SPECIAL SHAREHOLDER CONCERNS IN THE CLOSELY HELD CORPORATION

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I. INTRODUCTION.

A "closely held corporation" can be generally defined as a corporation with few shareholders and whose stock is not publicly traded. Often, a closely held corporation is thought of as an incorporated enterprise whose shareholders consider themselves more like partners. Shareholders routinely enter into agreements, which resolve many problems associated with the closely held corporation and, in some respects, obtain benefits similar to a partnership.

Ownership and management of the closely held corporation are frequently, but not always identical. Typically, the shareholders are few in number, know each other well, consider themselves owners, and are active in the management of the corporation. A closely held corporation is often a family business or a group of individuals who have chosen to devote all of their time, money, and energy to the operation of their own business.

As entrepreneurial enterprises have become more common and continue to be encouraged by states seeking to enhance and grow their economies, closely held corporations more frequently include non-management investors (i.e., equity or silent partners). Oftentimes, these investors are close friends, business acquaintances, or venture capital funds who are relying upon the business model and expertise of other shareholders to manage the day-to-day business operations. These “silent investors” or “equity partners” may utilize shareholder agreements to provide protections for their interests in the closely held corporation.

II. SHAREHOLDER AGREEMENTS.

A. Purpose.

Often a close corporation is the result of a relationship among individuals with a common business goal, complementing resources and an ability to work well together. Shareholders in a closely held corporation have justifiable concerns that should be

considered early in the corporation's formation. Some of these concerns are who their "partners" will be in the future, how and when the business will ultimately be dissolved, how managerial decisions will be made, what each shareholder's role will be, what the circumstances of each shareholder's employment will be, and how to resolve disputes among the shareholders. These subjects are often considered in a shareholders' agreement. While shareholders' agreements may cover the broad concept of corporate structure, buy/sell agreements normally are limited to resolving how shareholders ultimately turn their shares into value in the event of death, disability, or retirement of a shareholder. Sometimes these solutions are incorporated into a shareholder's agreement, but are more often included as attachments, or created as an independent document.

B. Shareholder Agreements in General.

Typically a shareholder agreement is entered into prior to incorporation to assure that all salient aspects of the corporation are agreed upon before shareholders commit themselves to an investment in the enterprise. However, shareholder agreements are entered into frequently when additional equity investment is made into the business, such as venture capital investment. The agreement becomes a binding contract between the parties when each contributes their consideration for the formation of the corporation. The agreement can be used to protect the position of minority shareholders in all aspects of concern. Often, the agreement promises to maintain each of the active shareholders on the board of directors, even though they may have minority voting rights. The agreement may also include provisions that may prohibit the exclusion from participation as an employee, officer, or director of one shareholder by the rest of the shareholders. Once the corporation is established, those aspects agreed to can only be modified by agreement of all parties. In addition to voting limitations and establishing officers and directors, these agreements frequently include agreement on:

Legal Counsel
Accountants
Casualty or Life Agent
Banking Relationship
Borrowing Authority
Limits on Corporate Activities
Capitalization Terms
Agreement on Time or Condition for Liquidation
Management
Employment Conditions
Chapter "S" Considerations

Historically, the law disfavored shareholder agreements, particularly when the agreement restricted the powers traditionally left in the hands of the board of directors. Through the years, the courts and the legislature have become more aware of the special needs of a closely held corporation. Effective January 1, 2003, the Iowa Legislature enacted amendments to the Iowa Business Corporate Act (the "Iowa Act"), some of which were directed specifically to closely held corporations. Under current §732 of the Iowa Act, shareholders of a corporation may enter into a shareholder agreement that is set forth either in the corporation's articles of incorporation or bylaws or in a written agreement, one or more provisions that:

> (1) eliminates the board of directors or restricts the discretion or powers of the board of directors;
> (2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in §640 of the Iowa Act;
> (3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;
> (4) governs, in general or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies;
> (5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation or among any of them;
> (6) transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation, including the

resolution of any issue about which there exists a deadlock among directors or shareholders;

(7) requires dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency; or

(8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.

This type of shareholder agreement must be approved or signed by all shareholders at the time the agreement is accepted. If the shareholder agreement is a separate written agreement signed by all shareholders, it must be made known to the corporation. Unless the agreement states otherwise, shareholder agreements such as this can be amended only by all persons who are shareholders at the time of the amendment and are valid for ten years.

Stock certificates evidencing shares in the corporation must conspicuously note on the front or back of the certificate the existence of the shareholder agreement. If shares have not yet been issued, then the information statement for the shares must conspicuously note the existence of the shareholder agreement. If the shareholder agreement is entered into after shares are issued, the shares must be recalled, and the existence of the shareholder agreement must be noted on new shares issued in substitution for the existing shares.

So long as the share certificates or information statement note the existence of the shareholder agreement, purchasers of shares take subject to the agreement. On the other hand, persons who purchase shares without knowledge that the shareholder agreement exists have, as their sole remedy, a right to rescind the purchase transaction if the share certificates or information statements fail to note the existence of the shareholder agreement. A person who purchases shares without examining the information statement or the share certificate in which the existence of the shareholder agreement is disclosed, does not have a right of rescission or a right to damages. An action to enforce the right of

rescission must be commenced within the earlier of ninety days after discovery of the existence of the shareholder agreement, or two years after the time the shares are purchased.

