



Center for Private Company Excellence Webinar
**Shareholders' Agreements:
The Good, the Bad and the Ugly**

Thomas Yankanich, CPA
Director, Audit and Accounting
Kreischer Miller

Brian Kitchen, CPA
Director, Tax Strategies
Kreischer Miller

Peter Smith, Esquire
Partner
Antheil Maslow MacMinn

AMM Antheil
Maslow &
MacMinn, LLP

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Agenda / Learning Objectives

1. Introduction
2. Shareholders' Agreement Risks
3. The Purpose of the Shareholders' Agreement
4. Owning Your Shareholders' Agreement
5. 5 Critical Design Elements of a Shareholders' Agreement
6. Tax Considerations
7. Circumstances Dictates Structure of Shareholders' Agreement



Polling Question

Why These Agreements are Critically Important

Important Questions:

1. What is your estimate of the % of the owner's personal net worth that is represented by private company stock?
2. Is the continued operating health of the company important to the shareholders, their families, employees, and other stakeholders?

The Shareholders Agreement is the only thing that determines the market for the company's shares among the shareholders and the company.

If Your Shares and the Company Are Important...

... You should be clear on the following things:

1. What the shares are worth – how are they valued?
2. What events trigger a transfer of the company's shares?
3. What are the terms and conditions of potential transactions that are triggered?
4. How are transactions in the company's stock structured?
5. How are transactions in the company's stock funded?

**How do these things affect the company,
shareholders, employees and family?**

Shareholders' Agreement Risks

Business

Family

Shareholders



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Risks to the Business

- ❑ Liquidity
- ❑ Cash Flow
- ❑ Banking/Financing
- ❑ Capital Allocation
- ❑ Succession/Continuity



Risks to the Shareholders

- ❑ Personal Financial Planning
- ❑ Credit Risk
- ❑ Retirement
- ❑ Taxes



Family/Relationship Risks

- Liquidity
- Disharmony
- Disputes/Litigation
- Taxes
- Estate Plan



Outdated Agreement - RISK

- ❑ Shareholder/Family Goals – Different?
 - Legacy Agreement vs. Buy/Sell Agreement
- ❑ Shareholder is Older – Different Expectations?
 - Expected price/terms
 - Length of buyout/fit with retirement plan
 - In sync with estate plan/gifting of shares
- ❑ Industry Economics Different
- ❑ Company Size, Cash Flows, Financial Condition – Different
 - Stress on business
- ❑ Shareholder Group Makeup - Different
 - Siblings vs. cousins - relationships may not be the same
 - Changes in philosophy of ownership
 - Working/non-working owners
 - Minority shareholder issues
 - Drag along rights
 - Tag along rights

Purpose of a Buy-Sell Agreement

1. Reflect the Intent and Bargain of the Shareholders relative to transactions in the company's shares.
 - Defines terms of trade and market in the company's stock for various triggering events.
 - Private company stock is normally the largest asset of an owner and deserves their attention in understanding how their shares are valued and transacted.
 - Active participation and understanding of the buy-sell agreement by the shareholders is critical.

Purpose of a Buy-Sell Agreement (cont'd)

2. Protect the Company

- Reasonable and sensible valuation based on the company's cash flows and financial condition
- Consideration given to the fact that the company is private and does not have access to capital
- Terms and conditions that protect the company based on its financial capacity and cash flow
- Insure liquidity events where possible to protect the company
- Restrictions on transfer to third parties
- Protect against estate tax "calamity"

Purpose of a Buy-Sell Agreement (cont'd)

3. Protect the Shareholders and their Families

- Clarity regarding economic consequences of shareholder exit allows shareholders to understand risks and plan their financial affairs
- Provide liquidity to protect shareholders' families in the event of death through proper amounts of life insurance
- Coordinated with estate planning
- Coordinated with retirement and financial planning

Purpose of a Buy-Sell Agreement (cont'd)

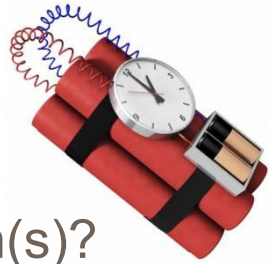
4. Provide Clarity in Shareholder Transactions to Avoid Disputes Between Shareholders and Family Members
- Active involvement in designing the agreement and regular review of the agreement provides understanding
 - Annual measurement of share value
 - Participation in the process should minimize disputes and litigation
 - The goal is to avoid surprises that could stress relationships and cause disharmony

Polling Question

Determining Value After the Fact – RISK

If the underlying value of the shares is not known:

1. How can shareholders plan their personal financial affairs?
2. How do you know if the company can afford the transaction(s)?
3. How can the company make rational decisions regarding the allocation of its capital for other things (expansion/borrowing/ etc.) if it does not know the affect of potential capital transactions?
4. How can you tell if the terms and conditions will not cause a problem with the company's financial condition and cash flow?
5. How do you know how much life insurance to carry to fund the transaction if there is a sudden loss of a shareholder?



