

Shareholder and Operating Agreements in Estate Planning

Presented by:

WEALTH MANAGEMENT ROUNDTABLE

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What it is?

- In this presentation we are treating shareholder agreements and limited liability company operating agreements as one and the same and we call them collectively “shareholder agreements.” The business owners will be referred to as “shareholders.”
- In its simplest form, a shareholder agreement is a document that determines the rights and obligations of the shareholders, the shareholders’ families and a business in the event of the sale of the business, the sale of a shareholder’s interest or upon the death or disability of a shareholder.

What is at stake?

- For most business owners their closely held business represents their largest asset and generally represents a lifetime of work. With proper planning it can be preserved. With improper or no planning disaster usually ensues.

Why is it so difficult to obtain a good shareholder agreement?

- Unfortunately shareholder agreements are governed by three complex areas of the law that overlap one another in a myriad of ways. The practitioner must be at ease in dealing with corporate law, the laws of inheritance and estate administration and tax law. The tax laws in this area are particularly complex. As situations vary so greatly there is no “standard” shareholder agreement form.

What will be covered?

- Although there are many facets that are typically covered in a shareholder agreement, as was pointed out earlier in this presentation, we are only going to deal today with the issues that arise on the death of a shareholder.

A Practical Study Example.

- Please review the example provided in the handout accompanying this presentation.

Key factors that a shareholder agreement should address.

1. Whether the widow and the children are to remain as shareholders or whether the shares owned by the estate are to be purchased.
- 1(A) If the widow and the children are to remain shareholders how can the remaining shareholder keep clear of unreasonable interference from the deceased shareholder's family? Also how can the deceased's family be paid on an ongoing basis assuming that no one wants to pay dividends?

Key factors that a shareholder agreement should address.

2. If the decedent's shares are to be purchased, what should be the purchase price? It will either be a fixed price, or formula-based, and will probably be fair as neither (we pray) knows whether they will be either a buyer or seller. This internal conflict and negotiation almost always sets a fair price that will be acceptable by the IRS, because it's "arms length".

Key factors that a shareholder agreement should address.

3. How will the purchase price be paid? Liquidity? Will the buyer be allowed to use notes, will the notes be secured, if secured, by what? Will the purchase be financed with life insurance? Who will own the life insurance? Other supplementary arrangements?
4. What about existing lenders? It's best not to wait until a shareholder has died before approaching your lenders and requesting their approval for the buyout of the deceased shareholder's interest. Remember almost all bank loans require bank approval before fundamental transactions may be undertaken.

Key factors that a shareholder agreement should address.

5. It must be remembered that if the corporation is the owner of the life insurance policy its proceeds will not only increase the value of the company for federal estate tax purposes but also, your lender may not allow the purchase to take place if the use of the cash would place their loan at risk. Tell me again why a corporation should ever own or be the beneficiary of a life insurance policy?!!!

Well Drafted Agreements Contain:

- Reasonable Restrictions on lifetime transfers – First Refusal
- Mechanics on post-death purchases – by whom and under what conditions
- Value – Method/Formula
- Manner and Timing of Payments
- Insurance – Proper Handling
- Triggering Events
- Provisions on Management and Control

Conclusion:

Properly conceived and executed a shareholder agreement should promote certainty, eliminate panic, insure continuity and reconcile all of the competing interests with relative fairness. Remember that a plan set in calm waters that has been thoroughly reviewed by the business owners and competent counsel will go a long way when one of the owners dies.