Shareholder Agreements for Closely Held Corporations

By Thomas D. Johnson

Prior to the creation of the limited liability company, most family or closely held businesses were formed as corporations. In order to obtain the limited liability protection afforded to the corporate form of entity, the corporation needed to adhere to all the corporate formalities required by the Iowa Business Corporation Act. Since the establishment of the limited liability company, many family and closely held businesses have elected to be organized as limited liability companies as opposed to the corporate form of entity. The main reason for electing the limited liability company was due to its flexibility with respect to the governance and other formalities of the entity. The rules have now changed for closely held corporations to allow flexibility with respect to the corporate formalities similar to limited liability companies.

Last spring, the Iowa legislature made numerous significant revisions to the Iowa Business Corporation Act ("Act"). The amendments, which become effective January 1, 2003, amend the Act to attempt to modernize the law (e.g., to make use of electronic filings), clarify or simplify the law, and give better guidance to directors, officers, shareholders and corporate counsel in planning transactions and generally conducting the corporation's business and affairs.

Recognizing the need for management flexibility in corporations that are closely held, the Act was amended to allow shareholders of corporations to do by agreement what members of a limited liability company have been able to do in an operating agreement or partners in a partnership have been able to accomplish through a partnership agreement.

What can a Shareholder Agreement do?

Prior to the amendments to the Act, agreements among shareholders which went beyond voting for directors and which attempted to control aspects of the management of the corporation were historically condemned or viewed with skepticism as being inconsistent with or attempting to override the Act's statutory requirements that entrust the management of the corporation's business and affairs to the board of directors.

The amendments to the Act now provide that an agreement among shareholders of a closely held corporation is valid and binding even though it is inconsistent with one of more provisions of the Act. Specifically, a shareholder agreement formed in compliance with Section 732 of the Act may, among other things:

* Eliminate the board of directors or restrict their discretion or powers,
* Govern the making of distributions whether or not in proportion to ownership of shares,
* Establish who shall be directors or officers,
* Establish the terms of any transfer or use of property,
* Transfer to one or more shareholders the authority to manage the business and affairs of the corporation,
* Require dissolution of the corporation at the request of one or more shareholders or upon the occurrence of a specified event, or
* Otherwise govern the exercise of the corporate powers or the management of the business and affairs of the corporation.

Can any Corporation Create a Shareholder Agreement?

A Shareholder Agreement is only available to corporations whose shares are not publicly traded. If the shares of the corporation are subsequently listed on a national securities exchange or are regularly traded in a market maintained by a securities association, the Shareholder Agreement will cease to be effective.

How do you create a Shareholder Agreement?

How does one create a valid and enforceable Shareholder Agreement? In order to be valid and enforceable, the amendments to the Act require that the Shareholder Agreement be set forth <u>either</u> in:

(i) the Articles or Bylaws and approved by all persons who are shareholders at the time of the agreement, <u>or</u>

(ii) a separate written agreement that is signed by all persons who are shareholders at the time of the agreement.

The existence of the Shareholder Agreement also must be noted conspicuously on the front and back of each stock certificate. Failure to do so does not affect the validity of the agreement, however, a purchaser of shares who did not have knowledge of the agreement at the time of purchase is entitled to rescind the purchase if the stock certificate failed to include the notation of the agreement's existence.

Continued Limited Liability Protection

Limited liability protection afforded corporations will not be jeopardized by a Shareholder Agreement. The amendments to the Act specifically provide that the mere fact that a Shareholder Agreement results in the failure to observe corporate formalities will not be grounds for imposing personal liability on any shareholder. However, shareholders should be aware that if a Shareholder Agreement limits the powers of the board of directors, the members of the board, if any, will be relieved of liability for acts or omissions of the corporation and such liability will be imposed on the person whom the powers are vested. Consequently, if the power is vested with the shareholders, shareholder liability can be created.

Other Considerations

Unless the Shareholder Agreement provides otherwise, the agreement is valid for only ten (10) years. In addition, unless the Shareholder Agreement provides otherwise, the Shareholder Agreement may be amended only by all persons who are shareholders at the time of the amendment. Accordingly, if the intent of the shareholders is for the term of the agreement to be other than 10 years or that amendments may be made by less than all the shareholders, specific provisions will need to be included in the Shareholder Agreement to provide for such terms.

Many closely held corporations currently have Shareholder Buy-Sell Agreements in place for the purpose of placing restrictions on the transfer of the stock of the corporation and providing rights of first refusal with respect to any transfer of stock. These Shareholder Buy-Sell Agreements will continue to remain valid and enforceable unless the new Shareholder Agreement specifically addresses the subject matter of the previous existing agreement.

If your business is currently operating as a closely held corporate entity, the revised Iowa Business Corporation Act now offers your company flexibility with respect to the manner in which it is governed and operated.

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