Shareholder agreements dealing with the types of issues listed above automatically cease to be effective if the shares of the corporation are listed on a national securities exchange or become regularly traded in a market maintained by one or more members of the national or affiliated securities association.

Shareholder agreements that comply with §732 of the Iowa Act are enforceable regardless of whether or not they conflict with other provisions of the Iowa Act, such as the requirement in §801 of the Iowa Act that the corporation must have a board of directors and that all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, the board of directors. In fact, §801(2) specifically recognizes the validity of a shareholder agreement authorized under §732.

[SAMPLE PROVISIONS ARE INCLUDED AT THE END]

C. Allocation of Control.

Under current law, a shareholder agreement may contain provisions allocating control of the corporation in a manner consistent with the shareholders' expectations and desires. A shareholder agreement may allocate voting power on specific or general issues among the shareholders in any manner the shareholders determine. For example, a shareholder agreement may mandate that each party votes his or her shares in a specified way for director positions, or the shareholder agreement may dictate that each shareholder, or a group of shareholders, is entitled to elect a specified number of directors Frequently all shareholders agree to elect and continue themselves as directors, particularly when equality of control is desired.

Shareholders may also agree to allocate voting power disproportionately to the proportion of shares owned. This type of agreement may give one key shareholder a proxy or a veto power without disturbing the allocation of shares.

Shareholders may by a shareholder agreement completely eliminate the board of directors and govern the corporation themselves in lieu of a board of directors. The shareholder agreement may otherwise restrict the discretion or the powers of the board of directors. For example, a shareholder agreement may provide that the business and affairs of the corporation shall be governed by the board of directors except that the shareholders alone shall have the power to determine whether or not the corporation will borrow money, grant liens on property or dispose of particular assets, whether in the ordinary course of business or otherwise. Other examples of issues with which shareholder agreements may deal include (a) provisions for breaking a deadlock in management, such as appointing a particular shareholder to cast an additional vote in order to break the deadlock or agreeing upon an independent third party to break the deadlock, and (b) provisions appointing the shareholders as officers of the corporation and specifying their compensation.

Any shareholder agreement that limits the discretion or the powers of the board of directors relieves the directors of liability for acts or omissions imposed by law on directors to the extent that such discretion or powers are limited. With this type of shareholder agreement, liability is imposed upon the person or persons in whom the discretion or powers are vested, e.g. the shareholders. If the shareholder agreement provides that the shareholders, as a group, will exercise the powers and perform the duties of directors under the Iowa Act, it is not clear the extent to which shareholders may be held liable for breaches of those duties. However, if the shareholder agreement vests the directors' powers and duties in one or more, but less than all of the shareholders, then the shareholders who are not vested with such powers and duties, as well as the corporation may have the right to enforce claims for breaches of those duties. Therefore, the

existence of the directors' liability shield provisions permitted by §202(2)(d) of the Iowa Act are important to the shareholders vested with directors' powers and duties.

Shareholder agreements dealing with the subject matters described above do not expand the personal liability of a shareholder to third parties for the acts or debts of the corporation even if the shareholder agreement or its performance treats the corporation as if it were a partnership or results in failure to observe corporate formalities. In other words, the existence of a shareholder agreement of the type described above does not create a basis upon which a third party may pierce the corporate veil.

Although shareholder agreements are enforceable among the shareholders and with respect to the corporation to the extent the corporation is bound by it, the terms of a shareholder agreement are not binding upon third parties, such as creditors, or governmental agencies. For example, a shareholder agreement that reserved to the shareholders the power to enter into contracts where the amount involved is in excess of $10,000, would not, without more, preclude a third party from relying upon principles of agency in entering into such a contract with the president of the corporation.

D. Limitation on Allocation of Control.

Shareholders may agree to combine their votes to implement a mutually desired corporate policy. Again, such an agreement cannot seek to obtain an unfair advantage for a shareholder contrary to the corporation's best interest, or to the detriment of another shareholder. Even in the absence of harm to other shareholders of the corporation, a shareholder cannot accept consideration for voting his stock a certain way. Section 193 of The Restatement (Second) of Contracts states, "a promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy," and comment (a) to Section 193 states that "the rule applies by analogy to shareholders with reference to their voting powers, although it does not

preclude agreements where the only advantage bargained for is one that will accrue to all shareholders through the ownership of shares."

Section 732 of the Iowa Act also provides a public policy exception to shareholder agreements. Section 732(1)(g) specifically states that the shareholder agreement provision cannot be contrary to public policy. By way of further illustration of the public policy exception, a shareholder agreement that exculpates directors' liability beyond the liability shield provisions of §202(2)(d) of the Iowa Act would likely not be validated under §732 because of the public policy reasons underpinning the exceptions to exculpating directors from liability in their fiduciary capacities.

The eight items listed in §732(1) are not exclusive. In addition, the catch-all provision in §732(1)(h) is designed to permit the court to define the outer limits of permissible shareholder agreements. The court is expected to apply the principle of *ejusdem generis* so that if a shareholder provision does not fall within the specifically enumerated categories in §732(1)(a) through (f), the court is expected to consider whether or not such provision is similar to the general concepts and categories of those categories.

