Stockholders' Agreements Line by Line

A Detailed Look at Stockholders' Agreements and How to Change Them to Meet Your Clients' Needs

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For additional copies or customer service inquiries, please e-mail west.customer.service@thomson.com.

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CONTENTS

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CONTENTS

Introduction

Forming a new venture, or financing an existing enterprise, typically involves several parties—founders, management, majority or minority equity investors, lenders, etc.—with varying and often divergent interests on a range of topics. In this book, we discuss in practical terms a variety of ways in which these parties can contract among themselves to resolve issues that arise commonly in the formation or continuation of a closely held private corporation.

Why a Corporation?

Investors form and invest in corporations primarily because they desire limited liability. Limited liability is a bedrock principle of modern investing, providing that, absent limited extenuating circumstances, an investor in a limited liability entity will be liable only to the extent of its investment. Without such assurances, the creditors of a business could have recourse to an investor's assets beyond its investment in the enterprise. As a matter of policy, the legislatures in all fifty states have concluded that allowing parties to limit their recourse in this manner helps promote innovation and capital deployment and have adopted statutes permitting the formation of limited liability entities.

Of course, a corporation is not the only form of entity that affords investors limited liability. Limited partnerships, for example, have been popular investment vehicles, especially in businesses that incur significant taxable losses, resulting from depreciable assets or otherwise, that can be passed through to the limited partners and potentially taken as a loss on such limited partners' tax returns, subject to certain limitations. In recent years, limited liability companies, or LLCs, have overtaken corporations in many states as the most popular form for organizing a new privately owned venture, because LLCs allow for many of the tax benefits of a partnership, can be structured in a manner similar to a corporation, and often are subject to less rigid statutory requirements and governance considerations than a corporation.[1]

Corporations remain useful and relevant for several reasons, including tax considerations, regulatory restrictions and, in some cases, the familiarity and apparent simplicity of corporations. Some early stage ventures, operating on a limited budget, might feel compelled to choose a corporation rather than a limited liability company on the basis that a corporation appears to be simpler to understand, the relevant statutes under which they are formed provide clearer rights and remedies and the existence of more readily accessible precedent documents. However, we believe the greater contractual flexibility, and opportunity for tax efficiency, of limited liability companies in many circumstances should afford clients a better alternative.

Even a cursory discussion of the issues that might lead the parties to a new venture to choose a particular form of entity is beyond the scope of this volume. Accordingly, we start with the simple premise that, for whatever reason, the participants in a venture have chosen to form a corporation to carry out a business plan.

Note, however, that the principles discussed in this book would apply in most respects to these other types of entities. The resulting contractual terms might be reflected in an operating or partnership agreement, as applicable, rather than a separate security holders agreement, although we also on occasion see parties memorialize some of the agreements among the members or partners in an LLC or partnership, as the case may be, in security holders agreements separate and apart from the operating or partnership agreement.

Why Enter into a Stockholders' Agreement?

Stockholders in a corporation typically use a stockholders' agreement to establish the understanding among them, and often times the corporation, regarding their respective rights and roles in the corporation's governance,

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[1] *See* Rodney O. Chrisman, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed In the United States Between 2004-2007 and How LLCs Were Taxed For Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459-489 (2010). In Delaware, more than 75 percent of new entities formed in 2007 were limited liability companies, and newly formed corporations outnumbered LLCs in only four states.

special approval rights, information and access rights, transfer rights and restrictions and participation rights in future capital raises and sale transactions. These rights and obligations are intended to complement the rights and obligations mandated by the corporation laws of the state of incorporation or, in some cases, the rights and obligations set forth in the corporation's certificate or articles of incorporation as filed with the secretary of state of the state of incorporation. The nomenclature varies from state to state, but, throughout this volume, we refer to these formation documents as the corporation's "charter."

A state's corporation statute creates the framework for the parties to form a corporation, and in many cases, the corporation statute will provide default rules as to the relationship among the corporation's stockholders. However, all corporation statutes, in varying degrees, are permissive statutes—allowing the parties, for the most part, to choose among themselves how the corporation will conduct its business. In some cases, a corporation statute might not provide any guidance as to how certain matters are to be dealt with. In other cases, the corporation statute might provide an answer that does not adequately address the expectations of the stockholders. For example, how should strategic decision-making be handled? When can an investor expect to exit its investment, and when and on what terms are new investors permitted to be brought into the enterprise? Stockholders employ stockholders' agreements to establish these and other rights that are above and beyond the rights inherent in the shares they own under applicable state law, and to ensure that the benefits of such rights are obtained.[2]

Many of the questions raised among the stockholders in negotiating a stockholders' agreement regarding governance rights, transfer restrictions and participation in future capital raises or sale transactions could be answered in a corporation's charter. However, more often than not, the stockholders in a closely held corporation will choose to address these topics outside the corporation's charter for several reasons. First, there is the issue of confidentiality. Private corporations typically wish to remain exactly that—private. A corporation's charter document is filed with the secretary of state in the state of incorporation and is accessible by anyone

[2] Corp. Law Comm. of the Ass'n. of the Bar of the City of New York, *The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*, 65 BUS. LAW. 1153, 1155 (2010).

who is interested. A stockholders' agreement for a closely held corporation typically would not be disclosed publicly.

Precedent is a related concern. The terms and conditions of stockholders' agreements typically are the result of extensive negotiations among the parties to the agreement, and a major controlling investor, or any stockholder for that matter, might be compelled to make concessions to another stockholder that it would prefer not become public knowledge or the source of discussion or explanation on its next deal. Keeping such terms and conditions in a confidential stockholders' agreement reduces the risk that adverse precedent will come back to haunt an investor.

