The Significance of Share Transfer Restrictions for Closely held Corporations
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While public corporations thrive on share trading in a dynamic market, private corporations often seek to restrict transfer of their shares. In particular, entrepreneurial enterprises foster the inclusion of non-management investors. These silent partners of closely-held corporations often require protective measures for their interests. Therefore, a buy-sell agreement may be utilized to define the parameters under which shareholders may transfer shares.

The parameters present in a buy-sell agreement provide obligations and place restrictions on share disposition when a shareholder leaves a business. Share transfer restrictions allow control over a transfer of shares to avoid undesirable business associates and preserve existing interests. Just as importantly, these transfer restrictions must be drafted to allow transfers in a manner to allow shareholders a market for their shares.

A buy-sell agreement is a contract among business owners or between each owner and the company. Once the agreement is executed, it becomes a part of the corporate bylaws, shareholder agreement or partnership agreement. While shareholders' agreements address broad concepts of corporate structure, buy-sell agreements contain narrow provisions that should be considered upon the occurrence of particular scenarios. For example, forced buyouts allow for a resolution to deadlocks or to remove unwanted shareholders. Similarly, buyout provisions in a buy-sell agreement might also come into effect upon the occurrence of particular events. Such a provision provides for a forced transfer of shares or an option for the other shareholders to purchase the shares.

One such event addressed in a buy-sell agreement is when an owner contemplates retiring or withdrawing from a business. An appropriate provision for this event would require the owner to first offer to sell his shares back to the remaining shareholders (or to the company) before accepting an offer from an outsider. Also, buy-sell provisions are appropriate when an outside party makes an offer for an owner's shares. That owner must first offer the shares to the company or its other shareholders on the same terms. If the insiders decline to purchase the shares, then the owner may sell to the outsider. Still yet, the death of a shareholder would prompt the company, or other individual shareholders, to purchase the deceased owner's shares from his estate. Of course, the estate would be required to sell those shares to the company.

Another event that is accounted for when drafting a buy-sell agreement is when a shareholder has a spousal separation. Again, the avoidance of unwanted business associates is accomplished if the shares are subject to forced transfer to the company or the remaining shareholders under these circumstances. Finally, a couple of financial situations that a business may encounter underline the significance of share transfer restrictions. If a business' ongoing financial needs prompt additional contributions from a shareholder or when a shareholder faces insolvency (bankruptcy), the company might realize that the shareholder in question is not able to contribute further to the company or the shareholder's shares are subject to seizure from creditors. Thus, it would be wise for share transfer provisions to be present in a buy-sell agreement for these occasions.

Another important consideration is when a closely held corporation elects to be taxed under Subchapter S of the Internal Revenue Code. To preserve S-Corporation status, a buy-sell agreement for a C-Corporation might not be adequate and the agreement must be tailored for a S-Corporation. A S-Corporation election would be terminated if a shareholder transfers shares to a corporation, certain trusts or a partnership.

Another caveat with S-Corporation agreements is the prevention of any breach of the agreement. While share transfer restrictions will limit how or to whom a shareholder's interest may be transferred, other provisions might be desirable. These additional provisions would assert 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 prior to the breach; and that the occurrence of an attempted breach automatically vests title of the shares in the corporation. Additionally, practitioners may also utilize liquidated damage provisions to help deter the occurrence of a breach.

The presence of share transfer restrictions should also provide a mechanism for establishing a fair price for the shares. There are as many methods of setting the purchase price of shares, as there are members of the Illinois Bar. The facts and circumstances of the business operations should dictate the method employed in setting a fair price. The important thing is to have a pricing method in place before the need arises.

For reference, please note the following relevant Illinois statutes that provide validity to share transfer restrictions contained in buy-sell agreements. In fact, Illinois law imposes share transfers restrictions on an entity that incorporates in the form of a Close Corporation. 805 ILCS 5/1.80(s) states: "Close corporation" means a corporation organized under or electing to be subject to Article 2A of this Act, the articles of incorporation of which contain the provisions required by Section 2.10, and either the corporation's articles of incorporation or an agreement entered into by all of its shareholders provide that all of the issued shares of each class shall be subject to one or more of the restrictions on transfer set forth in Section 6.55 of this Act."

As a point of interest, in *Edmonton Country Club v. Case* [1975] 1 S.C.R. 534 it was held that even with a presumption that shares are freely transferable, a transfer of shares can be restricted. So long as there is no absolute restriction on transfer, share transfer restrictions are generally valid.

Without an agreement restricting share transfers, corporate shares would be freely transferable and prevent the remaining shareholders from maintaining a desirable ownership structure. The provisions drafted in buy-sell agreements allow shareholders to control ownership and create a market for shares that are otherwise likely to be illiquid.

Consequently, buy-sell agreements allow for a smooth transition after the occurrence of the aforementioned situations.