

Drafting Shareholder Agreements for Closely Held Businesses

Structuring Enforceable Provisions on Voting Rights, Transfer of Shares, Buy-Sell Rights, Restrictive Covenants and More

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Today's faculty features:

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DRAFTING SHAREHOLDER AGREEMENTS FOR CLOSELY HELD BUSINESSES

***STRAFFORD WEBINARS
NOVEMBER 10, 2015***

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OVERVIEW

- **Purpose and Use of Shareholder Agreements**
- **Drafting Key Provisions**
- **Enforceability Considerations**

SHAREHOLDER AGREEMENTS

STATUTORY AUTHORITY

- **Authority for shareholder agreements under corporate governance statutes:**
 - **Section 218(c) of Delaware General Corporation Law: An agreement between two or more stockholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as provided by the agreement, or as the parties may agree, or as determined in accordance with a procedure agreed upon by them.**

SHAREHOLDER AGREEMENTS

STATUTORY AUTHORITY

- Section 7.71 of the Illinois Business Corporation Act of 1983:

(a) Shareholders may unanimously agree in writing as to matters concerning the management of a corporation provided no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated.

(c) No agreement created pursuant to this Section shall be invalid as between the parties thereto, or shall subject employees, officers, directors or shareholders to personal liability for corporation liabilities, on the basis that the agreement: (1) is an attempt to treat the corporation as if it were a partnership or to arrange the shareholders' relationship in a manner that would be appropriate only between partners; or (2) so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the board of directors.

INTERPLAY BETWEEN SHAREHOLDER AGREEMENTS AND CORPORATE STATUTES

- Regarding shareholder agreements, be mindful of statutory provisions which must be set forth in the articles of incorporation or bylaws.
- Different from limited liability company operating agreements, where owners are given broad latitude to vary statutory default provisions.

WHO NEEDS THEM?

- **Every business can benefit from owners' agreements, and in particular any business with multiple stakeholders, whether those are the present owners or potential future owners, who intend to make a significant return on their investment in the business**
- **A large majority of shareholders of closely-held companies intend to pass ownership to the next generation, but few small companies make it beyond the first generation, and less than 10% survive to the second generation**
- **Ideal “one-stop” contract**

PURPOSES

- **Create a well-defined organizational structure**
- **Create effective leadership, management and compensation systems**
- **Improve owner relations by determining relative rights, duties and benefits**
- **Improve management relations by clearly defining duties and responsibilities**
- **Improve creditworthiness of the company**
- **Manage expectations and conflicts among stakeholders before they ripen into costly litigation**
- **Define and manage non-competition arrangements**

PURPOSES

- **Protect intellectual property and trade secrets**
- **Protect from external threats, such as:**
 - **Risk from failure of business partners**
 - **Risk of litigation against business partners**
 - **Risk of extension of corporate liability to directors, officers and managers.**
- **Succession planning – maintain stability of operations or provide for an identified buyer for the company**
- **Ensure a market for the shares**
- **For estate planning, provide liquidity for payment of estate taxes (assuming the agreement is funded, which is key) and can establish the value of the company for estate tax purposes**

WHERE AND WHEN TO START?

- **Organization is the best time to start (with a clean slate), but owners' agreements oftentimes are done as changes occur in the business as well.**
- **In operating businesses, pay particular attention to existing corporate governance documents and contracts, including those of any subsidiaries and affiliates.**

ADDRESS CONFLICTS OF INTEREST

- **“Who is the client” is the first and key question when drafting owners’ agreements. Oftentimes, attorneys are asked to represent multiple owners and the business, and therefore conflicts of interest must be discussed and waived IN WRITING.**
- **Rule 1.7 Conflict of Interest, Current Clients**

FERRETING OUT CONFLICTS

- **Be mindful of who brought you into the business and why. How well do you know the person? What prompted the client to seek an attorney? What issues has the person identified? Are there others?**
- **Who is active in the business? Are there financial owners and “sweat” owners?**
- **Who holds the authority? Who holds leverage?**
- **Evaluate each person’s goals and expectations.**

CONFLICT WAIVER

- The conflict waiver should (i) acknowledge the conflicts, (ii) explain the possible consequences of multiple representation (including that the parties may need separate counsel in the future at additional cost), and (iii) consent to the representation.
- Include an acknowledgment in the agreement as well, for example:

The parties acknowledge that Arnstein & Lehr LLP has prepared this Agreement in its capacity as counsel to the Company, and each Shareholder has been provided the opportunity to retain separate legal counsel as he or she deems appropriate to represent the Shareholder in connection with this Agreement and the transactions contemplated herein. Each Shareholder has the right to retain separate legal counsel, and the fees and expenses of such separate counsel shall be at the expense of such Shareholder.

