

The Importance of Shareholder Agreements Between Owners

By Markley S. Roderick, Esq.

When two or more people form a business, they naturally focus on things like generating revenue and hiring the right employees. With all their energy focused on operations, the owners sometimes pay too little attention to the development of an agreement among themselves. A recent court case illustrates what can – and often does – go wrong.

The case involved three doctors who formed an orthopedic surgery practice. At the beginning of his 33-page opinion, the judge offered the following wistful summary:

The doctors appear to be gifted and talented physicians. However, in their zeal to focus on their developing medical practice, they appear to have paid little, if any, attention to the business management aspects of their practice – the corporate structure, office policies and controls, and particularly, developing an agreement should there be a death, divorce, or departure of one of their colleagues. This case stands as a stark and clear example for all doctors to heed the biblical admonition set forth in Luke 4:23: “Physician, heal thyself.”

To my knowledge, there are no biblical passages dealing with exporters, consultants, home builders, or technology companies. But no matter what the business, the lessons are the same.

The doctors in this case were indeed highly trained, skilled, and successful. They left the world of academic medicine to start a private practice with every indication that the practice would be lucrative. Although they met with a lawyer to form a professional corporation, for one reason or another the lawyer did not prepare a shareholders’ agreement. The consequences became apparent when one of the doctors decided to leave the practice and move to Mississippi.

Questions immediately arose: Should the departing doctor receive money as a buyout? Was there “goodwill” in the practice and, if so, how much? Was the departing doctor bound by a restrictive covenant if she decided to return to the area? Who owned the accounts receivable? Had the doctors entered into an oral contract about anything?

Meeting followed meeting, lawyers got involved, and eventually the lawsuit was filed.

By the time the court sorted through the testimony, it is fair to say that no one walked away happy. The court found that there was goodwill in the practice, but not much. The departing doctor was owed something for her shares, but this was more than offset by the money she owed back to the corporation. Various claims made by the doctors against one another and third parties were dismissed.

Based on our experience with similar situations, the case probably had consequences beyond those described in the judge’s opinion. For one thing, the dispute probably destroyed the personal and professional relationships that brought the partners together in the first place. For another thing, it consumed an enormous amount of their time and energy, with a high financial cost and an emotional cost (stress, anxiety) that cannot be calculated. Finally, it would not be surprising if the partners incurred legal fees in excess of \$100,000.

The lesson of the case was stated succinctly by the judge: “This case highlights the need for a shareholder agreement to be in place at the outset so that the valuation upon leaving is determined by consensus on day one of the firm and not imposed by a court.”

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In truth, valuation is just one of the issues that should be addressed by a shareholders' agreement. Others include:

- ❖ How much money or other property each partner will contribute, now and in the future
- ❖ Ownership percentages
- ❖ The compensation of the partners
- ❖ Management and decision-making
- ❖ Restrictive covenants (non-compete agreements)
- ❖ Time commitment
- ❖ Profit distributions
- ❖ Buy-sell issues (buyouts on death, etc.)

Dealing with these issues when a business is formed takes a little time, costs a little money, and can be a

little uncomfortable, precisely because the issues are important and the partners may come to the table with different assumptions. As the recent case illustrates, however, the cost of not dealing with these issues is many times greater. Partners who start their business relationship on a solid foundation are, in my experience, far less likely to encounter difficulty in the future.

Please let me know if you would like to discuss this, or learn more about what a good shareholders' agreement can do.

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