

# INSIGHTS

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## MERGERS AND ACQUISITIONS

### Protecting the Rights of Minority Shareholders in Privately-Owned Companies

*Minority shareholders in privately-owned companies often enter into contractual arrangements with majority shareholders concerning corporate governance rights. A contract alone, however, may not serve as an adequate shield for a minority shareholder. Practitioners should pay great care to properly effect and secure agreed corporate governance rights to deter subsequent manipulation by a majority shareholder.*

by **Stephen D. Bohrer**

The inherent vulnerable position of minority shareholders in privately-owned companies can lead to wily majority shareholders circumventing bargained-for-rights granted to the minority shareholders, unless comprehensive safeguard measures are utilized for the benefit of the minority shareholders. By owning less than a controlling interest of a company's voting capital, the vulnerability of minority shareholders stems from their inability to appoint members to a company's board of directors or influence actions submitted to the shareholders for approval. Majority shareholders, therefore, can use their share ownership power to exclude minority shareholders from corporate management

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and economic return. Nevertheless, the taking of a minority ownership position in a company by sophisticated investors is common practice, and is becoming even more widespread in connection with the rise in joint venture, strategic alliance and merger and acquisition activity.

Strategic and financial investors often are willing to take minority equity ownership positions in target companies for a variety of reasons, such as to gain an initial foothold in a company to determine whether a subsequent complete takeover is appropriate, obtain access to new technologies, markets, or projects in exchange for a "token" capital infusion, or allow the existing owner-managers to use their knowledge to operate the business while the minority investor provides expertise or capital in a cost efficient manner. For example, a minority investment in a company could provide the investor with a method to contribute development funding without incurring an expense on its own financial statements under US generally accepted accounting principles.<sup>1</sup> Strategic and financial investors are not blind to the risks of abuse and unscrupulous control that the existing majority shareholders may exert, and often request various corporate governance rights in order to protect their investment.

The corporate governance rights that minority shareholders most often seek to obtain from majority shareholders relate to the ability to: (1) appoint members to the board of directors; (2) influence the outcome of certain corporate actions; and (3) restrict transfers and acquisitions of shares. With

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proper planning and the implementation of certain techniques, minority shareholders can effectively preserve their agreed upon corporate governance rights and guard against oppressive measures adopted by majority shareholders who attempt to frustrate these provisions. A minority shareholder may need to take proactive measures to protect its bargained-for-rights since state corporate laws may not provide an impenetrable wall.

## State Corporate Law Protection

In general, there are two theories of liability under state corporate law that a minority shareholder in a privately-owned company may look to when countering an abusive action: (1) a breach of fiduciary duties owed by the board of directors, and (2) a breach of fiduciary duties owed by the majority shareholder. However, relying on state corporate law to protect the corporate governance rights of a minority shareholder could be a fruitless exercise and may leave the disgruntled minority shareholder with little to no relief.

**Director Fiduciary Duties.** Minority shareholders will encounter varying degrees of success when making a claim that they have been unfairly treated due to a breach by directors of their fiduciary duties owed to minority shareholders. State corporate law generally requires that the business and affairs of a corporation be managed by the board of directors. Directors are normally required to act in good faith and in a manner reasonably believed to be in the best interests of the corporation.<sup>2</sup> While each state may interpret this standard with a slightly different nuance, the foregoing standard is often interpreted to require a director to act prudently (generally referred to as the *duty of care*) and in the best interests of the corporation and all of its shareholders, rather than in the director's self interest (generally referred to as the *duty of loyalty*), with an overarching duty to always act in good faith. A director's satisfaction of the duty of care is usually evaluated under what is commonly termed the "business judgment rule," which is a rebuttable presumption that a director's decisions are informed and rationally undertaken and a court should not second-guess a board's decisions unless there are facts or circumstances that warrant the removal of this shield.<sup>3</sup>

Outside a change of control transaction or dealings with a real or potential conflict of interest, director fiduciary duties are not necessarily geared toward protecting the rights of minority shareholders. Although director fiduciary duties could provide relief to a minority shareholder in egregious circumstances (e.g., the subject company merging with an affiliate of the director on unfavorable terms to the subject company), a minority shareholder would most likely wind up empty handed if it makes a claim that it was unfairly prejudiced by the actions of the board of directors in a decision relating to the day-to-day operations of the company (such as the approval of an excessive capital expenditure plan or the entry into a new material contract against the wishes of the minority shareholder) because the board's duty of loyalty is normally to all of the shareholders and not the special interests of a few. The minority shareholder would need to demonstrate how its special interests are actually the best for all shareholders of the subject company, which could be a Herculean task.

