

How to Protect Against Misuse Of Business Ownership

Applies to All Types of Business Ownership Positions

- **Get Right of First Refusal**
- **Get Investment Representation**
- **Restrict Pledging of the Securities**
- **Get Indemnification from the Buyer/
Recipient**
- **Check Out Legal and Tax Consequences**
- **Know Who's Buying the Shares**

You and Your Ownership

There is a great deal of information in this **Resource Report** to protect you personally as a principal owner and to protect the business. It is *must* reading if you currently have minority owners — including family members and partners — or plan to have any in the future.

Minority owners can be troublesome, but they don't have to be crippling. Generally, that can be avoided by exercising great care in drafting a shareholder agreement. Done correctly, a shareholder agreement can avoid or minimize difficulties; done incorrectly, it can open the way for all sorts of problems with minority owners.

There are *many* circumstances when you may sell, transfer, or give away ownership in the business. So it's important that this Report be read very carefully. *Use it when:*

- Either you or the company is selling all or part of common stock.
- Giving stock to your children or spouse.
- Granting stock options to key employees.
- Entering into a buy-sell or other stock purchase agreement with other current or new owners.
- Raising capital via warrants (option to buy stock) or a convertible security (right to convert debt or preferred stock into common stock).

Applies to all entities: Although this Report discusses stock ownership, the concepts and cautions apply to *any* ownership position, including ownership in a C or S corporation, limited liability company, partnership, sole proprietorship, affiliated businesses, and the joint ownership of assets, e.g., real estate properties leased to the business.

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Many business executives don't give the matter too much thought when they give stock or options in their company to top executives as an incentive, or to a lending institution as a "kicker" to sweeten a loan arrangement, or even to family members as gifts. After all, they're only minority stockholders.

But that blind faith can be a serious mistake. This Report outlines the lurking dangers posed by minority owners — and how to avoid them. As you may know, perhaps from personal experience, a minority stockholder — even one with only one share of stock — can cause real problems. Even though a minority owner doesn't control the company, he or she can become an irritant. And that irritation can cause you more than just a little inconvenience; it can cost you a great deal of grief, time, and money. *Here are some examples.*

- You give some stock to your daughter; she gets divorced and her ex-husband winds up owning part of your business.
- Or, you give stock to an up-and-coming junior executive as an incentive to stay and grow with your company. After a few years, you have a falling out and you fire him. He is now an *unhappy* minority stockholder.
- Or, your partner dies and you now have his or her spouse as equal owner of the business.
- Or, another executive uses the shares as collateral for a loan. He defaults on the loan repayment and the lender picks up the stock — and now the lender is your minority stockholder.

Those examples should be enough to convince you that you must establish some controls when giving or selling stock for *any* purpose — and to *any* person or firm.

Behind the Stock Certificate

Before we present ideas on how to protect yourself, let's take a look at the character of closely held securities. The shares you give away can be either some of the original stock (called founder's stock) or new stock issued at some later date. Neither stock can be publicly sold nor traded *unless* it is registered with the Securities and Exchange Commission (SEC) and applicable states. There are exceptions to this rule, and your lawyer can advise you of them.

When an owner wants to give stock as a gift or reward, sell stock, or issue it via a stock option, he provides the recipient with a piece of paper called a stock certificate or an option to buy stock (e.g., a warrant or convertible security). And, in most cases, the business owner stops there. Too bad, because if he or she had taken only one more step he might have saved himself lots of potential grief. Instead of the stock certificate (or in addition to the certificate), he should have issued *Letter Stock*.

What Is Letter Stock? Simply stated, it is a stock certificate accompanied by an investment agreement which states that the buyer can't sell, encumber, gift, or transfer the shares. In addition, a legend is actually stamped or typed on the certificate which states that the shares can't be sold unless they are registered with the SEC or unless an exemption is available under the various SEC laws and applicable state laws. Typical wording of such a legend is shown on page 11.

The investment agreement and the legend written on the stock certificate are only the first steps in protecting against misuse of the shares. Also very important, indeed vital, are three other areas in which you should retain some control over the stock. Be sure you —

1. Provide for a right of first refusal for both you and the company to buy back the stock.
2. Restrict the future sale or transfer of the shares.
3. Restrict the use of the stock as collateral for a loan or other transaction.