Owning Your Agreement

Since your private company stock is probably the largest element of your net worth, you should clearly understand:

1. How the stock is valued
2. How the stock is transacted
3. The effect of a transaction on you, the company and your family

Taking Ownership of Your Agreement

	COMMON PROBLEMS/ISSUES	PROPER APPROACH
1.	Stale Agreement – not relevant to current business realities and shareholder expectations	Agreement kept current and reflects current business realities and is coordinated with shareholder retirement/estate plans
2.	Boilerplate Agreement – structure, terms and conditions boilerplate	Structure, terms and conditions reflect the uniqueness of the company and shareholders
3.	Legalese drives the agreement	Agreement is driven by shareholders’ “deal” between themselves and the company
4.	Viewed as corporate legal document – kept in the drawer	Agreement understood and reviewed annually by shareholders – working document
5.	Key elements dictated by third party experts	Key elements determined and understood by shareholders
6.	Share value not determinable	Valuation clear – share value measured annually

Big 5 Critical Design Elements

1. Share Price
 - Valuation Formula/Annual Calculation of Value
2. Triggering Events
 - What events trigger a transaction?
3. Terms and Conditions
 - Can vary with each triggering event
4. Transaction Structure
 - Redemption or Cross-Purchase
5. Funding Mechanisms
 - Life Insurance/Seller Note/Bank Debt, etc.

Tax Considerations

Tax Considerations

- Buy-sell agreements affect all entity types – C/S corporations, LLCs, partnerships, joint ventures
- Cross-purchase vs. Redemption each of their own tax considerations
- Insurance is typically an important piece of the planning
- Tracking tax basis of the shares is key in either scenario
- Estate tax implications need to be evaluated