**Majority Shareholder Fiduciary Duties.** There is no uniform view under state corporate law on whether majority shareholders in their capacity strictly as shareholders owe a specific set of fiduciary duties to the minority shareholders.<sup>4</sup> Most notably, Delaware has expressly declined to recognize any direct fiduciary duty owed by majority shareholders to the minority shareholders. In *Nixon v. Blackwell*,<sup>5</sup> the Delaware Chancery Court considered the question of "whether there should be any special, judicially-created rules to protect minority stockholders of closely held Delaware corporations." The Chancery Court held that a practice of purchasing key person life insurance policies for executive employees who were majority shareholders (and using the proceeds paid at the death of such employee to buy back the employee's stock from the estate) constituted discrimination and that the majority shareholders breached their fiduciary duties through its implementation. On appeal, however, the Delaware Supreme Court overturned the Chancery Court's ruling and rejected the notion of an oppression doctrine to protect minority shareholders in privately-owned Delaware corporations.<sup>6</sup> The court cited Delaware's legislation that enables close corporation shareholders to govern their relationships by

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contract, and stated that any shareholder protection should be sought through private contract negotiation and not by judicial intervention.<sup>7</sup>

Without assured protection from state corporate law, a prudent minority investor should request various measures to safeguard its corporate governance rights that have been agreed to with a majority shareholder. Which measures to adopt depends on the particular right granted to the minority shareholder, and the facts and circumstances of the investment, as discussed below.

### **Board Appointment Rights**

A minority shareholder may desire to have one or more designees sit on the subject company's board of directors for a variety of reasons, such as to have access to key information about the business and operations of the subject company (which is often far superior to the access granted to a shareholder). Furthermore, having a representative on the board of directors could enable the minority shareholder to influence the outcome of corporate decisions of the subject company, especially if the unanimous approval of all directors is required.<sup>8</sup> To facilitate the appointment of a minority shareholder's nominee to the subject company's board of directors, a minority shareholder could (1) request a cumulative voting system, (2) enter into a contractual arrangement with the majority shareholders, or (3) obtain board appointment rights pursuant to a classified share structure. Each method has its benefits and detriments.

**Cumulative Voting.** Under a cumulative voting system the number of shares held by a shareholder is multiplied by the number of directors to be elected, and the shareholder may cast for a single candidate either the total number of votes determined from this multiplication or may distribute the total among several candidates as the shareholder sees fit.<sup>9</sup> A cumulative voting system, however, has inherent pitfalls. For example, a minority shareholder may not be able to appoint a member to the board of directors if the number of directors to be elected is small because the majority shareholder will have more votes to disperse among the board candidates than the total number of votes allocated to the minority shareholder.<sup>10</sup> Because the boards

of directors of most privately-owned companies are small for various practical reasons, increasing board membership size to accommodate a minority shareholder may not be a practical alternative.

Furthermore, a majority shareholder intent on depriving a minority shareholder of board representation can cause the subject company to adopt various measures that can thwart the ability of a minority shareholder to benefit from the effects of a cumulative voting system. For example, the subject company's charter could be amended to introduce a staggered board system (which would render cumulative voting ineffective for the minority shareholder because fewer directors would be elected annually), or the subject company could reincorporate in another jurisdiction that prohibits the use of a cumulative voting scheme.

**Contractual Arrangements.** A shareholders or joint venture agreement is a common method used to agree on board representation for a privately-owned company. A minority shareholder can by contract agree with other shareholders how many persons it will be entitled to nominate to serve as directors of the subject company (with minimum suitability standards for the persons nominated if the parties require the assistance of the subject company), and the parties will agree in advance to cast their shares in favor of the other party's nominees. Although shareholders and joint venture agreements can be promptly implemented, such arrangements alone may not ultimately serve the best interests of a minority shareholder due to concerns relating to whether an effective remedy exists for a breach of the contract.

A minority shareholder may not be able to adequately enforce its board appointment rights by entering into a contractual arrangement. If a party breaches its obligations under the arrangement to vote in favor of the other party's board nominee(s), it will be difficult for the non-defaulting party (presumably the minority shareholder) to demonstrate monetary damages, thereby leaving the minority shareholder with a right that does not have an effective remedy for breaches. While the minority shareholder could request that specific performance be agreed as a remedy to cure defaults, enforcing

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a specific performance claim by a court often will require the non-defaulting party to incur significant time and legal expense, pending which the board of directors of the subject company will be lawfully constituted and could take actions contrary to the desires of the minority shareholder (which was the ostensible reason for entering into the contractual arrangement in the first place).<sup>11</sup> A more effective way for the minority shareholder to realize and enforce its agreed board appointment rights would be through incorporating such rights into the organizational documents of the subject company.

