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Shareholder and LLC Member Rights

*Drafting, Disputes &
Dilemmas*

Thursday, March 13, 2014

Introduction

- **Yep, we are in Delaware.**



Overview

- **Typical provisions in Shareholder Agreements**
- **Special provisions for LLCs**
- **Cases**



What is a Shareholder Agreement?

- **Flexible contract among Shareholders, when they are on good terms with each other, planning for certain circumstances**
- **Provides for rights in addition to statutory protections**



Who needs a Shareholder Agreement?

- **Not required – Shareholders have protections under corporate statutes without any further action**
- **LLC Members have limited protections under LLC statutes**
- **Think about difficult issues now rather than later**

How does SH Agreement Work?

- Typically the Shareholder Agreement terms bind to the shares – if shareholder transfers stock – the restrictions will stay with the shares
 - *Transferee shareholder will be bound*
- Make sure any new Shareholder – through a new issuance of stock from the Company – signs joinder to Shareholder Agreement

Overview of Typical Provisions

- **Management/Information Provisions**
 - Representation on Board
 - Special Approval for certain actions
 - Informational Provisions
- **Preemptive Rights**
- **Transfer Restrictions**
 - Drag
 - Tag
 - Right of First Refusal/First Offer
- **Resolving Deadlock**
- **Modification and Elimination of Fiduciary Duties**

Overview – Management Provisions

- Board of Directors Representation
- “Observer” Status
- Special Approvals



Board of Directors - Representation

- Shareholders with a meaningful investment in the Company will typically want to ensure their own representation on the Board
 - *Influence management*
 - *Ensure access to information*
- May want to also set number of Directors to maintain influence

Board of Directors – Observer Status

- If Shareholder can't get a Board "seat," consider "Observer" status on Board if your ownership is small
- Observer typically gets invited to attend all meetings of the Board in a non-voting capacity and copies of all notices, minutes, consents and other Board documents that it provides to the members of the Board
- Consider including a provision so that the Board can refuse to provide information/access for reasonable purposes
- Need to include confidentiality for such observer

Board of Directors – Special Approval

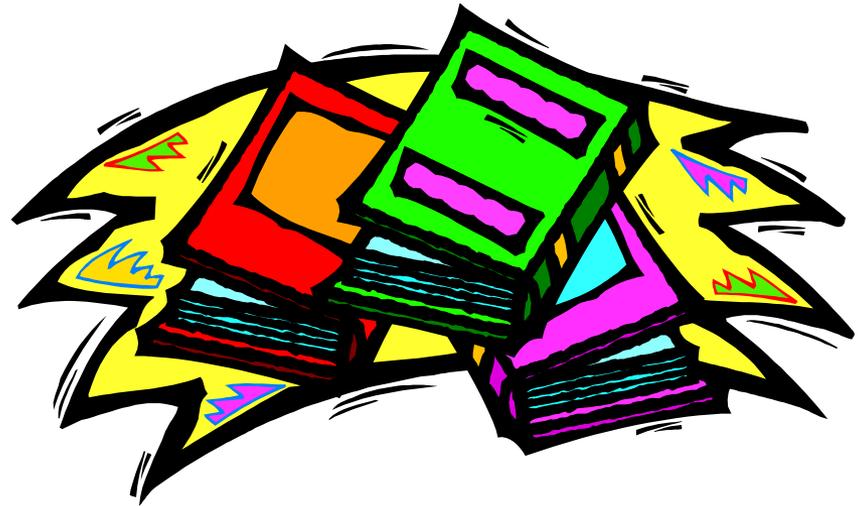
- Shareholders may want to limit the Board's statutory authority to act by imposing additional requirements on the Board in the form of special approval provisions
- Special approvals can be:
 - *Unanimous act of the Board,*
 - *Supermajority act of the Board, or*
 - *Shareholder consent*
- Special Approvals can provide minority shareholders with disproportionate power in matters that can directly impact the value of their investment in the Company

Board of Directors – Special Approval

- Examples of special approval triggers:
 - *Fundamental changes to purpose of business*
 - *Financing and pledging of assets*
 - *Additional stock issuance*
 - *Mergers or acquisitions*
 - *Expenditures over a certain dollar threshold.*
 - *Adoption of budget or business plan*
 - *Compensation to employees*
 - *Material change in dividend distribution*

Overview – Information Rights

- Statutory Information Rights
- Additional Access to Books and Records
- Covenants of the Company



Information Rights - Statutory

- Under §13.1-771A :

A shareholder of a corporation is entitled to inspect and copy, during regular business hours at the corporation's principal office, any of the records of the corporation described in subsection E of 13.1-770 [charter, bylaws, minutes of shareholder meetings, written notices to shareholders] if the shareholder gives the corporation a signed written notice of the shareholder's demand at least five business days before the date on which the shareholder wishes to inspect and copy.