E. Allocation of Distributions.

Section 732(1)(b) of the Iowa Act permits shareholders to authorize non-pro rata distribution on its shares. For example, shares may be owned equally by three shareholders, but shareholder A has invested $100,000 of personal funds in developing the corporation's business plan and business concept for which shareholders B and C agree shareholder A should be compensated. The shareholder agreement could provide for additional distributions to shareholder A from profits of the corporation in order to compensate shareholder A for the $100,000.

If the corporation is a regular corporation (i.e., a "C" corporation), non-pro rata distributions would most likely be viewed by the Internal Revenue Service as the corporation having multiple classes of stock and would not give rise to any particular

issues. However, one must be careful if the corporation has made a Subchapter S election since Subchapter S corporations are limited to a single class of stock. If the Internal Revenue Service views non-pro rata distributions as multiple classes of stock, the corporation would no longer qualify for the Subchapter S election.

F. Irrevocable Proxy.

An alternative to an agreement for shareholders to vote as a unit is an irrevocable proxy. An irrevocable proxy arrangement transfers the power to vote shares. The transferee may be one of the shareholders or even a trusted third party. An argument can be made that an irrevocable proxy is invalid since the right to vote one's shares is a fundamental right of stock ownership. Likewise, one may argue that a proxy is an agency, and under principles of agency, it is inherently revocable. However, an irrevocable proxy arrangement entered into by or among the shareholders for consideration is a common method used to allocate the control of the closely held corporation among the shareholders in accordance with their needs and is enforceable.

G. Voting Trust.

Another method of allocating control is the voting trust. Under this method, some or all of the shareholders transfer their shares to a trust. The trustee(s), usually called voting trustees, must vote the shares according to the directions given in the trust agreement executed by the shareholders. The shareholders may be given "voting trust certificates" to document their beneficial interest in the trust in lieu of shares. This arrangement is similar to the irrevocable proxy except that the trustee(s) may act as owners, rather than as mere agents, since title to the shares has been transferred to the trustee(s). Often, one or more of the shareholders is named as the trustee, although any qualified fiduciary may serve in this capacity.

The agreement creating a voting trust should clearly define the purpose and term of the trust. Furthermore, the trust documents should expressly provide for the right of trustees to elect themselves as directors and officers of the corporation if that is a desired result to avoid an appearance of conflict of duties. In addition to who may be designated trustees, some other considerations are whether a trustee can be removed, how to accomplish the removal of a trustee, how to replace trustees who have died or become unable to continue, what will be the responsibilities and permissible activities and limitations on the actions of the trustees, and under what circumstances the trust may be amended.

III. BUY/SELL AGREEMENTS.

Typical buy/sell agreements discussed in this section would not be subject to the unanimity requirement of §732 of the Iowa Act. Section 732 was enacted to validate and provide certainty to shareholder agreements that might otherwise be determined to conflict with other provisions of the Iowa Act. Buy/Sell agreements ordinarily do not contain terms that conflict with the provisions of the Iowa Act and therefore, would be enforceable among the shareholder parties who sign the agreement.

A. Purpose.

Buy/Sell agreements essentially have two major purposes: to control ownership, and to provide a ready market for shares that may otherwise be entirely illiquid. Planning ahead, acquiring all available facts, correctly ascertaining the needs of the shareholders and careful drafting of buy/sell agreements, can assure a smooth transition and effective means of providing an orderly separation from the corporation resulting from a cataclysmic event or when a shareholder is ready to retire.

B. Controlling Ownership.

In contrast to owning a partnership interest, corporate stock is normally freely transferable. Without entering into an agreement addressing the transfer of shares, the remaining shareholders may not have a choice of with whom they will share ownership and control of their business.

For example, assume three individuals own a closely held corporation equally, each taking an active role in the operation. Should one shareholder die and leave one third of the outstanding stock to a surviving spouse, an almost infinite number of potential problems could arise. What if the spouse should want to take an active role in the corporation but does not understand the business? What if the spouse sells the stock to an unwanted third party or to only one of the remaining shareholders? What if the spouse retains the stock in an inactive role and expects the deceased spouse's salary to continue in the form of large dividends at a time when the active owners prefer to build the business? What if the spouse is willing to sell the shares but, as it often happens, has an inflated estimate of the value of the stock? These questions illustrate just a few of the types of problems that can and usually will arise if not addressed before some cataclysmic event occurs. A buy/sell agreement is an effective way of avoiding such catastrophes.

C. Providing a Ready Market.

Though stock is normally freely transferable, subject to the state and federal securities laws, the stock of a closely held corporation frequently is more difficult to sell. Because the stock of a closely held corporation is not publicly traded, there is no ready market similar to that which a stock exchange provides for publicly held companies. Furthermore, purchasers often will not be interested in such stock unless they can acquire a controlling interest.

Additionally, most shareholders of closely held companies take an active role in the operation of the business. Inactive shareholders want dividend income from their stock

holdings, while active shareholders are usually paid a salary and usually prefer to retain corporate earnings to build the business. Because they are not tax deductible, closed corporations seldom pay significant dividends unless forced to by tax laws. It may be very difficult for a shareholder who wants out of the business to find a buyer who is willing to hold an illiquid, non-income producing investment in the corporation unless they wish to purchase the shares in order to assume an active role. Even if such a buyer is found, they may not be qualified to fill the role of the selling shareholder, or they may be incompatible with the remaining shareholders.