**Classified Shares.** One of the most effective ways of assuring that a minority shareholder will have representation on the subject company's board of directors is to set up two or more classes of stock, provide each class with the right to elect a specified number or a stated percentage of the subject company's directors (such right would appear in the company's charter designating the class of stock), and then issue the classified share to the minority shareholder. Providing board appointment rights through a classified share structure is extremely effective because actions taken by persons to bypass such rights would be in contravention of the subject company's charter. A minority shareholder would not need to seek the assistance of a court or sue for contract damages because actions taken against a company's charter would be invalid by operation of law and considered null and void. The minority shareholder, therefore, would be able to swiftly enforce its board appointment rights at a minimal cost.<sup>12</sup>

A classified share structure offers a variety of other advantages, such as the following:

- **Versatility.** If a company has three shareholders and each will have director appointment rights, then the company may issue three classes of shares, denominated classes *A*, *B*, and *C*. One class would be issued to each shareholder, and each class would be entitled to elect one director. The classes could be similar in all other respects, or they could have different dividend or liquidation rights. Furthermore, to reflect the capital contributions of each class, *Class A* would consist of 100 shares, *Class B* could consist of 50 shares, and *Class C* could consist of

25 shares. Of course, these permutations could be multiplied indefinitely. One class could be given the right to elect three directors, or one shareholder might be issued two or more classes of stock with each class having the right to elect one director. With a classified share structure a shareholder could sell up to 50 percent of his shares and still have the necessary votes to elect a director, thereby giving the minority shareholder financial flexibility over his investment in the subject company.

- **Certainty.** Class voting can assure a minority shareholder a position on the board of directors in situations in which the minority shareholder could not elect a director by cumulating his vote. Reducing the number of directors or staggering the terms of existing directors could not frustrate a classified share voting system.
- **Counter Board Stacking.** Limiting the size of the board of directors is important if the minority shareholder is granted super-majority veto rights for board decisions because without such protection, a majority shareholder could increase the size of the board to such a large number that the minority board member could not block the board action. A majority shareholder, however, could find it difficult to unilaterally increase the size of the subject company's board of directors under a classified share structure because by providing that the *Class A* shareholders may elect two directors and the *Class B* shareholders may elect three directors, the subject company's charter has in effect limited the size of the board of directors to five.<sup>13</sup>
- **Survival.** The majority shareholders and their director nominees may not be able to orchestrate an amendment to the subject company's charter to eliminate or diminish the rights granted to the classified shares without the consent of the relevant class holders.<sup>14</sup>

**Preserving the Directorship.** A minority shareholder who has secured the power to appoint a director must also prevent the subsequent removal of the director from office. The danger may come from both the other shareholders and the other directors. The safest course is to provide in the subject company's charter that only the shareholders may declare vacant the office of a director. This provision accomplishes three objectives. First, it negates any possible

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distinction between the declaration of a vacancy by the board of directors and the removal of a director by the shareholders. Second, it prevents the board from ousting a director on an enumerated statutory ground. Third, the suggested provision might forestall a bylaw amendment requiring qualifications that the minority director does not meet.<sup>15</sup> In addition, to guard against the possibility that the board might otherwise take action while a shareholder's director nominee is not serving on the board of directors (e.g., due to death or resignation), a provision should be placed in the subject company's charter or bylaws prohibiting board action until the vacancy has been filled. Also, if the office of a director appointed by a particular class of stock becomes vacant, the shareholders of that class should be protected by a provision in the charter that only they, or the other directors elected by the class, may fill the vacancy.<sup>16</sup>

### **Influencing the Outcome of Certain Corporate Decisions**

Veto rights and minimum quorum requirements are common devices used to enable a minority shareholder to influence the key business and operating decisions of a subject company. While board appointment rights are beneficial, a minority shareholder is ordinarily not able to influence corporate decisions because it owns few shares and the board of directors is dominated by the majority shareholder. With veto rights, the board of directors and other shareholders of the subject company are not permitted to take specified actions without the affirmative approval of the minority shareholder. Opponents of veto rights and minimum quorum requirements may contend that empowering a shareholder to determine the outcome of fundamental activities relating to the business and management of the subject company improperly strips the board of directors of its statutory authority to supervise and manage the company. While some statutory provisions and early court cases could support this interpretation, these authorities appear dated and modern courts are unlikely to follow these precedents.<sup>17</sup>

#### **Veto Rights**

*Scope of Veto Rights.* A veto right over key corporate events can provide significant assurances to

a minority shareholder that it will be able to protect its investment and shape the operations of the subject company. While the business activities over which a minority shareholder may seek to have a veto right should be tailored to the facts and objectives of the particular investment, how actively the minority shareholder wants to monitor the business and operations of the subject company, and whether the minority investor has a long-term interest in ultimately acquiring the subject company, a minority shareholder may wish to have a blocking vote over the subject company (and its material subsidiaries) with respect to the following activities:

