

Place Controls on Who Owns Your Company Stock

How would you like a 10 percent minority owner in your company to give two percent of his ownership to each of his five children? Or, your daughter's divorced husband owning part of your company? Or, a creditor becoming a stockholder? Or, someone you never met getting shares of stock in your business?

When either you *or* your company (be it a regular C or S corporation, partnership or limited liability company) sell or transfer any ownership position through a sale, gift or option; be sure the buyer (or recipient) represents that the stock *is being acquired or given for investment purposes only*. Also, stipulate that the shares cannot be sold or transferred without complying with the rules of the Securities and Exchange Commission and applicable state laws. Use the following precautions to protect yourself and your company.

Precaution #1. An investment agreement should be prepared and executed that specifies all of the terms, restrictions, and conditions of the stock sale, transfer, gift, or option to buy stock.

Precaution #2. The investment agreement should grant to both you (as owner) and your company a right-of-first-refusal before shares can be sold or transferred.

Precaution #3. On the face of the actual stock certificate issued, print a legend alerting any potential buyer of the following:

- a. The shares of stock are subject to an investment agreement.
- b. The shares cannot be sold, encumbered, gifted, or otherwise transferred except as stipulated in the investment agreement and in full compliance with the Securities Act of 1933 and applicable state laws.

Precaution #4. Include in the investment agreement that even in the event that right of first refusal rights may go unexercised from time to time, all shares held by any buyer (no matter how such shares were acquired or received) will be bound by the investment agreement and by the written legend on the stock certificate.

Precaution #5. Indicate in the agreement that the stock *cannot* be encumbered, e.g., used as collateral for a loan. That way, you eliminate the risk that the shareholder's creditor becomes an owner via a foreclosure on the collateral.

Remember, these precautions also apply to stock option agreements with key executives, as well as gifts of stock to your children. *Why?* That executive or family member may get divorced and you could wind up with his or her ex-spouse as a disgruntled and troublesome minority owner.

The final message: Get good legal advice before selling, transferring, or giving options on any ownership position, including warrants and convertible securities sold to investors to raise capital for your business. And, if you now have minority owners, check with your lawyer to be sure their stock or stock options comply with the above precautions.