USES

- **While shareholder agreements are far from one-size-fits-all, generally speaking, the agreement should, at a minimum, address the following issues:**
 - **Dividends and distributions**
 - **Corporate governance and management**
 - **Business opportunities and conflicts of interest**
 - **Restrictions on transfers of ownership**
 - **Purchase and sale of interests (buy-sell provisions)**
 - **Valuation**

DIVIDENDS AND DISTRIBUTIONS

- **For corporations, generally in accordance with share ownership subject to preferences**
 - **S-Corporations, must be pro rata or risk loss of S-Corp status**
 - **Should provide for tax distributions to the shareholders**

CORPORATE GOVERNANCE UNDERSTANDING THE ROLES

■ Corporations:

- Shareholders are the owners who provide capital to start the business.
- Directors are elected by the shareholders and establish management guidelines and decide on key policies and corporate transactions.
- Officers are elected by the board of directors and carry out the day-to-day operations of the business.
- Individuals can serve in more than one role (i.e., shareholders who are active in the business can serve as directors and officers, and may hold multiple offices).

CORPORATE GOVERNANCE – KEY MATTERS FOR APPROVAL

- **The shareholder agreement should address key governance matters such as:**
 - **Amendment of governing documents**
 - **Nomination and election of directors**
 - **Removal of directors**
 - **Filling vacancies of directors**
 - **Issuance of shares**
 - **Payment of dividends or distributions**
 - **Salaries and other compensation**

CORPORATE GOVERNANCE – KEY MATTERS FOR APPROVAL

- Significant corporate expenditures
- Corporate borrowing
- Major contract approvals
- Employment matters, including hiring and firing
- Corporate re-structuring or merger
- Sales of assets outside the ordinary course
- Related-party transactions
- Sales of stock or membership interests

CORPORATE GOVERNANCE – KEY MATTERS FOR APPROVAL

- In each case:
 - Whose approval is required?
 - Threshold for approval?
 - Majority, super-majority, weighted voting or approval of certain owners
- Regarding appointments, can certain shareholders appoint certain directors?
- Extend agreements to subsidiaries and affiliates when appropriate

CORPORATE GOVERNANCE – DEALING WITH DEADLOCK

- **Mediation**
- **Arbitration**
- **Referral to advisory board or third-party arbiter**
- **Officer casts deciding vote**
- **Trigger of buy-sell provisions**
- **Dissolution (rare)**

CORPORATE GOVERNANCE – FIDUCIARY DUTIES

- **Most common ground for disputes among shareholders are allegations of breaches of fiduciary duties. Clients need to understand them and the agreement should address them.**
 - **Duty of loyalty – act in a manner that the person reasonably believes to be in the best interest of the company and its owners**
 - **Duty of care – perform duties with the knowledge, judgment, skill, diligence and timeliness that an ordinarily competent person in a like position would use under similar circumstances**

CORPORATE GOVERNANCE – FIDUCIARY DUTIES

- **At a minimum, the agreement should address:**
 - **Whether the owners will (must) actively participate in the business**
 - **Whether the owners may invest and/or actively participate in other businesses**
 - **Whether the owners are expected to offer opportunities in the same line of business before pursuing them independently**
- **The agreement also should address restrictive covenants:**
 - **Non-competition**
 - **Non-solicitation**
 - **Use of confidential information**

TRANSFER RESTRICTIONS – PURPOSES

- **Protect against transfers to unwanted business partners (avoid threats by minority)**
- **Protect value of ownership (avoid threats by the majority)**
- **Maintain S-Corp status**
- **Maintain professional corporation status**
- **Protect against third-party agreement defaults (such as mortgages with change of control provisions)**
- **Protect against violations of local licensing laws**