- Amending its charter or bylaws;
- Entering into any merger, consolidation, reorganization or joint venture;
- Purchasing or acquiring in a single or a series of transactions all or substantially all of the assets or any shares of capital stock of another entity in excess of an agreed threshold;
- Selling, leasing, or otherwise disposing of all or a material portion of its assets or properties in a single or a series of transactions;
- Issuing any security or reclassifying any of its securities (including any options, warrants or other rights to purchase any voting security), changing the rights and preferences of any of its securities, or redeeming or repurchasing any of its securities;
- Approving any affiliate transaction above an agreed threshold, or entering into any other transaction which is not in the ordinary course of its business consistent with past practices or is not on an arm's length basis;
- Declaring dividends or other distributions of any kind to its shareholders;
- Filing a bankruptcy petition, initiating any type of dissolution or reorganization event (whether voluntary or not), or acquiescing in the appointment by a court of a trustee, receiver or liquidator of all or any substantial part of its properties or assets;
- Approving its annual business plan and any deviations in excess of an agreed threshold;
- Engaging in any new line of business or any transaction not in the ordinary course of its business consistent with past practices;
- Entering into, assigning, extending or materially modifying any of its agreements that have a value in excess of an agreed threshold;

- Adopting its annual capital expenses and operating budgets or agreeing to any amendment in excess of an agreed threshold;
- Incurring, assuming, or guaranteeing any indebtedness (including loans, capitalized leases, or otherwise) in excess of an agreed threshold, or repaying any indebtedness prior to its stated maturity;
- Extending any form of loan in excess of an agreed threshold;
- Creating or permitting to exist any lien or encumbrance upon any of its properties or assets, now owned or hereafter acquired, in excess of an agreed threshold;
- Entering into any agreement pursuant to which it is obligated to pay or entitled to receive payments in excess of an agreed threshold over the term of the agreement;
- Appointing or terminating the services of its independent accountants;
- Changing its financial, tax or accounting year, and establishing its accounting methods and procedures (and any material changes thereto);
- Determining the salaries and other compensation and benefits for its senior executives where the benefits to be paid are in excess of an agreed threshold;
- Dismissing, materially changing the job responsibilities, or placing on secondment any of its senior executives;
- Making any capital contribution or purchasing or acquiring a beneficial interest in any securities in excess of an agreed threshold;
- Forming or acquiring any subsidiary to carry out its principal business;
- Acquiring in a single or a series of transactions any business or assets (other than inventory) with a gross fair market value in excess of an agreed threshold; and
- Initiating, terminating or settling any litigation or arbitration where the potential damage claim is in excess of an agreed threshold or where the counter-party is a governmental agency (other than routine collection actions in the ordinary course of its business consistent with past practice).

The foregoing activities may require the approval of the subject company's board of directors and/or

shareholders depending on the corporate law of the subject company's jurisdiction of incorporation. Therefore, the veto list ultimately agreed with the majority shareholder may need to obtain veto protective measures at both the board and shareholder levels of the subject company depending on which body has the authority to approve the particular action. In addition, because veto rights can stall the subject company's operations if the majority and minority shareholders are unable to agree on a particular veto matter, the majority shareholder will likely request that appropriate deadlock procedures be agreed (*e.g.*, the ability to put or call shares) to prevent the subject company's business operations from unnecessarily deteriorating if the debate is prolonged.

***Establishing Veto Rights.*** Under the corporate laws of most states, a matter is approved on receipt of a majority vote of the board or a majority of the voting power of shares at a duly convened meeting. The easiest and most certain way to establish a minority shareholder veto right, therefore, is to set a unanimous or super-majority vote requirement at the board and shareholder level of the subject company. For example, if a minority shareholder owns 15 percent of the outstanding shares of the subject company, veto items at the shareholder level could require the unanimous approval of the shareholders or the approval of at least 86 percent of the voting shares represented at a duly convened shareholders meeting. Similarly, if a minority shareholder is entitled to appoint two of five members to the subject company's board of directors, then board level veto items could require the unanimous approval of all directors or the approval of at least four directors (which would require at least one of the director nominees of the minority shareholder to approve the action). Most state corporation statutes permit a company to establish a vote requirement for board or shareholder action higher (but not lower) than the standards set forth in the state's statute.<sup>18</sup>

A minority shareholder may prefer to effect its veto protective measures through the issuance of a classified share in order to (1) prevent new shareholders from blocking its veto powers and (2) preserve its veto rights regardless of its share ownership

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percentage (which may be the precise reason why a majority shareholder would object to the classified share issuance). While unanimity and super-majority approval requirements are easy to manage when it is unlikely that additional shareholders will be introduced in the future, if the subject company will issue new shares or provide future shareholders with board appointment rights, then the special rights provided to the existing minority shareholders could be negatively impacted. In particular, a unanimous approval requirement would allow the new shareholder similar blocking rights, and a super-majority consent requirement could be satisfied without the approval of the existing minority shareholder if significant share ownership dilution occurs. A special class of stock issued to the minority shareholder could avoid these issues because for those veto matters requiring shareholder approval, the subject company's organizational documents would indicate that the consent of the holder of the special class of stock would be required to approve the action. For those veto matters requiring the approval of the board of directors, the subject company's organization documents could indicate that such matters would also require shareholder approval (and, in particular, the approval of the holder of the special class of stock issued to the minority shareholder) in order to be adopted.