A separate contract among the parties that is not prescribed by or subject to statutory requirements also affords the parties greater flexibility, including the ability to modify its terms over time. Certain provisions, if adopted through a charter, may only be adopted in the manner provided for by statute, whereas those same matters, when addressed through a stockholders' agreement, may be treated in a more nuanced fashion. In addition, any amendment to the charter of a corporation must be achieved through a statutorily prescribed process, possibly requiring a meeting of stockholders, while amendments to contracts generally will be governed only by the terms of the contract itself. Finally, the consequences of an adverse outcome in a dispute over a stockholders' agreement—*i.e.*, a contract breach and the resulting remedies negotiated among the parties—should be more manageable, with the potential greater for settlement short of a final judicial determination. In contrast, failing to comply with terms set forth in a charter document could give rise to a claim that a corporation exceeded its prescribed authority and might be more difficult to resolve or cure without the support of possibly all stockholders.[3]

By relying on a stockholders' agreement, rather than charter provisions, the parties leave for themselves the ability to craft the intended consequences

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[3] If a corporation breaches a charter provision, any stockholder, not just those who are a party to a stockholders' agreement, might allege that the actions were *ultra vires*, a Latin term translated literally as "beyond the powers." Under Section 124 of the Delaware General Corporation Law (the "DGCL"), a corporation's lack of authority will not necessarily invalidate its actions. However, such lack of authority may be asserted in a stockholder action to enjoin such actions if the court deems such remedy to be equitable. DEL. CODE ANN. tit. 8, § 124 (2011).

of a breach. This topic often is overlooked in the negotiation of covenants and restrictions in a stockholders' agreement. What should happen if a party to the agreement fails to comply with a covenant? In many cases, money damages are difficult to prove, or might not be known for years, and often, equitable remedies are not much more appealing. Throughout this volume, we attempt to focus on the importance of addressing the intended remedies in the course of negotiations and understanding their inherent limitations.

Our Approach

The stockholders' agreement included in Appendix A in its entirety and excerpted in the sections that follow is not intended as a model agreement. You can access form stockholders' agreements from several reliable sources.[4] Instead, we have chosen to look at a negotiated stockholders' agreement entered into in connection with the acquisition of an interest in a target business. The agreement is by no means perfect, which makes it useful for our purposes. You should use the provisions in this agreement as precedent in the same manner as any precedent document, with a judicious amount of skepticism and attention to the particulars of your own situation.

Please note that we did not represent anyone who was a party to this particular agreement, and we offer no opinion on who fared best in this negotiation. In a few places, we exercised a bit of editorial license and added or deleted provisions where it served our purposes. By and large though, the stockholders' agreement in this volume should provide a good basis to explore the types of unvarnished outcomes that often occur in a transaction.

Where we felt it helpful or appropriate, we described the types of modifications that often are sought by one party or another, including an explanation for why a party might prefer that such provisions be modified. We did not attempt to outline every single provision that one might find in

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[4] For example, a task force of the Business Law Section of the American Bar Association is working on an annotated model shareholders agreement as of the date of publication of this book. Also, *see Investor Rights Agreement, Model Legal Documents*, NAT'L VENTURE CAPITAL ASS'N., (last updated Feb. 2011), http://www.nvca.org/index.php ?option=com_content&view =article&id=108&Itemid=136; *Stockholders Agreement (Two-party)*, PRACTICAL LAW CO., http://uscorporate.practicallaw.com/1-385-5108?q=& qp&qo=& qe= (last visited Aug. 17, 2011).

a stockholders' agreement. Rather, we adhered to the "80/20 rule" and attempted to provide insight into the provisions we encounter most frequently. Also, where appropriate, we included some discussion on how these provisions might differ where no one stockholder held a controlling interest, such as in a prototypical venture capital investment, as well as in other limited liability entities, most often limited liability companies.

One topic we avoided entirely is registration rights, which generally provide one or more stockholders or groups of stockholders with the right to demand that the corporation register, under applicable federal and state securities laws, the shares held by these stockholders in order to permit increased transferability of the shares. Registration rights are a discreet topic often, but not always, addressed in an agreement separate from the stockholders' agreement. In many cases, such rights may not apply to all stockholders. More substantively, a meaningful discussion of registration rights would require a detailed discussion of the registration and underwriting process, and the laws, rules, and regulations that apply to such process, and probably would justify its own book.[5]

The Players

The sample stockholders' agreement was entered into in connection with the funding of an acquisition by a wholly owned subsidiary of the aptly named "XYZ Holding Corporation," a Delaware corporation that we refer to as the "Company" in this volume.[6] The Company contributed capital to its wholly owned subsidiary to finance the acquisition at issue. The Company raised this capital by borrowing money from a group of lenders

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[5] *See* Carl W. Schneider, *Registration Rights Agreements – Variables and Practical Considerations*, Pennsylvania Corporate Forms and Practice Manual. § 36 (2010); *What Are Registration Rights?*, PRACTICAL LAW CO., http://usfinance.practicallaw.com/3-386-4395?source=relatedcontent (last visited Aug. 17, 2011).

[6] We chose a Delaware corporation, and focused to a large degree on Delaware law, because Delaware is the jurisdiction most frequently selected for incorporation. Many practitioners favor Delaware because they perceive its corporation statute to be more permissive and flexible in its approach to governance than the corporate laws of other states. There also is a large body of legal precedent spanning a variety of legal issues, and an efficient, streamlined judicial process overseen by Delaware's Court of Chancery and its Supreme Court, which are widely viewed as experienced, sophisticated and unbiased with respect to matters of corporate and contract law. *See* Leo E. Strine, Jr., *The Delaware Way: How We do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673 (2005).