TRANSFER RESTRICTIONS

- **Transfer restrictions should address:**
 - **Approvals required to transfer ownership**
 - Generally, transfers permitted for estate planning purposes
 - **Documents to be delivered upon approval**
 - Joinder to the agreement
 - Copies of governing documents of entity owners
 - Opinion of counsel
- **Caution – transfer restrictions are strictly construed, so draft carefully!**

BUY-SELL PROVISIONS - OVERVIEW

- Identify the purchaser
- Identify the triggering events
- Identify the form of the transaction
- Identify price and payment terms
 - Valuation

BUY-SELL – VALUATION

■ General Comments:

- Get a professional involved!
- Consider Internal Revenue Code §2703

■ Methods:

- Agreed price with periodic amendment
 - Advantage – simple, cheap
 - Disadvantage – often no criteria, ripe for disagreement
 - Mitigate with back-up valuation method

BUY-SELL – VALUATION

- Appraisal
 - Provide for specific appraiser, time period and method of valuation
 - Income approach (value based upon present value of the company's future economic benefits)
 - Market approach (multiples from comparable arms-length transactions, public or private)
 - Asset approach (market value of assets less liabilities)
 - Provide for selection by approval of owners or corporate fiduciaries
 - Considerations
 - Inventory methods
 - Goodwill to be included?
 - Minority discounts?
 - Willing to “bet the ranch” that the appraiser is right?
 - Consider multiple appraisers

BUY-SELL – VALUATION

- **Book value**
 - Based upon balance sheet
 - Typically determined by company accountants
 - Major disadvantage – does not reflect current value as a going concern
 - Particular concern for service businesses
 - Management may control the value

BUY-SELL – VALUATION

- **Formula based upon earnings, revenue or other criteria**
 - Consider weighted averaging and adjustments for nonrecurring items (abnormal years, unusual business conditions, changes in business operations, owner compensation)
 - Consult with business broker to determine an appropriate multiplier
 - Specify who will make calculations
- **Combination**

MESSERLI & KRAMER

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Nathan J. Nelson

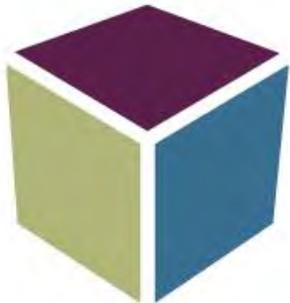
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- Nate Nelson is a shareholder in the Business Services Division of Messerli & Kramer PA in Minneapolis, Minnesota. Nate focuses his practice on addressing general and specific business matters, including start-ups, shareholder control agreements, acquisitions, dissolutions and mergers. He has over 20 years of experience in solving business succession and tax planning challenges that many entrepreneurs confront from time to time. Nate drafts tax efficient legal plans to transfer wealth and businesses from one generation to the next.



Drafting Shareholder Agreements for Closely Held Businesses

■ SHAREHOLDER CONTROL AGREEMENT

- A contract amongst shareholders of a Corporation to delineate the roles, responsibilities and expectations of Shareholders.
- An expression of operational intent outside the default rules of the applicable state Business Corporation Act.
- A mechanism to directly address events the Corporation is expected to face in the future.
- A tool to set parameters on the resolution of unexpected or undesired matters.



Cite to Enabling Authority

■ Statutory Authority

- As a contract, many states have adopted enabling legislation to permit Shareholders to freely describe the ground rules for almost any sort of business relationship.
- To evidence Shareholder consent, knowledge and agreement to the Shareholder Control Agreement and compliance with the Act, reference the enabling statutory authority:
- The parties intend that applicable provisions of this Agreement shall constitute a shareholder control agreement under Section 302A.457 of the Business Corporations Act and shall be enforceable and binding in accordance with such Section, and that all provisions of this Agreement, notwithstanding the application of Section 302A.457, shall be fully enforceable and binding upon all parties hereto, to the extent permitted by law. For purposes of compliance with Section 302A.457, the Shareholders hereby acknowledge and agree that:
- This Agreement has been signed by all persons who are now shareholders, whether or not all shareholders of the Corporation have voting rights, and by all subscribers for shares, whether or not voting shares, to be issued;
- A copy of this Agreement shall at all times be kept on file in the office of the Secretary of the Corporation;
- The existence and location of a copy of this Agreement shall be noted conspicuously on the back of each certificate for shares of the Corporation;
- Every shareholder, beneficial owner of share, and other person having a permitted security interest in shares shall have the right, upon written demand, to obtain a copy of this Agreement from the Corporation, at the expense of the Corporation.