A classified share structure also would serve as an effective way to handle concerns that a minority shareholder's board designee cannot represent the interests of only the minority shareholder because directors owe fiduciary duties to represent the best interests of the company and *all* shareholders. By requiring that board action be subject to class shareholder approval as well, the minority shareholder could vote its shares as it sees fit and impact corporate activities without undergoing a complicated director fiduciary duty analysis. If a classified share structure is not permissible or desirable, then the minority shareholder could achieve the same foregoing benefit by moving the relevant matters that would ordinarily be resolved by the subject company's board of directors to the shareholder level.<sup>19</sup>

***Placement and Protection of Veto Rights.*** Including veto provisions in a contractual arrangement is

common practice. Unfortunately, all too often counsel to a minority shareholder may mistakenly believe that the contract is the first and only instrument to document and protect the veto rights of a minority shareholder. Similar to placing board appointment rights in a contractual arrangement, relying on breach of contract damages or specific performance to enforce a veto right could leave the minority shareholder a right without an effective remedy depending on the encroaching actions taken by the majority shareholder.<sup>20</sup> Instead, the minority shareholder should insist that the veto provisions also be memorialized in the organizational documents of the subject company so improper actions are invalidated swiftly by operation of law without the need for the minority shareholder to initiate an enforcement action.

State corporate law and relevant judicial decisions often will dictate whether director and shareholder veto rights should be placed in the corporate charter or bylaws. The analysis may hinge on the subject matter of the veto right, and whether the veto right is at the board or shareholder level. Placement in either the charter or the bylaws is often acceptable, which is the case for companies incorporated in Delaware. There are certain notable exceptions. For example, New York corporate law authorizes a veto right over shareholder and board action only if the right appears in the company's certificate of incorporation.<sup>21</sup> Counsel should not, however, automatically conclude that all veto rights should be included in the subject company's charter as a safety measure. Because charters are publicly available, the disclosure of such information may be against the interests of all shareholders since competitors could use this information to the detriment of the subject company. For instance, if a third party whose acquisition overtures were rejected by a subject company gained knowledge that a particular shareholder exerted significant influence over the subject company's operations, then the hostile acquiror could further its acquisition goals by acquiring the minority shareholder (which could be an easier takeover target).

Depending on the instrument containing the veto provisions, a variety of methods are available to support its continuing effectiveness. If placing veto

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rights in the corporate charter is not desirable, then the provisions could be placed in the subject company's bylaws, so long as (1) the bylaws require that any changes to the veto provisions be approved only by a super-majority vote of the shareholders (or the share class if a classified share structure is adopted) and such bylaw provision has its own amendment protection provision, and (2) the charter specifies that the foregoing bylaw itself can be amended only by a super-majority shareholder vote (or the share class if a classified share structure is adopted) and not by the directors, and this charter clause is coupled with its own amendment protection provision.<sup>22</sup> Denying the board of directors the power to amend or repeal relevant bylaws is critical, otherwise the board could subsequently eliminate a key deal point without the consent of the minority shareholder—wiping away a deal feature that may have been extracted by the minority shareholder in exchange for a significant concession. If public disclosure of the veto rights is not sensitive, then placement of the provisions in the charter could be preferable since amending the charter often requires the approval of the subject company's board of directors and shareholders (which makes amendments more difficult to effect against the wishes of the minority shareholder). The charter should specify that the veto provisions can be amended only with a super-majority vote or the approval of the share class (if a classified share structure is adopted), and the foregoing charter amendment clause itself should have its own amendment protection provision.

Special care should be taken to prevent the board of directors from delegating its authority to a special committee over veto matters that would ordinarily be resolved by the full board. Other than determining specified fundamental corporate matters (*e.g.*, entering into a merger agreement or amending an organizational document), many state corporate law statutes permit committees of the board of directors to exercise the power and authority of the board of directors and can resolve matters in lieu of full board action.<sup>23</sup> If a special committee that does not have a representative of the minority shareholder is given the responsibility to determine a particular matter, then the minority shareholder's board member will not be able to participate in the deliberations or impact the outcome even if a super-majority or classified share structure exists. Accordingly, the minority shareholder should

insist that the subject company's charter or bylaws (depending on the requirements of the relevant state law) prohibit the board of directors from delegating relevant matters for the consideration and determination by a board committee, and such provision should have its own amendment protection provision.

