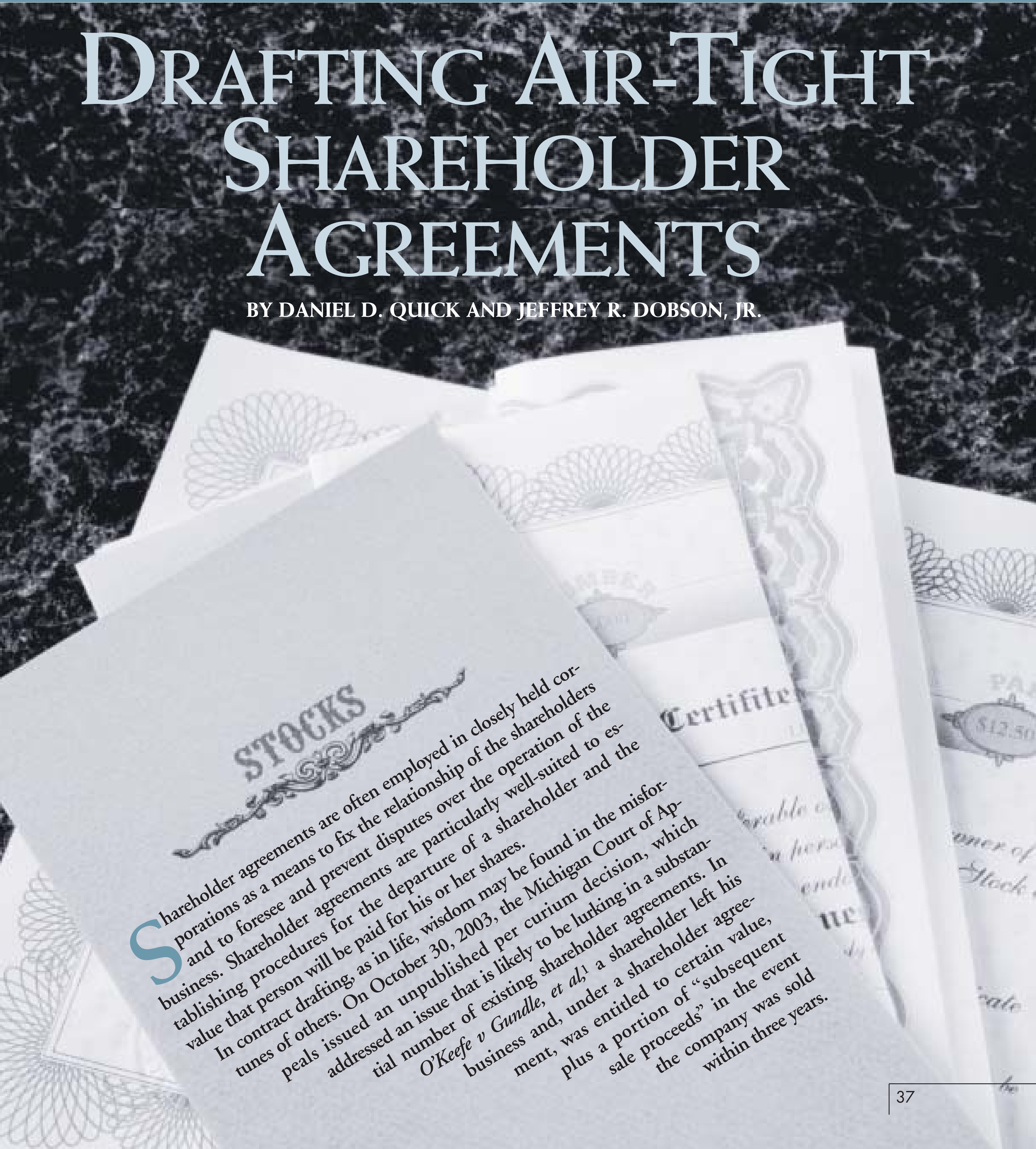
The Michigan Court of Appeals Exposes a Potential Loophole

Drafting Air-Tight Shareholder Agreements

BY DANIEL D. QUICK AND JEFFREY R. DOBSON, JR.



Shareholder agreements are often employed in closely held corporations as a means to fix the relationship of the shareholders and to foresee and prevent disputes over the operation of the business. Shareholder agreements are particularly well-suited to establishing procedures for the departure of a shareholder and the value that person will be paid for his or her shares.

In contract drafting, as in life, wisdom may be found in the misfortunes of others. On October 30, 2003, the Michigan Court of Appeals issued an unpublished per curium decision, which addressed an issue that is likely to be lurking in a substantial number of existing shareholder agreements. In *O'Keefe v Gundle, et al*,[1] a shareholder left his business and, under a shareholder agreement, was entitled to certain value, plus a portion of "subsequent sale proceeds" in the event the company was sold within three years.