Assume, again, our three active shareholders example. If the deceased shareholder's shares are passed to the deceased shareholder's estate, the estate administration will likely want to liquidate the shares. Since there is no ready market, they will likely have to turn to the corporation or the remaining shareholders. The estate naturally would like to replace the deceased shareholder's salary to provide for the needs of the family, but are at the mercy of the shareholders, officers, and directors of the corporation. They may fail to offer a reasonable purchase price without an agreement in place providing for these needs. A well-researched and drafted buy/sell agreement can provide an effective means of providing a ready market for such situations.

D. Planning Ahead.

Having recognized that problems will almost assuredly occur eventually, shareholders should provide a means at the inception of the corporation for handling death, disability, retirement, dissension, and termination. If a buy/sell agreement is entered into, there is a ready-made solution for many difficulties before the specific shareholder with a problem is identified. If dealt with in advance, the terms of the buy/sell agreement are likely to be fair to each party since none will know which side of a problem may be theirs. It behooves lawyers to help clients recognize that any business

relationship will eventually come to an end. Planning for that event in advance is much more efficient than sorting out the problems later.

E. Types of Buy/Sell Agreements.

In general, a buy/sell agreement is a pre-set mechanism for reallocation for shares of stock when a cataclysmic event occurs. The shareholders and their counsel must make several decisions in drafting a buy/sell agreement. The foremost consideration is what type of buy/sell agreement should be used. There are two basic types, the cross purchase agreement and the redemption (or entity) agreement. Simply stated, a cross purchase agreement is one in which the remaining shareholders purchase the stock being sold. A redemption agreement is one in which the corporation purchases the stock and retires it. There is a third type of buy/sell agreement that may be used which is a combination of the two basic types (sample form provided). This form of agreement postpones the decision until the event occurs.

A corporate redemption leaves the ownership ratio of the remaining shareholders unchanged. A cross purchase buy-out usually requires each shareholder to purchase a quantity of shares in proportion to the percent of outstanding stock owned by each individual respectively, in order to not affect the relative position of the remaining shareholders. Use of corporate funds in stock redemption results in only a single tax on the earnings used to fund the purchase. In a cross purchase, on the other hand, the shareholders themselves must fund the purchase, generally with after-tax dollars.

A combination purchase agreement may be set up in several ways. For example, the corporation may be given the first right of refusal or option to purchase those remaining shares that it can legally purchase. Except for a professional corporation, shares may only be redeemed from a surplus. The shareholders of the corporation may be required to purchase all of the shares not purchased by the corporation, or, in the alternative to find a buyer for them.

F. Setting the Price.

There are as many methods of setting the purchase price of stock as there are drafters of buy/sell agreements. The market may set the price in the case of a third party offer to a shareholder. However, in the case of a cataclysmic trigger event, no such market price exists automatically. In this case, some other method must be employed. Mechanisms frequently employed are:

The parties may set a fixed figure per share. However, since the value of a share is likely to change continuously, this method requires periodic review at relatively short intervals. It is a good idea to require revision of a fixed price within a specific time period for the fixed price to be considered valid. Failure to set a new price within the fixed time would trigger another formula, or allow appraisal, or some other resolution. An alternative for protection of the parties is to equate the fixed price with the book value net worth on the date it is set, and to establish a ratio with the net worth on the date of sale (see separate form).

A price determined by formula should plug in the current variables at the time of the triggering event. This method requires considerations and decisions regarding the accounting methods to employ in setting the price. It is wise to determine at the inception of the corporation which accounting methods will be used to value goodwill, inventory and depreciation variations. Two common methods used are the book value method and the multiple of earnings method. The drafter should consider how many accounting periods will be used in determining the purchase price. One interesting formula is a weighted average over five years, applying a factor of one times the net earnings before taxes for the preceding five years, two times for the fourth year, progressing to a factor of five times the net earnings for the past twelve months. Divide the result by 15 and multiply by the weight factor that the client wishes to give net earnings in order to determine the value of

the corporation. Next, divide the result by the number of outstanding shares to determine the value of each share.

Though appraisal of a closely held corporation is difficult and may require hiring an expensive expert appraiser at the time shares are to be transferred, it is a comparatively accurate method of establishing fair market value, if the parties are otherwise unable to agree.

A put/call method (or either/or method) may be employed in some situations, particularly when the buy-out of a shareholder is triggered by shareholder dispute or unrest. In this method, one shareholder establishes a price and the remaining shareholder(s) can decide whether to buy at the price set by the proponent or to sell their own shares for the same price. Because the first party does not know whether they are buying or selling, the price is usually set at a level deemed, at least by them, to be fair. The other parties will buy if they feel the price is low or sell if the price is deemed high. A protection for the shareholder forced to buy can be built into the period of payment. Perhaps the party forcing the sale should have a short time to perform. If the other shareholders agree to buy they should have a more extended payment plan.

A buy/sell agreement may utilize any combination of the available methods and link a method to the appropriate trigger event. In this way disadvantages of one method can be offset with advantages of another. An example would be to use book value if a shareholder leaves the employee of the corporation and use an appraisal in the event of death where estate tax considerations and value for a life of service are more important. Book value may be more fair when a person refuses to continue contributing.