### **Quorum Requirements**

Establishing board and shareholder quorum requirements is often a necessary measure to ensure that the minority shareholder is represented at the relevant meeting, otherwise a veto right granted to the minority shareholder could be circumvented by holding a board or shareholder meeting at which only the majority shareholder is represented (which would allow the majority shareholder to control the outcome). The parties can agree to a super-majority quorum requirement to ensure minority shareholder representation at shareholders meetings and for its designees at board meetings, but setting the precise level can be a difficult exercise depending on the subject company's share ownership and board structure. A classified share structure enables the establishment of a more precise quorum requirement because a quorum for the board of directors can be achieved if only the director nominee of the class is represented and a shareholders meeting can be held if only a majority of the voting power of the classified shares is present at such meeting. Without the relevant minority shareholder representation, the board or shareholder meeting cannot be lawfully convened and any actions taken can be nullified.<sup>24</sup> While providing a minority shareholder with quorum rights may appear at first blush to significantly empower the minority shareholder, quorum rights alone may not be an effective method to protect the veto rights granted to a minority shareholder.

Quorum rights should be coupled with a super-majority voting requirement in order to enable a minority shareholder to impact corporate decisions. Without the direct ability to influence the outcome of a vote (rather than the convention of a meeting), a veto right granted to a minority shareholder can be circumvented. For example, once a director or shareholder attends a meeting, a quorum may exist for the entire meeting even if the



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director or shareholder subsequently withdraws.<sup>25</sup> This can be particularly significant if the minority shareholder attends a board or shareholders meeting under the belief that certain actions will be decided, a quorum is achieved, but new matters are subsequently submitted for approval against the wishes of the minority shareholder. This scenario is not purely theoretical, as the agenda for board and shareholders meetings often state that any other lawful matters properly raised at the meeting can be discussed and resolved. Without a super-majority vote requirement, class share system or other protective measure, the minority shareholder would be unable to block the matter. Furthermore, repeated attempts by a minority shareholder to frustrate the holding of a shareholders meeting by intentionally being absent may allow the other shareholders or directors to obtain the support of a court to deem the existence of a quorum without the presence of the minority shareholder.<sup>26</sup>

## Share Transfer Restrictions

Share issuances and transfers often are restricted in privately-owned companies. A motivation for such transfer restrictions is to deny the subject company's shares falling into the hands of a competitor or a new shareholder that does not share a common vision for the management and future of the subject company. Minority shareholders also may have special concerns that the subject company will issue new shares that could dilute the ownership position of the minority shareholder (which is particularly relevant if such issuance would cause the minority shareholder's ownership percentage to fall below a super-majority threshold) or the majority shareholder will sell its entire stake to a third party, thereby introducing a new control person into the subject company.

There are various techniques to impose share transfer restrictions. To preserve the harmony of the existing shareholder group, the parties may prohibit the transfer of the subject company's shares without the consent of the board of directors or the other shareholders, or give the board of directors or other shareholders a right of first refusal or offer to purchase over the subject company's shares being offered for sale by a shareholder prior to such shares being sold

to the third party.<sup>27</sup> In the absence of share transfer restrictions, change of control concerns can be alleviated by granting the minority shareholder with tag-along rights to join in a sale of the subject company's shares by the majority shareholder, or the majority shareholder may demand drag-along rights to force the minority shareholder to join in a sale of the subject company's shares by the majority shareholder so full control of the subject company can be conveyed to a third party. To prevent share ownership dilution, the company could grant the shareholders preemptive rights over new share issuances.

Share transfer restrictions can be implemented in a variety of ways depending on the state corporate law of the subject company's jurisdiction of incorporation. For example, Section 202 of the Delaware General Corporation Law allows a company's certificate of incorporation, bylaws or an agreement to contain securities transfer restrictions. For the same reasons discussed previously, a prudent minority shareholder should request that transfer restrictions be placed not only in an agreement, but also in the subject company's charter or bylaws (with necessary amendment protections) so violations can be promptly quashed by operation of law (without incurring the time and expense of court intervention). Placing share transfer restrictions in the charter is more common than in the bylaws because Section 8-204 of the Uniform Commercial Code states that transfer restrictions on a security imposed by an issuer will be effective only if the restriction is conspicuously noted on the stock certificate (or for companies that do not issue stock certificates, the restriction is contained in an initial transaction statement sent to the holder), so publicity concerns that may have warranted placement in the bylaws are not a relevant consideration.<sup>28</sup> Preemptive rights also normally appear in the subject company's charter, and must be specifically granted in order to comply with the default rule that shareholders are normally not entitled to preemptive rights over new stock issuances unless explicitly permitted under the charter.<sup>29</sup>

## Conclusion

Investors in companies with a small number of other shareholders and no ready market for their

shares often require the greatest amount of protection, especially if such investors do not have a position in the management of the subject company. The classified share structure is often a superior way to protect agreed on corporate governance rights given its location within the subject company's organizational documents, which makes violations of the arrangement invalid by operation of law. Classified shares may offer bonus effects as well, as they can provide the holder with superior liquidation, redemption and dividend rights over ordinary common shares. While the classified share structure and other techniques may aid the minority shareholder against oppressive acts of a majority shareholder, no method can preserve a deal if the parties do not share similar ethical scruples and have a common understanding regarding the power sharing arrangement.