The company was sold and the plaintiff alleged that the remaining shareholders had simply taken sale proceeds and disguised them in certain side agreements and had thus unfairly defeated the intent of the shareholder agreement. The court, without explaining its reasons, ruled that the plaintiff had not offered evidence sufficient to refute the view of the transaction that these side agreements were "employment bonuses" that were contingent upon the defendant's employment with the successor corporation and thus valid. As a result, plaintiff received less than he claims he was entitled to under the shareholder agreement.

It is easy to see that employment arrangements like those in *O'Keefe* could be used to circumvent a shareholder agreement and thus deprive a shareholder of the fair value for the sale of the business. Michigan attorneys must now be sure to draft shareholder agreements as inclusively as possible to avoid hidden consideration controversies or they must be sure to establish actual evidence of hidden consideration before proceeding to trial on such a claim.

A Word About Shareholder Agreements

Shareholder agreements address many interrelated issues, but the constant theme found throughout them is the maintenance of stability. Stability is critical to both the closely held corporation and to the shareholders thereof because these enterprises normally rely upon a core group of individuals to insure their survival. The loss of one or more of the shareholders can quite literally terminate the business because they are frequently the company's key, if not only, employees. Not surprisingly, this group will want to retain control over who may obtain or transfer an equity interest in the corporation and how they go about doing it.

In order to preserve this stability, shareholder agreements almost always include a provision that restricts a shareholder's ability to transfer his or her stock. In fact, a "typical" shareholder agreement prohibits all transfers of the corporation's stock, unless the other shareholders consent. The "typical" shareholder's agreement also contains a provision that creates an "option" whereby the corporation is required to purchase a shareholder's shares upon the occurrence of certain trigger events, such as a shareholder's death or disability, the termination of a shareholder's employment with the corporation, or upon the offer of a third party to purchase shares. These provisions are essential to most closely held corporations because they allow the core personnel to regulate who is coming in and going out of the corporation. In other words, they provide stability.

Because there is often no market for the shares, it is difficult to determine the value of a shareholder's investment at any given time. Shareholder agreements deal with the valuation problem in many ways. One common technique is for one or more independent business appraisers to examine the corporation, develop a net value and then divide this value by the number of shares currently outstanding. Then, the parties can either agree to use this value, hire new appraisers to reassess the number, or arbitrate/litigate the issue.

An additional measure of protection can be obtained by including a provision whereby if the corporation is sold, then any shareholder who previously sold his or her shares back to the company, within a certain period, is entitled to receive the difference between the price he or she previously received and the share price for which the company was actually sold. The theory underpinning such a provision is that the actual price paid by a third party for the company is more indicative of its actual value than is an appraisal. While the use of such a provision might appear to create a solid barrier against bad faith dealing among the corporation and the remaining shareholders, *O'Keefe* provides an example of how this might not be the case.

The *O'Keefe* Case

In *O'Keefe,* the court considered a breach of contract claim involving a shareholder's agreement in a closely held corporation. The relevant facts of this case were typical of what happens in many closely held corporations.

In 1986, the defendant Pfeister Corporation ("Pfeister") hired the plaintiff as a controller. The plaintiff worked his way up to become both a vice-president and a director of Pfeister, at which point he became eligible to purchase Pfeister stock. The plaintiff invested in Pfeister by purchasing 50 shares of its stock in September of 1991 and another 50 shares in 1994. The plaintiff also executed a "Shareholder's Agreement." The plaintiff resigned in December of 1994 and his last day at Pfeister was January 9, 1995. Pursuant to a forced-buyback provision in the Shareholder's Agreement, the plaintiff "offered" his stock to Pfeister upon his resignation. Pfeister purchased the plaintiff's stock in two transactions for a purchase price of $978.86 per share; one transfer of 50 shares occurred on December 27, 1994 and another transfer of 50 shares occurred on January 24, 1995.[2]

About three years later, Pfeister merged with another company—Crossmark, Inc. ("Crossmark"). The Pfeister shareholders swapped shares of Pfeister stock, which they had valued at $1,154.11 per share, for shares of Crossmark stock. Crossmark also entered into certain agreements with the Pfeister shareholders that went to work for Crossmark including a "Wage Continuation Agreement," certain long-term incentive plans, and non-compete agreements (collectively the "Agreements"). These individuals also formed a company to purchase certain real estate owned by Pfeister that Crossmark did not want. Following this transaction, the plaintiff sued Pfeister and these individuals.

The plaintiff argued that he was entitled to an adjustment in the purchase price of his shares because the Shareholder Agreement provided that if the corporation underwent a "disposition" of substantially all of the company's stock or assets, then any shareholder that had sold his or her shares within the three years proceeding such a disposition would be entitled to an adjustment of his or her purchase price to reflect "an amount equal to a Selling Shareholder's

FAST FACTS:

O'Keefe appears to be a victory for form in the battle of form versus substance.

The *O'Keefe* court held that it was the departed shareholder's burden to demonstrate that compensation paid in side deals to remaining shareholders was actually disguised consideration for the sale of the company itself, even though a shareholder agreement called for inclusion of "any consideration" paid either to the company or to shareholders.