Let's review each one so you can see the dangers and how to protect yourself.

#1 — Get Right of First Refusal

Both you and your corporation should have the right of first refusal on any shares the minority owners wish to sell or transfer. This protects you against their selling or giving shares to outsiders or family members.

Reason: If you have, say, 10 minority stockholders in the company and they have an average of three children each, you could wind up having 30 minority stockholders with whom to contend. Even worse, the rights of minors are protected by the courts and state laws. And you may have to contend with a guardian or trustee if a minority stockholder has transferred stock to his or her

children.

Caution: A restriction on the buyer to *never* sell the stock may be unenforceable as an "unreasonable restraint." *Right of first refusal* is a key way to protect you and the company. This is a particularly important right with employees who may leave the company.

#2 — Get Investment Representation

The individuals who buy or receive the stock should represent that the shares are being *acquired for investment purposes only* and can't be sold or transferred to the general public without complying with both federal and state laws (referred to as blue-sky laws). Again, the actual shares should contain a *legend*, in writing, indicating that such an investment agreement exists.

More protection: If a stockholder has the right to sell or give stock to other individuals, indicate in the investment agreement that the buyer or recipient also must be bound by the terms of the investment agreement and by the legend indicated on the stock certificate.

#3 — Don't Encumber the Shares

To protect the right of first refusal, have new stockholders agree, in writing, that the shares cannot be encumbered by any liens or put up as collateral for a loan; again, you don't want a bank or other lender becoming a minority owner. The legend on the stock certificate will alert a lender that an agreement exists relative to the shares it is considering taking for collateral.

Use in Buy-Sell Agreements

Consider executing a buy-sell agreement between stockholders, possibly funded by life insurance, to provide for the purchase of the shares upon death, disability, or the retirement of any stockholders. The agreement can be a:

- *Stock-redemption* — the corporation buys the shares from the stockholder(s).
- *Cross-purchase* — the individual owners buy the shares from each other.

In addition, the agreement can specify that it is mandatory (you must buy the shares) or optional (right of first refusal). The agreement also should set the

per-share price for the stock purchase and include a formula for determining the future price; that way you will avoid future valuation disputes. The formula can be simple, e.g., the current purchase price *plus* any increases or decreases in the company's net book value per share or a multiple, say five, of the increase or decrease in the company's operating profits or net income.

Who's Buying the Stock?

Make sure that you and your counsel thoroughly analyze who is buying the stock. Among many other regulations, there are rules on who qualifies to buy investment stock, particularly in a closely held business. Basically, an investor must:

- be sufficiently sophisticated to understand the risks of the business *or* be represented by an investment adviser or lawyer who is knowledgeable in the purchase/sale of closely held securities,
- understand the restrictions on the stock, e.g., it can't be readily sold or transferred, and
- be able to absorb any capital losses (i.e., the investor is wealthy and has a sufficient net worth to take a loss on the stock).

An example: If a business sells \$50,000 of common stock to a local resident — e.g., a business associate, friend, or relative — who is not "sophisticated" or "substantial" (say, has a net worth of *less* than \$1,000,000), you're asking for trouble. He or she may be able to rescind the transaction on the grounds that he wasn't "qualified" to buy the stock in the first place.

Moreover, violation of securities laws involves both corporate and personal liability. Your "corporate veil" may not protect you if this minority stockholder wants to take action against you and your corporation.

More Cautions and Advisories

Buy-back option: When selling stock to outsiders or stock options to key employees, try to get an *option* to buy back the stock — even at two times the initial purchase price or two times the company's book value per share. *Why?* If the minority owner dissents on a major corporate matter you wish to effect, such as a major expansion or the acquisition of another business, you have some latitude. The option takes away the minority stockholder's leverage in killing an

attractive deal. He or she is afforded a nice gain and you retain flexibility in implementing major corporate decisions.

Family members: If you intend to gift any stock ownership to your children, ask your lawyer how you can protect yourself in case of a divorce. You don't want to wind up with your son's or daughter's former spouse as a disgruntled minority owner.