## NOTES

1. See Mark A. Medearis and Michael W. Hall, "Minority Equity Investments in Connection with Strategic Alliances," appearing in the Practising Law Institute program "Structuring, Negotiating & Implementing Strategic Alliances" (2005).
2. Section 8.30(a) of the Model Business Corporation Act (3d Edition).
3. A plaintiff challenging director action normally bears the burden to plead and prove facts that a majority of the directors had a disabling conflict of interest or failed to act with the requisite care or good faith, in which case a court may lift the veil of protection afforded by the business judgment rule and apply a stricter review standard to the transaction by requiring the board of directors to demonstrate that the terms of the deal were fair to all shareholders. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), in which the Delaware court applied an "entire fairness" test to the actions of a board when it approved a merger with a majority-owned subsidiary, and shifted the burden of proof to the board that its actions were fair to all shareholders in terms of price and from a procedural point of view.
4. For a discussion of the diverging views courts have taken in California, Delaware, Massachusetts, and New York regarding the duties owed by majority shareholders to minority shareholders, see Jeffrey M. Leavitt, "Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies," 6 *N.C. J.L. & Tech.* 233 (Spring 2005).
5. *Nixon v. Blackwell*, C.A. No. 9041 (Del. Ch. Sept. 26, 1991).
6. *Nixon v. Blackwell*, 626 A.2d 1366, 1379 (Del. 1993).
7. *Id.*, at 1380. But see *Hollis v. Hill*, 232 F.3d 460, 469 n.28 (5th Cir. 2000) ("the Delaware Supreme Court has yet to consider the precise issue in this case, namely whether a controlling shareholder is liable for actions taken with the purpose and effect of freezing out another shareholder") and *Abraham*

*v. Emerson Radio Corp.*, C.A. No. 1845-N, 2006 WL 1879205 (Del. Ch. July 5, 2006) (a controlling shareholder is liable for selling its control block to a looter if the controlling shareholder acted with *scienter*).

8. The foregoing benefits of having board representation would be moot if the board of directors meets infrequently or acts by written consent. A minority shareholder, therefore, should request that the subject company's board of directors meets in person at specified intervals (e.g., quarterly).

9. A cumulative voting system is easier understood through a hypothetical. For example, if a minority shareholder owns 15 shares in a corporation with a total of 100 shares outstanding and seven director positions, then the minority shareholder can always elect at least one director because he will be entitled to cast 105 votes ( $7 \times 15$ ), which can be cast for a single candidate, while the other shareholders are entitled to cast in the aggregate 595 votes ( $7 \times 85$ ), a number which is too small to permit as many as 105 votes to be cast for each of the seven director positions.

10. In the example above, if the subject company's board of directors consists of five members, then the minority shareholder may not be able to appoint a member because its total number of votes will equal 85, which is the same as the number of votes that the majority shareholder could spread among the five candidates. If the size of the board is reduced further to three members, then under no circumstances would a minority shareholder have enough votes under a cumulative voting system to appoint a director.

11. As an alternative, if the voting provisions of a shareholders agreement are breached, the contract could allow the non-defaulting shareholder to put his shares or call the shares of the defaulting party at an extremely favorable price. However, this may not be ideal for the non-defaulting shareholder if he does not want to exit the investment at such time (in the case of the put) or he does not have adequate financial resources to acquire additional shares or the desire to control the subject company (in the case of the call). A breach of the shareholders agreement could also trigger a cross-default under one or more of the other operative agreements to the transaction. Depending on the strength of the parties (e.g., if the minority shareholder is providing key technology to the subject company under a licensing agreement), the threat of terminating a material contract could persuade a majority shareholder not to breach the agreement.

12. If the subject company is an S corporation, it should consult with a tax expert prior to creating a classified share structure because creating two classes of stock could jeopardize the company's ability to elect Subchapter S status. An S corporation, however, may have classes of stock with different voting rights so long as each class has the same economic rights. This could be helpful if the subject company elects a high vote stock class structure (e.g., the Class A shares are entitled to one vote per share while the Class B shares are entitled to 100 votes per share). See Sections 1361(c)(4) and 1361(b)(1)(D) of the Internal Revenue Code of 1986, as amended.