Percentage of any consideration received by [Pfeister] or the shareholders of [Pfeister]."[3] The plaintiff argued that he was entitled to receive a portion of the money paid by Crossmark as subsequent proceeds, including a consideration of the amounts paid pursuant to the Agreements and any other compensation offered by Crossmark to the defendants because this was included within the purview of the "any consideration received" language of the Shareholder's Agreement.

The plaintiff further argued that he was entitled to receive an adjustment for all 100 of his shares because the merger was created effective November 1, 1997. If true, this would mean that both of his sales occurred prior to the three-year time limit provided for in the Shareholder's Agreement. In support of his argument, the plaintiff introduced a letter authored by a Crossmark employee that indicated the Agreements were executed effective as of November 1, 1997.[4] However, the same letter indicated that the "merger" was to be effective as of December 31, 1997 and the defendants introduced the deposition of one of themselves, which supported the view that the merger was effective as of this date.

The trial court refused to consider the Agreements as being any part of the consideration for the transaction. Accordingly, it held that the plaintiff's damages could only be measured as the difference in the value of the shares from the time the plaintiff sold them to Pfeister and the time that Pfeister exchanged them with Crossmark.[5] Likewise, the trial court also held that there was no genuine issue of material fact that the merger occurred effective December 31, 1997 and it granted the defendants summary disposition on the point.[6] Therefore, the plaintiff could not recover anything for the 50 shares sold on December 27, 1994 because of the three-year limitation period in the Shareholder's Agreement.[7]

The court of appeals affirmed on both of these points.[8] The court summarily ruled that the Agreements were not consideration for the merger, but rather that they constituted "bonuses" and that they were "directed at" the continued employment of the defendants with Crossmark.[9] In doing so, the court did not address the terms of any of the Agreements. The court simply held that the defendants' view of the transaction was supported by the deposition of a Crossmark employee and noted that the plaintiff had "offered nothing to refute this."[10] The court also reasoned that the plaintiff was not entitled to any amount of the "employment bonuses" because he was never employed by Crossmark.[11] Correspondingly, the court affirmed the holding that the merger had been effectuated on December 31, 1997 and that the damages were properly limited to the difference in value as to only 50 shares.[12]

Lessons Learned

Although without binding affect, *O'Keefe* appears to be a victory for form in the battle of form versus substance. At a minimum, it holds significant lessons for both transactional attorneys and litigators.

On its face, the Shareholder Agreement in *O'Keefe* appeared to provide protection from exactly what might have, in fact, occurred. It clearly provided that if any post-distribution adjustment was to be made, that it would include "any consideration" received by either the corporation or the corporation's shareholders. This was apparently an attempt to circumvent a possible reduction of share value by the use of side agreements. However, the *O'Keefe* court did not review the side agreements that were used in the merger at all when deciding that they could not constitute any portion of the consideration thereof. In so doing, *O'Keefe* might embolden some to engage in what—from the departed shareholder's point of view—are unethical or even fraudulent transactions. For example, the shareholders of an acquisition target faced with a situation like the one in *O'Keefe* could simply agree to work as "consultants" for the surviving entity at exorbitant rates that are, in reality, compensation for the target. By framing the deal this way, they could cut out any shareholders that had recently left and might be entitled to an adjustment. As outside "consultants" the shareholders would never even be required to be hired by the successor corporation. Furthermore, the shareholders could direct the consulting fees to the entity of their choice, thereby reducing their own tax liability.

The key to the *O'Keefe* case may be the fact that it is unpublished and thus did not receive full treatment in the unpublished opinion. Moreover, the court suggested plaintiff did not present any evidence to shore up his arguments. Under appropriate circumstances, a plaintiff in a similar situation could hire a valuation expert who might opine that the value inherent in the side agreements should be considered together with the per share value in order to approximate the "real" value of the shares.

In any event, transactional attorneys should view *O'Keefe* as a clear warning that terms such as "any consideration" or "all consideration" may not be enough to protect shareholders. However, there may not be much they can do about it. Obviously, shareholder agreements must now be drafted as specifically enumerating as many possible side agreements as possible, but, in light of *O'Keefe,* the question remains as to whether a court will scrutinize such agreements closely or even at all, and whether further specificity might have led to a different result. Litigators should read *O'Keefe* to mean that a court will require actual evidence that such side agreements were intended as additional consideration for the shares in such a transaction. Generalized allegations and equitable arguments will not likely be enough to carry the day. ✦

Daniel Quick is a partner in the Bloomfield Hills office of Dickinson Wright PLLC. He concentrates his practice in business torts, including shareholder litigation, and is the co-author of Michigan Business Torts (2nd ed. 2003).

Jeff Dobson is an associate in the Ann Arbor office of Dickinson Wright PLLC. He practices in the fields of commercial, real estate, and environmental law.

Footnotes

1. 2003 WL 22462117 (Mich App 2003).
2. The plaintiff actually received less than the total amount due for some unspecified reason.
3. Id. at 1.
4. Id. at 4.
5. Id at 2.
6. Id.
7. Id.
8. See Id. at 8.
9. Id. at 5.
10. Id.
11. Id.
12. Id. at 4.