SELLING CORPORATE SHARES – BE CAREFUL

One of the touted advantages of owning a corporation is the ease in transferring shares. In many cases, this assumed benefit is simply wrong.

Transfer Shares

According to “experts”, using a corporation has one bid advantage over other entities. The advantage is the ability to freely transfer shares without impacting the business or viability of the corporate structure. Consider the following example.

If I own a 60 percent interest in a general partnership, I can’t just sell it to someone else. In most states, the transfer of more than 50 percent of an interest in a partnership automatically terminates it. With a corporation, however, there is no such prohibition.
Instead, I am free to transfer shares without restriction and the business just purrs along without any interruption.

As with many assumptions, the “free transferability” assumption runs into problems in the real world. This is particularly true if the corporation has entered into contracts with other large companies.

Accidentally Terminating Contracts

State laws govern the formation and running of most business entities. These laws, however, do not trump general contract law. Instead, deference is given to the terms two or more parties agree upon in the formation of a contract and this is where the free transferability experts fall on their faces.

In our modern economy, a majority of companies will require language in a contract stating that any transfer of more than “xxx” percentage of shares automatically voids the contract between the parties. The reason for this is parties want to know whom they are doing business with at all times. Assume I want to do business with a corporation that has three engineers who are the best in their field. I don’t want to sign a five-year contract with them only to see the three engineers sell their shares and leave the company during the term of the contract. In requiring the language restricting share transfers, I am making sure I will benefit from their expertise.

Many shareholders in small businesses fail to take into account share restriction language in contracts. Instead, they go out and sell their shares to a third party with dreams of retirement on a white beach somewhere. They are more than a little surprised when served with a lawsuit by the share buyer who is angry because a number of contracts for the corporation have been terminated. In Seinfeld terminology, “No white beaches FOR YOU!”

Before you get excited about selling your shares in a corporation make sure you check the language of all contracts with third parties. You don’t want to have to come back from that white beach.