G. Funding.

An often employed means for providing funding for a buy-out of a deceased shareholder's stock is life insurance. Under a redemption agreement, the corporation is the owner, premium payor, and beneficiary of a policy on each shareholder's life. This

funding method raises alternate minimum income tax issues for the corporation. Under a cross purchase agreement, each shareholder must maintain a policy on the lives of every other shareholder. This may be a more expensive method since there could be more total policies, each of a lesser amount than maintaining a single policy on each shareholder's life. For example, if there are five shareholders, the corporation would maintain five total policies where a redemption agreement is used. Under the cross purchase agreement, each shareholder would maintain four policies, one on the life of each of the fellow shareholders, for a total of 20 policies. Use of an insurance trust can solve this problem. This tool would provide for a policy on each shareholder’s life and divide the insurance proceeds according to the trust agreement. Additionally, a “first to die” insurance policy may be available on the lives of the shareholders.

The cross purchase arrangement raises the issue of the premium requiring the use of after-tax dollars. This problem can be shifted from the shareholder to the corporation through the use of a split dollar agreement. A split dollar agreement provides the owner of the policy (a shareholder other than the insured or the trustee) with a continuing means of acquiring corporate loans equal to the required premiums. When the insurance proceeds are obtained, the loan is repaid. If there is doubt of repayment, the policy may be collaterally assigned to the corporation.

The corporation may accumulate assets to create a reserve for the purpose of purchasing a shareholder’s stock. Under a cross purchase agreement, these funds may be loaned to the purchasing shareholders if they do not have the means of satisfying the obligation on their own. Some corporations sell fixed assets and lease them back to obtain the necessary funding. A frequent alternative is an extended payment contract with funds generated out of future earnings. There are as many options in choosing resources for funding the purchase of a shareholder’s interest as in any financing arrangement for both the corporation and the shareholder. Planning ahead for financing share purchases may simplify the task when the need arises.

H. The "S" Corporation.

The ability of certain corporations to elect to be taxed under Subchapter S of the Internal Revenue Code is subject to several qualifications. The details of a shareholder agreement and buy/sell agreement can jeopardize "S" corporation status. An adequate buy/sell agreement for a "C" corporation may not be adequate if there is an "S" election.

Foremost, an "S" corporation needs provisions in the agreement among the shareholders that protect the "S" corporation status. For instance, if a shareholder were to transfer shares to a corporation, certain trusts, or a partnership, the "S" corporation status would be terminated. Provisions which limit how or to whom a shareholder's interest can be transferred, called share transfer restrictions, can be incorporated into the initial shareholder's agreement or a subsequent "S" corporation agreement.

On occasion a share transfer restriction may not be adequate protection since breach of such agreement may be remedied only by a cause of action for damages. Further, protections against such a deliberate breach may be deemed desirable. Examples of such protections are: provisions that attempted transfers in violation of the agreement are void on their face; that the corporation's or other shareholder's purchase options are given effect just prior to the occurrence of a breach; and that the occurrence of an attempted breach automatically vests title in the subject matter shares in the corporation. Also liquidated damage provisions may help to deter the occurrence of a breach.

IV. ETHICS IN PRACTICE.

When a client approaches an attorney at the inception of a closely held corporation, the lawyer's counseling may be sought for one individual, only a portion of the parties who are involved, all of the parties, or to represent the corporation and not the shareholders. Each scenario represents potential ethical problems for the lawyer. The lawyer is cautioned against representing multiple shareholders and should document by a letter to

each shareholder who the lawyer represents in the formation of the corporation. The least problematic situation exists when the lawyer represents just one of the incorporators. In this scenario, the lawyer must closely examine the client's position in relation to the other parties. For example, if the client is to be a minority shareholder with limited wealth or funding, the lawyer should focus on protection of minority shareholders and provide for long-term financing of buy-outs. In contrast, where the lawyer represents the corporation, there should be full disclosure of the possibility of a conflict of interest among the shareholders. It should be stressed that the lawyer cannot represent or take sides with one party against another. Normally, preserving the on-going business or business opportunity in the best interests of the corporation is the focus of the attorney.

V. CONCLUSION.

A shareholder agreement may be designed to deal with such cataclysmic events in a closely held corporation as death, disability, resignation of a shareholder, or termination of employment. At such times, such issues arise as purchase options, determination of purchase price of shares, methods of payment, and restrictions on free transferability of stock. In addition, the flexibility provided by §732 of the Iowa Act to vary provisions in the Iowa Act will enable shareholders to craft their business arrangements with more certainty. The functions served by a properly drafted shareholder agreement are to protect the control of a closely held corporation, to facilitate investment of capital at critical times in development of the corporation's business through a specifically crafted shareholder agreement and to provide a ready market at a fair price for an otherwise illiquid asset. Proper planning and careful consideration in drafting a shareholder agreement can make handling potentially devastating events in a closely held corporation a smooth and systematic process.

Sample Provisions
Shareholder Agreement

I. ELIMINATION OF THE BOARD OF DIRECTORS.

A. Option 1: Provision in articles of incorporation:

Article ___

This corporation shall have no board of directors. All powers and duties otherwise given to the board of directors under the Iowa Business Corporation Act, including, but not limited to, management of the business and affairs of the corporation, shall be vested in and exercised solely by the shareholders of the corporation.

B. Option 2: Bylaw or Shareholder agreement provision:

The corporation shall have no board of directors. The business and affairs of the corporation shall be governed and managed by the shareholders. All powers and duties otherwise given to the board of directors under the Iowa Business Corporation Act shall be vested in and exercised solely by the shareholders of the corporation.