S corporations: If the business is an S corporation, you should include an automatic restriction on the sale, gift, or transfer of any shares which would *invalidate* the tax status of the S corporation and disqualify it from being taxed as an S corporation.

Indemnification: It is customary practice that both the seller and buyer agree to indemnify each other against violation of any securities laws (both federal and state) in the sale or transfer of any shares.

Legal and taxation: On the sale or transfer of any securities (including stock given to family members or stock options given to employees), always use a lawyer who is well versed in this subject. And, of course, verify the tax implications to the seller (transferor) and the buyer (recipient) *before* effecting the transaction.

Summary of 8 Steps

Here is a review of the steps to take when selling, transferring, or issuing stock or options to buy any securities you or the company own.

1. Legend the stock certificate and execute an investment agreement.
2. Restrict the sale, transfer, or gift of the securities.
3. Get the right of first refusal for both you and the company to reacquire the stock.
4. Restrict pledging of the securities as collateral for a loan or other transaction.
5. Bind all future recipients of the shares to the terms of the investment agreement.

6. Get indemnification from the buyer or recipient of the shares.
7. Check out the legal and tax consequences.
8. Use a lawyer who is well versed in the sale and purchase of securities.

Last, if you *don't* already have this list of controls and protection with current minority owners, talk to your corporate lawyer to see how you would go about obtaining it on stock and options already issued.

Reference: For a sample investment letter and stock legend, please see the following pages. □

Before completing any purchase or sale of securities, *always* get sound legal advice. *Important:* If you have already sold or transferred any stock, discuss this Report with your corporate lawyer to see if you can build in similar protection retroactively.

Sample Investment Letter from the Buyer

Re: Share Acquisition

Dear (Seller or Company):

In connection with your private sale of stock to me of 500 common shares, par value \$.10 (the "Shares"), of XYZ Corp. (the "Company"), I hereby represent that I am acquiring the Shares without a view of (i) any public sale or distribution thereof within the meaning of the Securities Act of 1933 (the "Act") or the rules and regulations thereunder or (ii) any resale thereof not permitted by the Act or such rules and regulations.

I understand that the Shares have not been registered under the Act or under other applicable laws, and I agree to hold the Shares subject to all applicable provisions of the Act and the rules and regulations thereunder, as well as applicable provisions of other securities laws. I further understand that the shares must be held indefinitely unless subsequently registered under the Act and other applicable laws or unless an exemption from such registration is available. I understand that neither you nor the Company is under any obligation to register the Shares and that if Rule 144 promulgated under the Act becomes applicable, any routine sales of securities made in reliance upon that rule can be made only in limited amounts and in accordance with the terms and conditions of that rule.

I agree that I will not, except pursuant to an effective registration statement under the Act, offer, sell, encumber, transfer, or otherwise dispose of any of the Shares without further obtaining and delivering to the Company and to you an opinion of counsel satisfactory to the Company and you that such disposition may be made without registration of the Shares under the Act and other laws. All certificates or instruments representing the Shares shall contain a legend conspicuously noted thereon to the following effect:

Stock Certificate Legend

The Shares represented by this certificate have not been registered under the Securities Act of 1933 or under any other laws and, except pursuant to an effective registration statement under such Act and other laws, may not be offered, sold,

transferred, pledged, encumbered, or otherwise disposed of without an opinion of counsel, satisfactory to the Company, that such disposition may be made without such registration.

These shares are being acquired for investment purposes only and can't be sold, encumbered, or transferred *without* the written approval of the Company.

Very truly yours,

Check with your lawyer; this letter is only a sample.

Stock Legend: See next page

Sample Stock Certificate Legend

The legend below should be *conspicuously* placed on the face of the stock certificate.

The Shares represented by this certificate have not been registered under the Securities Act of 1933 or under any other applicable laws and, except pursuant to an effective registration statement under such Act and other laws, may not be offered, sold, transferred, pledged, encumbered, or otherwise disposed of without an opinion of counsel, satisfactory to the Company, that such disposition may be made without such registration.

There is also an investment agreement which accompanies this stock certificate.

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The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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