- Additional records may be obtained under §13.1-771C if the demand is made in “good faith and for a proper purpose”
- Statutory provisions do not contain much information and can be costly and slow to produce

Information Rights – Contractual

- Consider a provision where the Shareholders agree to receive additional information about the Company outside of statutory provisions:
 - *Access to Management or Company's advisors*
 - *Automatic financial statements*
 - *Shareholder/stock ledger lists*
- Shareholders would need to be bound by certain confidentiality terms
- Would also want to include language where the Company can withhold certain information if there is a reasonable reason

Information Rights - Covenants

- Consider including covenants of the Company:
 - Require CPA to prepare financial statements
 - “Complied,” “reviewed” or “audited” standard
 - Require quarterly or monthly reports
 - Require certain levels of insurance
 - Require notice to be given of certain events (loss of contract, litigation)

Overview – Preemptive Rights

- Statutory Preemptive Rights
- Contractual Preemptive Rights
- Other considerations

Preemptive Rights – Statutory

- Preemptive rights provide shareholders with the opportunity to purchase additional shares of the company so as to avoid dilution
- Under Virginia law, the Shareholders of a corporation incorporated on or before December 31, 2005 have preemptive rights to acquire proportional amounts of a corporation's unissued shares upon the decision of the board of directors to issue them, unless such rights are limited or denied in the corporation's articles of incorporation

Preemptive Rights – Contractual

- If preemptive rights are desired by the Shareholders, drafting can become very complicated;
 - Could only cover issuance of the same securities – so you would exclude different securities (only covers common stock, not non-voting preferred)
 - Could only cover new securities (non-voting preferred)
 - Only becomes triggered after a certain quantity of options are issued
 - If all the new shares are not subscribed for, who can buy the other shares?

Preemptive Rights – Other Considerations

- Consider that – for corporations - preemptive rights may belong in the charter document if preemptive rights will cover all the shareholders. Delaware law will find Shareholder Agreement provisions enforceable.
- Consider that preemptive rights will cause costly delays to future share issuances.

Overview – Transfer Restrictions

- Generally
- Drag Along Rights
- Tag Along Rights
- Right of First Refusal/Right of First Offer
- Redemption



Transfer Restrictions – Generally

- Typically used to ensure that the Shareholders don't unwittingly become co-owners with an unknown or undesirable replacement shareholder
- Restrictions must be in writing
- Must be listed ON THE SHARES (UCC §8-204) (§13.1-649B)
- Cannot be absolute
 - law tries to balance corporation's desire to limit transfers for a legitimate purpose with public policy considerations of transferring property.
 - In Delaware, restrictions must be reasonably necessary to advance the corporation's welfare (DGCL §202)
 - In Virginia, restrictions must be for a reasonable purpose (§13.1-649C)
- Transfers to certain family members or an affiliate, or for estate planning are typically "Permitted Transfers"

Transfer Restrictions – Drag Along

- *Drag Along Rights*
 - Provisions that give a party the power to force a sale of all of the shares of the Company
 - Effectively grants an option to the holder to sell all of the Company without getting specific approval from the other shareholders
 - Gives a majority – or minority owner – power to liquidate their assets in the future
 - Good for Exit strategy planning

Transfer Restrictions – Tag Rights

- *Tag-Along Rights*
 - Provisions typically require that a shareholder who proposes to sell his shares offer the other shareholders an opportunity to sell a pro rata portion of their shares to the same purchaser on the same terms and conditions
 - Typically a minority protection
 - Minority shareholders are not “left behind”
 - Minority can participate in a “control” premium if a controlling ownership position is sold

Transfer Restrictions – Right of First Refusal

- Right of first refusal (ROFR) or a right of first offer (ROFO) gives the shareholders rights over any stock that another Shareholder seeks to transfer
 - A ROFR requires the transferring shareholder to have first received an offer from a bona fide third party
 - A ROFO involves one shareholder (the offeror) offering the shares to the other shareholders at a set price. If that other party does not accept, the offeror is free to sell the shares for at least that price for a specified period of time

Transfer Restrictions – Redemption

- A Provision for the mandatory redemption of shares by the Company at a certain triggering event will preserve the continuity of ownership of the Company.