II. PARTIAL RESERVATION OF DIRECTORS POWERS.

A. Bylaw provision or Shareholder agreement:

The business and affairs of the corporation shall be exercised and governed by the corporation's board of directors, except as hereinafter provided. Only the shareholders shall have power to (list powers reserved to shareholders). The board of directors shall have no power to exercise the powers reserved to the shareholders.

III. ELECTION OF DIRECTORS AND OFFICERS.

A. Option 1: Shareholder agreement provision:

At all regular, special or adjourned meetings of shareholders of the corporation, each shareholder shall vote such shareholder's respective shares of stock in the corporation for each other as directors of the corporation and for no other person or persons.

For the best interests of the corporation, the shareholders desire to have the following named persons elected as officers of the corporation:

President... shareholder A

Vice President...................................... shareholder B

Secretary... shareholder C

Treasurer/Chief Financial Officer .... shareholder C

Such officers shall serve until the earlier of their voluntary resignation, death or incompetency.

In case any shareholder is absent from any meeting of shareholders of the corporation, the remaining shareholders shall have an irrevocable proxy to vote the shares of stock standing in the name of the absent shareholder in accordance with the provisions of this agreement.

This agreement shall be binding upon the heirs, personal representatives, successors, and assigns of the shareholders.

B. Option 2: Shareholder agreement provision:

The board of directors shall consist of [insert #] members, of which [insert #] persons shall be nominated by shareholder A, [insert #] persons nominated by shareholder B, and [insert #] persons nominated by shareholder C. Each shareholder agrees to vote his/her respective shares in favor of each nominated person at all regular, special or adjourned meetings of shareholders of the corporation. The persons so nominated shall at all

times be directors of the corporation so long as A, B and C own shares in the corporation. Such persons may only be removed as a director upon the unanimous vote of shareholders A, B and C.

Shareholders A, B and C shall be president, vice president and secretary, respectively, of the corporation, so long as they own stock in the corporation, are active in the business, are reasonably able to perform and do perform their respective duties, and make the management of the corporation their principal business occupation.

As such officers, A, B and C shall be compensated as follows: (specify compensation) ____

IV. DEADLOCK PROVISION.

A. Option 1: Bylaw or Shareholder agreement provision:

In case of any management deadlock among the shareholders or the board of directors, shareholder A shall have the exclusive right to cast a vote in order to break the deadlock, regardless of the number of shares in the corporation owned by shareholder A and whether or not shareholder A has previously exercised a vote.

B. Shareholder agreement provision:

The shareholders agree that in case of any management deadlock among the shareholders and the board of directors, John Doe will have the exclusive right to break the deadlock. The shareholders and the corporation agree that John Doe shall have the benefit of the liability shield for directors and officers set forth in Article [__] of the corporation's articles of incorporation and shall be indemnified in the same manner and to the same extent as provided for directors and officers in Article [__] of the

corporation's articles of incorporation and section [__] of the corporation's bylaws.

V. NON-PRO RATA DISTRIBUTION.

A. Option 1: Shareholder agreement provision:

For the period (the "Recoupment Period") of January 1, 2004 through December 31, 2009, until such time as shareholder A shall have received Net Profits equal to the sum of (a) shareholder A's share of Net Profits for each fiscal year based upon his/her proportional ownership of shares and (b) $100,000.00, shareholder A shall be entitled to receive sixty percent (60%) of the corporation's Net Profits and shareholders B and C shall each receive a pro rata distribution of the remaining forty percent (40%) of Net Profits determined by dividing the number of shares owned by each such shareholder by the aggregate of all shares owned by shareholders B and C. For all periods after the Recoupment Period, shareholders, A, B and C shall receive distributions of the corporation's Net Profits based upon their proportional ownership of shares in the corporation determined as of any date of distribution. For purposes of this bylaw provision, the term "Net Profits" shall mean the corporation's net profits before taxes as determined by the corporation's accountants.

B. Option 2: Shareholder agreement provision:

For the period (the "Recoupment Period") of January 1, 2004 through December 31, 2009, shareholder A shall be entitled to receive sixty percent (60%) of the corporation's Net Profits and shareholders B and C shall each receive a pro rata distribution of the remaining forty percent (40%) of Net Profit determined by dividing the number of shares owned by each such

shareholder by the aggregate of all shares owned by shareholders B and C. For all periods after the Recoupment Period, shareholders, A, B and C shall receive distributions of the corporation's Net Profits based upon their proportional ownership of shares in the corporation determined as of any date of distribution. For purposes of this bylaw provision, the term "Net Profits" shall mean the corporation's net profits before taxes as determined by the corporation's accountants.

C. **CAVEAT:** If the corporation has made a Subchapter S election, carefully consider the impact of non-pro rata distributions on the continued validity of the Subchapter S election. The Internal Revenue Service may consider non-pro rata distributions as multiple classes of stock.

