with a shareholders’ agreement to address these concerns.

For example, it may be helpful to explain to your children your view of fairness. You may be compelled to

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assist a child who is less capable or has been less fortunate by providing that child with more. A careful explanation may curb the assumptions and expectations of another child who believes all siblings should be treated equally, and give pause to that child before they proceed with any legal action.

Culture and Values

Your company may have a personality, culture, or core values that you wish to preserve.

While companies can evolve and take on new businesses, you should consider whether there are any types of business that your family should be restricted from entering into, no matter how profitable.

It is possible to impose restrictions in a shareholders' agreement, but a side letter may also prove to be useful.

Conclusion

It is important to review your existing shareholders' agreement to ensure it continues to be effective as part of your overall business and estate planning.

The value of an existing shareholders' agreement may decrease if the agreement is not updated to meet the individual circumstances of your family business.

If you do not have a shareholders' agreement for your company, these are also important factors to consider in whether or not to have one in place.

A well-crafted shareholders' agreement will minimize the risk of litigation, and the associated cost, time, and stress.

To learn more about this topic, contact Max Shilleto, Arielle Lavender, Rutsu Shikano or any other member of the Estate & Wealth Advisory and Business Services Groups.