- Triggering events:
 - Death
 - Termination of employment
 - Bankruptcy
 - Incapacity
- Considerations:
 - Timing
 - What is the repurchase price?

Overview – Resolving Deadlock

- Drafting mechanisms
- Judicial dissolution
 - Corporations
 - LLCs



Exit Strategies – Deadlock Drafting

- Shotgun provisions
 - When shareholder wants to get out, she makes an offer to the other shareholders. Either the other shareholders buy her out at that price, or she buys out the other shareholders
- Texas Shoot-out
 - Parties provide sealed purchase prices to a neutral party and highest sealed “bid” wins and buys out the other shareholders at the bid price
- Dutch Auction
 - Parties send in a sealed bid for the lowest price for which they would sell their shares. The highest “bid” wins and gets to buy the other party for their low price.

Exit Strategies – Dissolution - Corp

- What if Shareholder Agreement is not effective to resolve deadlock?
- Pursuant to § 13.1-747 of the Virginia Stock Corporation Act, the court may dissolve a corporation if it is established that:
 - The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock.

Exit Strategies – Deadlock - LLCs

- What about LLCs?
- Pursuant to §13.1-1047 of Virginia's LLC Act, the court may decree dissolution of a limited liability company "if it is not reasonably practicable to carry on the business in conformity with the articles of organization and any operating agreement."
- Under Section 18-802 of the Delaware LLC Act, Delaware Courts will grant judicial dissolution if the purpose for which the LLC was created no longer exists or can no longer be achieved
- Does the LLC Agreement contemplate judicial dissolution? In Delaware, without language in LLC Agreement, Court may not dissolve LLC

Overview – Modification of Fiduciary Duties

- Fiduciary duties generally
- Fiduciary duties owed to minority shareholders
 - *Corporations*
 - *LLCs*



Fiduciary Duties

- Directors owe two duties to a corporation and its stockholders:
 - Duty of Care, and
 - Duty of Loyalty
- In Virginia - directors are required to discharge their duties to the Company in accordance with his good faith business judgment of the best interests of the corporation (VSCA 690(A))
- In Delaware – directors discharge their duties to the Company in good faith, with the care an ordinarily prudent person would use in similar circumstances, and in a manner they reasonably believe to be in the best interests of the Company.

• Fiduciary Duties for Shareholders?

- Under Delaware law, “a shareholder owes a fiduciary duty [to minority shareholders and the corporation] only if it owns a majority interest in or exercises control over the business affairs of the corporation.” Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110 (Del. 1994)
- However, the fiduciary obligation of a controlling shareholder “does not require self-sacrifice.” Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970)
- In Virginia shareholders have “the right to be treated fairly by the corporate officers and directors in accordance with the officers’ and directors’ fiduciary duties.” Colgate, et al. v. The Disthene Group, Inc. (August 30, 2012, Case No. CL-11-117, Buckingham County)

Fiduciary Duties for LLCs

- Delaware – “The rules of law and equity, including the rules of law and equity applying to fiduciary duties ... shall govern” (§18-1104)
- Virginia – “A manager shall discharge her or its duties as a manager in accordance with the manager’s good faith business judgment of the best interests of the limited liability company.” (§13.1-1024.1)
- To whom is duty owed?
 - Virginia Managers owes fiduciary duty to the LLC – not the individual members. Individual members would not be able to bring direct actions against Managers, only derivative actions (*Remora Investments v. Orr*, 277 Va. 316 (2009)).

Elimination of LLC Fiduciary Duties

- Pursuant to §1101(c) of the Delaware LLC Act:

To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

Elimination of LLC Fiduciary Duties

When would you modify or eliminate fiduciary duties?