VI. AGREEMENT FOR USE/TRANSFER OF CORPORATE PROPERTY.

A. Shareholder agreement provision:

The shareholders agree that shareholder B shall be entitled to use the corporation's proprietary software in shareholder B's software research and development company for an annual fee of $100. The shareholders further agree that if the corporation for any reason ceases to use such proprietary software, or in the event that the corporation is liquidated or dissolved, such propriety software shall be transferred or distributed to shareholder B at no cost. The shareholders also agree that all enhancements, modifications, improvements, or variations to or of such proprietary software ("Software Improvements") shall belong to shareholder B and that the corporation shall have the first right of refusal to purchase the Software Improvements or to

license the use of the Software Improvements at an annual fee to be mutually agreed upon between shareholder B and the corporation.

VII. DISSOLUTION PROVISION.

A. Option 1: Bylaw or Shareholder agreement provision:

The corporation shall be dissolved upon the earlier to occur of (1) twenty-five (25) years from the date of its incorporation or (2) the sale of all of the corporation's real estate.

B. Option 2: Shareholder agreement provision:

Upon the death or permanent disability of shareholder A, the shareholders agree to attempt for a period of six (6) months thereafter (the "Sale Period") to attempt to sell the corporation as a going concern, either through the sale of all of the shareholders' shares in the corporation or the sale of all or substantially all of the assets of the corporation. If within the Sale Period the shareholders have entered into an agreement (the "Sale Agreement") for sale of the shareholders' shares, or all or substantially all of the corporation's assets, then the Sale Period shall be extended automatically without further action of the shareholders until such time as the transactions contemplated by the Sale Agreement are closed or terminated. Upon the closing of such a sale or upon the expiration of the Sale Period, then the shareholders agree to cause the corporation to dissolve in accordance with the provisions of the Iowa Business Corporation Act.

VIII. VENTURE CAPITAL INVESTMENT PROVISIONS

Venture capital investment may come in the form of a professional venture capital fund, professional venture capitalist or a wealthy, community-minded citizen who believes in the corporation's business and business plan. Professional venture capital investment in "C" corporations ordinarily takes the form of preferred stock and may be documented with a stock purchase agreement, investment agreement, right of first refusal and co-sale agreement, and/or a shareholder agreement. Obviously, professional venture capital investment in the form of preferred stock will not work for "S" corporations, which are limited to one class of stock. Investments in "S" corporations are more likely to be governed by stock purchase agreements or investment agreements and provisions in shareholder agreements that define the various rights, benefits, duties and obligations with respect to the venture capital investment the stock issued to the venture capitalist. Set forth below are various topics that are often addressed in venture capital investment and that could be topics for inclusion in shareholder agreements. One must be careful in structuring the venture capital investment in an "S" corporation not to run afoul of the requirements to qualify for the subchapter "S" election.

A. Example 1: Venture Capital Share Attributes:

Since the corporation has no board of directors and the shareholders are exercising the powers and duties of directors, the shareholders agree that Venture Capital Shareholder shall be entitled to votes comprising 40% of all shareholder votes regardless of the number of shares in the corporation owned by Venture Capital Shareholder.

So long as Venture Capital Shareholder owns shares in the corporation, Venture Capital Shareholder shall be entitled to elect two (2) persons as members of the corporation's board of directors.

Venture Capital Shareholder shall have preemptive rights to acquire a sufficient number of new shares in the corporation when offered by the corporation so that at all times Venture Capital Shareholder’s percentage ownership of the corporation shall be at least twenty percent (20%). The shareholders agree that the corporation shall not issue any new class of capital stock or new shares of the existing classes of capital stock without first obtaining the written consent of Venture Capital Shareholder and complying with the terms of this provision.

This Agreement and the rights and obligations of the parties hereunder shall inure to the benefit of, and be binding upon, their respective successors, assigns and legal representatives, but shall not otherwise be for the benefit of any third party. The rights of the shareholders hereunder are only assignable (i) by each of such shareholders to any other shareholder, or (ii) to an assignee or transferee who acquires all of the corporation’s shares purchased by a shareholder.

This Agreement may be amended or modified only upon the written consent of the corporation and holders of at least a majority of the corporation’s shares, which majority must include the shares owned by Venture Capital Shareholder.

The obligations of the corporation and the shareholders under this Agreement may be waived only with the written consent of the holders of at least a majority of the corporation’s shares, which majority must include the shares owned by venture Capital Shareholder.

B. Example 2: Basic Financial Information and Reporting:

The shareholders shall cause the corporation to maintain accurate and complete books and records of account reflecting all of corporation's business transactions pursuant to a system of accounting established and administered in accordance with generally accepted accounting principles consistently applied, including required accruals and reserves.

As soon as practicable after the end of each fiscal year of the corporation, and in any event within one hundred twenty (120) days thereafter, to the extent requested by Venture Capital Shareholder, the corporation will furnish Venture Capital Shareholder financial statements, including a balance sheet of the corporation, as at the end of such fiscal year, and a statement of income and a statement of cash flows of the corporation, for such year, all prepared in accordance with generally accepted accounting principles consistently applied and setting forth in each case in comparative form the figures for the previous fiscal year, all in reasonable detail.

The corporation will furnish Venture Capital Shareholder, within twenty (20) days after the end of each [monthly/quarterly] accounting period in each fiscal year of the Corporation, internally prepared financial statements, including a balance sheet of the corporation as of the end of each such [monthly/quarterly] period, and a statement of income and a statement of cash flows of the corporation for such period and for the current

fiscal year to date, prepared in accordance with generally accepted accounting principles.

