

Avoiding Shareholder Disputes: The Corporate Marriage Between Shareholders

By: Yosef S. Adler

Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

Have you ever asked yourself – “Is this the right person for me? Are we compatible with each other? Are we interested in the same outcomes in this relationship?”

Why not begin every business relationship in your life with these questions? The relationship between shareholders in a closely held corporation is like a marriage. The shareholders have to interact with each other, for better or for worse. Acrimonious situations cannot only harm the relationships between the shareholders; they can result in corporate instability, loss of revenue and even dissolution of the corporation. So why put yourself through such instability? You can take steps at the beginning of the relationship to avoid unrest and protect yourself in the event of a corporate divorce.

In marriage, relationships can start in a mature manner and endure without disputes. However, at some point in the relationship you may encounter a situation that cannot be resolved easily. This is when you wish you had done something differently at the outset. In business, the excitement of a new venture and the need for capital can lead to accepting shareholders that may not be entirely compatible with the other shareholders. This can create problems and disputes down the road. These occurrences could be avoided, or at least minimized, with proper planning and due diligence prior to committing to the relationship.

This series of articles provide insight into 1) what a corporation and an investor should consider when deciding to enter into their “corporate marriage”, 2) possible mechanisms to avoid a “corporate divorce” and 3) if corporate divorce is inevitable, how can it be best resolved.

The following are some of the primary considerations and protective mechanisms you should implement when becoming partners/shareholders/co-founders with other individuals:

- 1. Conduct Business, Legal and Interpersonal Due Diligence:**

Whether you are the company looking for investors or the investor looking to become a shareholder of a corporation, due diligence should be conducted by both parties before the corporate marriage is consummated. Due diligence should focus both on the interpersonal aspects between the shareholders, the goals of the corporation *vis-à-vis* the investor, and whether the investment in the corporation will satisfy these goals.

- 2. Enter into Shareholder’s Agreement:**

A shareholder’s agreement is the best way to protect both the corporation and the shareholders in a corporate marriage from possible situations where disputes may arise. It is akin to a prenuptial agreement in a marriage. This agreement can provide for resolutions to possible disputes or situations such as the death of a shareholder, how shares can be transferred or sold, resolving a deadlock at a shareholders’ meeting, and how a shareholder can be bought out.

- 3. Implement Dispute Resolution Provisions in Shareholder’s Agreement:**

A dispute resolution mechanism can be invaluable for resolving disputes and disagreements in an effective and efficient manner. Like any relationship, a

business relationship may have its ups and downs. A dispute resolution provision can provide for mediation or arbitration in the event of a disagreement and a guideline to resolving disputes which may result in corporate divorce.

This article, being the first in a series, focuses on the first mechanism described above. The following are a number of due diligence items that should be considered by both the shareholders and the corporation contemplating the possibility of a “corporate marriage”:

Shareholders:

Interpersonal

- Are the shareholders' personalities compatible? For example, are they risk takers, aggressive, socially conscious, etc.?
- What is the management structure of the corporation? Who will make the decisions? What level of input will each shareholder possess?
- What skills does each shareholder contribute to the relationship?
- Are the shareholders trustworthy?
- Are shareholders willing/able to put in the required time to fulfill their responsibilities?
- How is the business of the corporation conducted?
- Are people in the corporation happy?
- Are the investors sophisticated / Does each shareholder truly understand what they are getting into?

Goals

- How will the investment funds be spent?
- What is the expected return on capital and associated timeline?
- What are the terms of the investment? For example, what will be received in exchange for the investment and how will this be delivered and over what time frame?
- How long will it take for the investment funds to be exhausted?
- Will there be a need for additional investment?
- What are the reasons for investing in the corporation?
- Will shareholdings be diluted in the near future?
- Is there an exit strategy? What are the corporation's short term and long term goals with respect to this strategy?
- What are the respective visions for the corporation? Are they diverse or united?
- What are the material business relationships of the corporation?
- Do the investors/shareholders understand the operational aspects of the business?
- What are each individual's detailed responsibilities?

Investors

If you are the investor looking for the right corporation to invest in, there are additional items which you should consider before making the final commitment:

- Do you understand the financial situation of the Corporation?
- What is your level of understanding of the market in which the company operates and the competitive advantage of the corporation?

- Identify the projected profit of the corporation and on what basis and assumptions these projections are based on.
- Identify what your expectation for return on your investment?
- Are there any shareholders agreements which I will be bound by?
- What are the major assets of the corporation?
- Are there any liabilities of the corporation and would you become liable for anything if you become a shareholder?
- Does the corporation rely on certain “key” employees and are these individuals happy in their current roles?
- Identify the debts and liabilities of the corporation.
- Acquire an organizational chart of the corporation.
- Request copies of the constating documents and by-laws.
- Review the financial statement (including interim reports) of the corporation and a summary of the business activities.
- Ascertain whether there the company is involved in any litigation or is facing any potential litigation.

It is unlikely that you will be able to get answers to all the items outlined above. It also may not be appropriate in your situation to request all the information. However, every situation is unique. Possibly, your values and personal situation will give you the ability to proceed with the relationship regardless of whether these points are all covered. The key is that you give considerable thought at the beginning of your relationship and you seriously consider the interests, goals, and motivations of all the parties involved. The initial stages may in fact be the most significant in establishing a long and prosperous corporate marriage.