Tax Considerations

Cross-Purchase Agreement



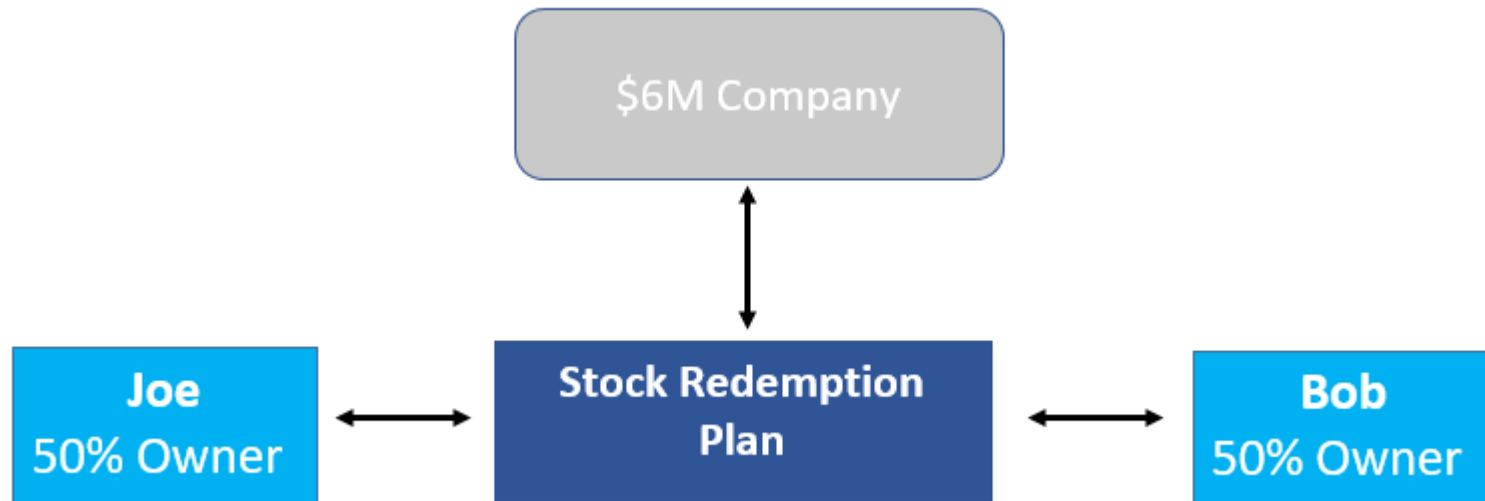
Tax Considerations

Cross-Purchase Agreement

- Bob wants out of the company. Joe will have to purchase Bob's Shares.
- Joe funds \$3M buyout of Bob's shares.
- Bob pays income taxes on \$3M less his tax basis.
- Joe now has \$3M more tax basis in the company as a result of the purchase.
- If Company sells for \$6M the next year, assuming the only basis Joe has is the \$3M he just paid, there would be a taxable gain of \$3M to Joe on the sale of his stock.

Tax Considerations

Redemption Agreement



Tax Considerations

Redemption Agreement

- Bob wants out of the company. The Company will have to purchase Bob's Shares.
- Company funds \$3M buyout of Bob's shares.
- Bob pays income taxes on \$3M less his tax basis.
- Joe's basis has not increased as the Company has purchased Bob's shares, not Joe.
- If Company sells for \$6M the next year, assuming Joe has zero basis in the stock, there would be a taxable gain of \$6M to Joe on the sale of his stock.

Tax Considerations

Life insurance in conjunction with the plan

- Premiums are not tax deductible
- Life insurance proceeds are not includible in taxable income

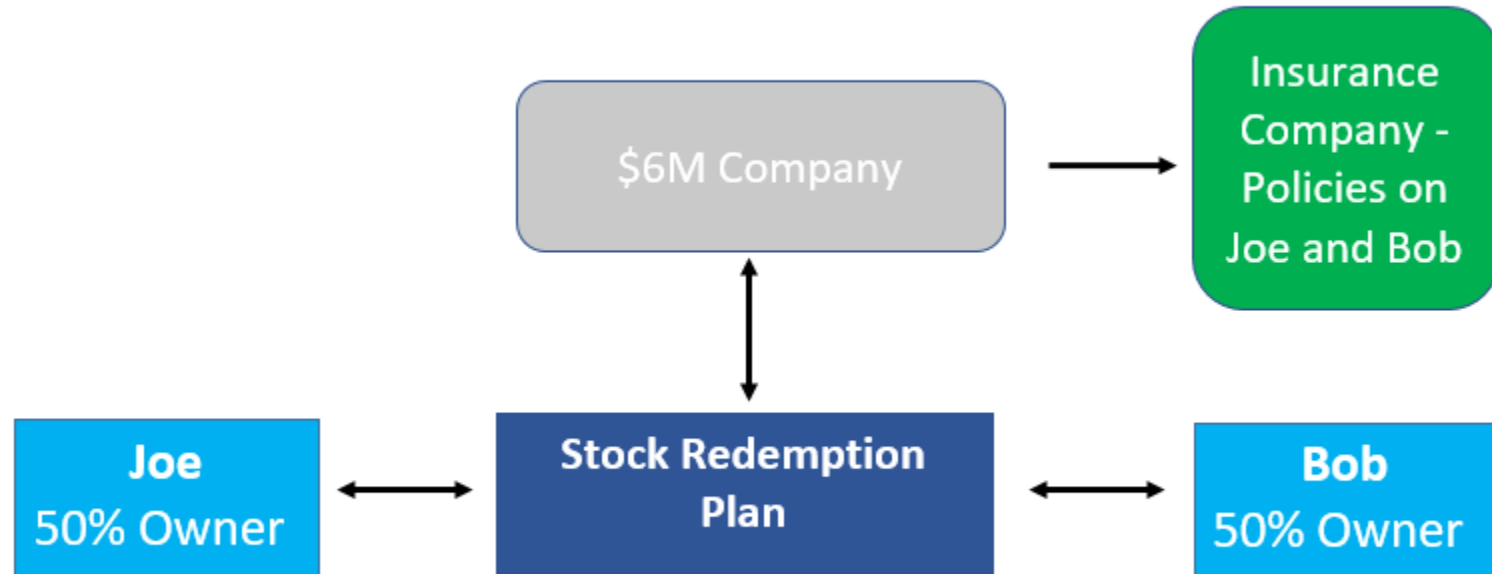
Tax Considerations

Cross-Purchase with Life Insurance



Tax Considerations

Redemption Agreement with Life Insurance



Tax Considerations

Tax Basis

- An owner's tax basis can play a significant role in the tax implications
- Proceeds from exchange of stock less tax basis = taxable gain
- Tax basis can have annual fluctuations and needs to be maintained
- May not be largely relevant in the event of death