C. Example 3: Inspection Rights:

Venture Capital Shareholder shall have the right to visit and inspect any of the properties of the corporation or any of its subsidiaries, and to discuss the affairs, finances and accounts of the corporation or any of its subsidiaries with its officers, and to review such information as is reasonably requested all at such reasonable times and as often as may be reasonably requested.

D. Example 4: Confidentiality of Records:

Venture Capital Shareholder agrees to use, and to use its best efforts to insure that its authorized representatives use, the same degree of care as Venture Capital Shareholder uses to protect its own confidential information to keep confidential any information furnished to it which the corporation identifies as being confidential or proprietary (so long as such information is not in the public domain), except that Venture Capital Shareholder may disclose such proprietary or confidential information to any accountant, banker, attorney, partner, subsidiary or parent of Venture Capital Shareholder for the purpose of evaluating its investment in the corporation as long as such partner, subsidiary or parent is advised of the confidentiality provisions of this Agreement.

E. Example 5: Termination of Covenants:

All covenants of the corporation and the shareholders contained in this Agreement shall expire and terminate as to Venture Capital Shareholder upon the earlier of (i) the sale, lease or other disposition of all or substantially all of the assets of the corporation; (ii) an acquisition of the corporation by another corporation or entity by consolidation, merger or other reorganization in which the holders of the corporation's outstanding voting stock immediately prior to such transaction either do not own any securities in the corporation or other entity surviving such transaction, or own, immediately after such transaction, securities representing less than fifty percent (50%) of the voting power of the corporation or other entity surviving such transaction, provided that this provision shall not apply to a merger effected exclusively for the purpose of changing the domicile of the corporation; or (iii) Venture Capital Shareholder’s shares are sold, assigned, or transferred to another Shareholder or redeemed by the corporation.

F. Example 6: Right of Co-Sale:

In the event of any proposed sale of shares by any Management Shareholder, Venture Capital Shareholder shall have the right and option to require the Venture Capital Shareholder’s shares be purchased on the terms and conditions set forth in this Section [____]. Each Management Shareholder which is an Offeror shall send notice of Completion of the

Offering to each Venture Capital Shareholder stating that it is a notice of Completion of the Offering, identifying each of the intended purchasers and the number of Shares they each intend to purchase and stating the purchase price and other terms and conditions at which the share are proposed to be sold. Within five (5) days after Venture Capital Shareholder has received written notice from the Management Shareholder Offeror of the Completion of the Offering with the required information, Venture Capital Shareholder desiring to exercise its rights of co-sale under this Section [___] shall send notice of exercise of the rights of co-sale to the Management Shareholder Offeror directed to the Offeror at the Offeror's address as shown on the books of the corporation or, if a different address is specified in the notice of Completion of the Offering, at that address, which notice of exercise shall state the number of shares the Venture Capital Shareholder desires to sell up to the "Co-sale Proportion" (as hereinafter defined). The "Co-Sale Proportion" shall be defined as the number of shares determined by multiplying the number of shares proposed to be sold by the Management Shareholder Offeror times the fraction, the numerator of which is the number of shares owned at the time of exercise by the Venture Capital Shareholder exercising the rights of co-sale under this Section [___] and the denominator of which is the number of outstanding shares owned by all shareholders at the time of such exercise. The number of shares as to which Venture Capital Shareholder has exercised its rights of co-sale under this Section [__] shall be purchased by the purchaser up to the Co-Sale Proportion along with the

shares of the Management Shareholder Offeror on the same terms and conditions as the Offeror. The Management Shareholder Offeror shall reduce the number of shares to be sold by such Management Shareholder Offeror in order to permit the co-sale by the Venture Capital Shareholder. In the event that Venture Capital Shareholder notifies the Offeror of its exercise of its rights of co-sale under this Section [___], on or before the Settlement Date Venture Capital Shareholder shall deliver to the Management Shareholder properly endorsed certificates representing the shares to be purchased in exchange for the payment by the Management Shareholder for the shares. In the event Venture Capital Shareholder exercises its rights of co-sale under this Section [__], the shares to be sold in such transaction by Venture Capital Shareholder need not be offered to the corporation or the other shareholders as otherwise provided in this Agreement. In the event that Venture Capital Shareholder fails to exercise its rights of co-sale within five (5) days after receipt of notice of Completion of the Offering with the required information, the Management Shareholder Offeror shall have the right to sell the shares which were subject to the rights of co-sale on the same terms and conditions set forth in the Offer to the corporation or Offer to Shareholder, but if such sale is not made within sixty (60) days after Completion of the Offering, the provisions o this Section [__] shall again apply to the sale of the shares.

G. Example 7: Legend:

Each existing or replacement certificate for shares now owned or hereafter acquired by any shareholder of the corporation shall bear the following legend upon its face:

THE SALE, PLEDGE, HYPOTHECATION, ASSIGNMENT OR TRANSFER OF THE SECURITIES REPRESENTED BY THIS CERTIFICATE IS SUBJECT TO THE TERMS AND CONDITIONS OF A CERTAIN SHAREHOLDER AGREEMENT BY AND BETWEEN THE STOCKHOLDER, THE CORPORATION AND CERTAIN SHAREHOLDERS OF STOCK OF THE CORPORATION. COPIES OF SUCH AGREEMENT MAY BE OBTAINED UPON WRITTEN REQUEST TO THE SECRETARY OF THE CORPORATION.