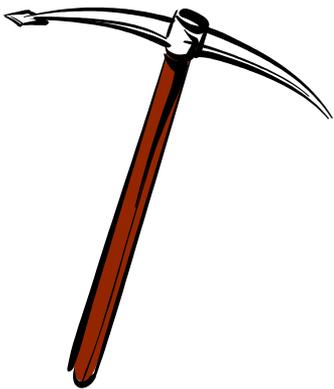
- Eliminate corporate opportunity issues – majority owners can go after other corporate opportunities
- For an LLC, if you have a joint venture – two other entities forming an LLC for a specific purpose – you can have each entity appoint a manager whose loyalties are to the appointing Member and not the LLC
- Elimination of the unpredictability resulting from traditional corporate fiduciary duties

What does it mean to eliminate fiduciary duties?

- Under Delaware law the one duty the parties to an LLC cannot waive is the duty to act within the covenant of good faith and fair dealing. (§18-1101(c)) - cannot go below the “floor”

Scenario I

- Family business is to operate a mining company (“Mineco”). Ownership of Mineco’s stock is split between brother and sister. Sister dies leaving two children of her own. Brother promises on sister’s deathbed to take care of sister’s children (“Minority Owners”)
- Brother proceeds to oppress Minority Owners of Mineco
 - » Provides himself and his son with excessive salaries
 - » Denies jobs to Minority Owners
 - » Cuts amount of dividends
 - » Uses corporate assets for personal use
 - » Misrepresents value of stock when redeeming minority interests
 - » Denies Minority Owners meaningful corporate records



Scenario I - Cont.

- Minority Owners sue alleging that Mineco should be dissolved because Brother has engaged “in a pattern of oppressive and fraudulent conduct designed to disadvantage the minority shareholders...” and wasted corporate assets
- Virginia Court finds that Minority Shareholders have rights – however limited they may be - and should those right be denied, the Minority Shareholders have the right to seek legal recourse
- Dissolution of Mineco is ordered as the appropriate remedy

Scenario I - Drafting Solutions

- Drafting solutions?
 - Requirement for Board Representation
 - Requirement for consent to employment/salary of shareholders/directors and suppression of dividends
 - Procedure to determine FMV of minority shares

Scenario II

- Family construction business (“Constructco”) where a minority owner (son of majority owners) wants to buy out non-family member
- Because of ROFR provision, Son can’t buy his parent’s stock. Son resigns employment with Constructco and starts his own business. First task, submit an offer to purchase assets of Constructco
- Non-family member eventually submits offer to purchase the assets of Constructco for at least \$600k more than Son’s offer
- Son’s offer is accepted by both Board of Directors and Shareholders



Scenario II - Cont.

- Non-family member sues claiming that:
 - *Directors of Constructco breached their fiduciary duties in approving sale to Son*
 - *Sale to Son was a conflict of interest transaction*
- The Virginia Supreme Court affirmed the Circuit Court decision dismissing all claims finding that the evidence clearly demonstrated that defendants, as directors of Constructco, engaged in an informed decision making process that produced a defensible business decision
- No “Revlon Duties” in Virginia

Scenario II - Drafting Solutions

- Consider additional “Exit” strategies, not just ROFR
 - Mandatory redemption at retirement or some time period
 - Require Board seat with veto over sale of substantially all of the assets of the Company
- Use LLC structure to specifically outline or eliminate duty of loyalty issues

Scenario III

- Home improvement celebrity (“Villa”) entered into an agreement with non-celebrity (“Hill”) to form a Delaware LLC (“Homeco”) and offer home improvement advice on-line
- Homeco was owned 49% by Villa, 49% by Hill and 2% by a separate trust, with Villa and Hill the sole Managers
- Homeco’s LLC Agreement required consent of both managers to implement a business strategy – so when Villa and Hill disagreed over the operation of Homeco – either to expand or to maintain status quo - they became deadlocked
- Homeco’s LLC Agreement was silent regarding deadlock procedures and Villa petitioned the Delaware Chancery Court for dissolution



Scenario III – Cont.

- In ruling for a dissolution of Homeco, the Chancery Court found that Hill had been able to take unilateral authority over Homeco and implement a business strategy Villa opposed through the deadlock
- Because the LLC Agreement required unanimous consent of the Managers to approve a business strategy, the Court found it was not reasonably practicable to continue to operate Homeco

Scenario III – Drafting Solutions

- Drafting solutions?
 - Include Deadlock provisions
 - Appoint a third Manager
 - Include redemption provision for Company or other Member to buy out dissenting Member

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