Tax Considerations

Estate Tax Implications

- It is common for a buy-sell agreement to use a formula for the valuation
- This value is not binding for estate tax purposes
- FMV may be higher (or lower)
- Buy-sell agreements should be mindful of this and look to require a formal valuation of a company if the agreement is triggered due to death

Polling Question

Overview – Circumstances Dictate Structure of Shareholders' Agreements

- Importance of Corporate Form (S. Corps.)
- 50/50 Deadlock
- Alternative Dispute Resolution
- Majority Control
- Minority Protective Provisions
- Business Succession/Tax/Estate Planning
- Alternatives – Profits Interests/Phantom Plans

Corporate Form

- S. Corps. - Limitations
 - Who can be an S. corp. shareholder?
 - Individual (US citizen or resident) or SMLLC (individual owner/disregarded)
 - S corp. (QSSS only)
 - Certain qualified trusts
 - Pro rata distributions/Reasonable compensation if active in business
 - No second class of stock - IRC Section 1361(b)(1)(C)
 - Voting versus non-voting stock
 - Voting Trust (DE)
- C Corp./Limited Liability Company – Much more flexibility

50/50 Shareholder Agreements

- Deadlocks
- Independent Advisor (Binding or Advisory)
- Shotgun Provision
- Practical Control
- Contractual vs Statutory Claims (Attorneys' and Professionals' Fees)

Alternative Dispute Resolution

- Court versus ADR
 - Cost
 - Confidentiality
 - Speed
 - Finality
- Negotiation
- Mediation
- Private Arbitration
 - Arbitration Services (AAA, ADR Options, JAMS)
 - Award of Costs and Fees

Majority and Minority Ownership Issues

- Majority Control
 - Pennsylvania Business Corporation Law – Default Majority Consent
 - Drag Along Rights
 - Restrictions on Transfer/ROFR
 - Disposition on Death, Disability, Voluntary Separation, Termination for Cause – Call Option
 - Failure to Transfer Shares
 - Appointment/Removal of Directors and Officers – Cumulative Voting 15 Pa. C.S. 1758(c)(1)
 - Capital Contributions
 - S Corp. Provisions

Majority and Minority Ownership Issues

- Minority Protective Provisions
 - Super Majority or Unanimous Consent Provisions – Dissenter’s Rights
 - Required Capital Contributions
 - Mandatory Tax Distributions
 - Tag Along Rights
 - Appointment of a Director(s)
 - Access to Books and Information

Business Succession/Estates/Tax Planning

- Issues Trying to Address:
 - Family/Ownership/Succession Issues
 - Tax/Estate Planning
 - Owner Cash Flow and Retirement
 - Company Cash Flow/Financing Concerns
- Life Insurance Funding

Business Succession/Estates/Tax Planning (continued)

- Gifting Strategies
 - Annual Exemption Amount - $\$16,000 \times 2 = \$32,000/\text{year/person}$
 - Forgivable Promissory Notes
 - Lifetime Gifting Exclusion $\$12.060\text{M} \times 2 = \24.120M
(only until 12/31/2025)
 - Gift Tax Return
 - Valuation Discounts
 - Recap – Voting and Non-Voting Shares
 - SLAT, Grantor and Similar Trusts
 - Voting Trusts (DE)

Business Succession/Estates/Tax Planning (continued)

- Family Succession Issues
 - Family Inside/Outside Business (Harmony)
 - Establish Line of Succession and Control
 - Establish Independent Board of Directors
 - Goal – Economic Success/Family Harmony

Polling Question

Profits Interests/Phantom Plans

- Profits Interests - Rev. Proc. 93-27; Rev. Proc. 2001-43 = 2nd class of stock
- Alternative – JV with employee/S corp. through JV LLC
- Phantom Stock Plans
 - Stock Appreciation Rights
 - Distribution Equivalent Rights

Contact the Presenters

Thomas Yankanich, CPA
Director, Audit and Accounting
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tyankanich@kmco.com

Brian Kitchen, CPA
Director, Tax Strategies
Kreischer Miller
bkitchen@kmco.com

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psmith@ammlaw.com



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