13. To provide even greater assurances against board stacking, a minority shareholder should include a provision in the charter specifying the maximum number of directors, and couple this clause with a super-majority or class vote requirement to amend the provision (which is referred to as an "amendment protection" provision).

14. See, e.g., Section 242(b)(2) of the Delaware General Corporation Law (DGCL) and Section 804 of the New York Business Corporation Law (NYBCL).
15. See Thomas J. Andres, Jr., "Louisiana Close Corporations: Problems of Control Under the Louisiana Business Corporation Law," 45 *Tul. L. Rev.* 259, 305 (Feb. 1971).
16. The parties should also consider how to fill a vacancy on a board elected by a cumulative voting scheme. Even though a minority shareholder has elected a director, the minority shareholder would not have sufficient votes to fill the vacancy.
17. See F. Hodge O'Neal & Robert B. Thompson, O'Neal's Close Corporations (3d ed. 1998), at Section 4.1.
18. See *id.* at §§ 4.12, 5.6-5.8.
19. The ability to shift board decisions to the shareholder level (but not vice versa) is common, but dependent on the state corporate laws applicable to the subject company. See, e.g., §§ 141(a) and 351 of the DGCL and § 620 of the NYBCL.
20. If a subject company's organizational documents contain a term that conflicts with a contractually agreed provision (such as a veto or board appointment right), then the minority shareholder would not be able to seek injunctive relief because the terms of a company's organizational documents are normally superior in right to contractual arrangements between shareholders. The disgruntled minority shareholder could still initiate a breach of contract claim against the counter-party, but demonstrating meaningful damages could be an uphill battle.
21. See §§ 616 and 709 of the NYBCL.
22. If protective provisions are placed in the bylaws, counsel also should take great care that there are no desired provisions in the bylaws that are inconsistent with the charter (then existing or in the future), because bylaws are normally subordinate to a company's charter (and conflicting bylaw provisions could be voided). To avoid future amendments to the charter that could invalidate the bylaws, charter amendments should require a super-majority vote (or the share class if a classified share structure is adopted), and the foregoing charter amendment clause should have its own amendment protection provision.
23. See, e.g., § 141(c) of the DGCL and § 712 of the NYBCL.
24. State corporate law will dictate whether the quorum requirement should be placed in either the charter or the bylaws.
25. For a discussion relating to Delaware corporate law, see R. Franklin Balotti and Jesse A. Finkelstein, *Del. Law of Corps. & Bus. Orgs.* (3d ed. 1998), at §§ 4.10 and 7.22.
26. See, e.g., § 211(c) of the DGCL.
27. The transfer to an affiliate of the transferor is a common exception to share transfer restrictions. Care should be taken to confirm that such transferee of the transferor remains wholly or majority-owned by the transferor and the transferee becomes a party to any contractual arrangement relating to share ownership.
28. A sample transfer restriction legend on a stock certificate could read as follows: "THE SALE, PLEDGE, HYPOTHECATION OR TRANSFER OF THE SECURITIES REPRESENTED BY THIS CERTIFICATE IS SUBJECT TO THE TERMS AND CONDITIONS OF THE COMPANY'S CERTIFICATE OF INCORPORATION AND A CERTAIN SHAREHOLDERS AGREEMENT, DATED \_\_\_\_\_, BY AND AMONG THE COMPANY AND THE HOLDERS OF SHARES LISTED ON THE SIGNATURE PAGES THERETO. COPIES OF THE SHAREHOLDERS AGREEMENT AND THE COMPANY'S CERTIFICATE OF INCORPORATION MAY BE OBTAINED UPON WRITTEN REQUEST TO THE SECRETARY OF THE COMPANY. NO REGISTRATION OR TRANSFER OF THESE SHARES WILL BE MADE ON THE BOOKS AND RECORDS OF THE COMPANY UNLESS AND UNTIL SUCH TERMS AND CONDITIONS HAVE BEEN SATISFIED. THE HOLDER HEREOF, BY ACCEPTANCE OF THESE SHARES, AGREES THAT IT WILL NOTIFY ANY SUBSEQUENT PURCHASER OF THESE SHARES FROM IT OF THE FOREGOING TRANSFER RESTRICTIONS." A standard legend regarding the lack of registration under the US Securities Act of 1933, as amended, should be included as well.
29. See, e.g., § 102(b)(3) of the DGCL and § 622 of the NYBCL. When preparing a preemptive rights clause, the drafter should consider whether certain exceptions should apply to the application of preemptive rights, such as treasury stock issuances and stock issuances in connection with stock option exercises, corporate reorganizations, conversion of convertible securities, and payments in kind for services rendered by third parties.

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