Certificate Legend

- The certificates representing shares owned by the Shareholders shall bear the following legend:
- "The shares evidenced by this certificate, and the sale, exchange, pledge, assignment, or other disposition thereof, are subject to the terms of that certain Shareholder Control Agreement dated effective as of _____ __, 201__, a copy of which is on file in the office of the Secretary of the Corporation."



Common Override Provisions

- Shareholder Control Agreements often:
 - Define the Purpose of the Corporation;
 - Provide for the Appointment of the Board of Directors;
 - Provide for the exercise or division of voting power by Shareholders and Directors;
 - Provide for the Appointment of Officers of the Corporation;
 - S Corporation Status;
 - Provide the terms and conditions for certain corporate actions;
 - Provide for deadlock among of Shareholders, Directors or Officers;
 - Provide for dispute resolution procedures;
 - Conflict acknowledgment and waiver
 - Other Matters:
 - Provide for the dissolution of the Corporation;
 - Provide for restrictions on transfer of shares;
 - Termination of Shareholder Control Agreement;



Purpose

- As a general rule, corporations may be formed for any lawful purpose. Often investors prefer to narrow the scope of permissible pursuits or activities of the Corporation in which they invest.
- **Purpose.** The purposes and character of the business of the Corporation are (i) to operate a gas station and convenience store, and (ii) to engage in any and all activities related or incidental to such purpose. The Corporation has the power to do any and all acts necessary, appropriate, proper, advisable, incidental or convenient to or in furtherance of the foregoing purposes. Except as otherwise specifically provided in this Agreement, the Corporation shall not engage in any activity that is not reasonably necessary or appropriate to accomplish such purposes without the unanimous consent of the Shareholders.
- **Restriction on Competing Activities.** The Shareholders each acknowledge and agree that they shall not engage in any activity or activities within ___ miles of the City of the Corporation's principal office, that compete directly with the business of the Corporation without the prior written consent of all other Shareholders.



Composition and Appointment of Board of Directors

- Composition of Board of Directors. The Corporation's Board of Directors (the "Board") shall consist of one or more natural persons. At each regular meeting of the Shareholders, the Shareholders shall determine the number of Directors; provided, that between regular meetings, the authorized number of Directors may be increased or decreased only by the Shareholders owning all of the Shares entitled to vote.
- Required Vote. Each Director shall be elected by an affirmative vote of the Shareholders owning a majority of the Shares having voting rights; provided, however:
 - that for as long as CS is a Shareholder then CS shall be entitled to be a Director on the Board of Directors and the Shareholders shall vote all of the Corporation's Shares in favor of CS as a Director.
 - that for as long as JT is a Shareholder then JT shall be entitled to be a Director on the Board of Directors and the Shareholders shall vote all of the Corporation's Shares in favor of JT as a Director.
- Alternative:
- Elections.
- Required Vote. Each Director shall be elected by an affirmative vote of the Shareholders owning a majority of the Shares having voting rights; provided, however, that for as long as MT is a Shareholder holding a majority of the issued and outstanding shares of Common Stock, then MT, or his designee, shall be entitled to be a Director on the Board of Directors for so long as he is alive and not Disabled or Removed, and the Shareholders shall vote all of the Corporation's Shares having voting rights in favor of MT as a Director.
- Initial Directors. It is agreed the initial Board of Directors of the Corporation following the effective date of this Agreement shall consist of MT as the sole director.



Removal Event

- Sometimes Shareholders desire to define only a few instances where a Director or Officer may be removed from such position.
- Removal Event. Any Director or officer of the Corporation (collectively, a “Principal”) may be removed by the unanimous action of the Shareholders, other than the Principal who is the subject of a Removal Event, as provided herein under the following circumstances (a "Removal Event"):
- The Principal: (1) commits a criminal act which materially adversely affects the Corporation, (2) misapplies any funds derived from the Corporation, including deposits, insurance proceeds and condemnation awards; (3) commits fraud, makes a material misrepresentation, commits gross negligence or willful misconduct; (4) intentionally damages or destroys Corporation property or assets; (5) takes or causes to be taken any action constituting a Major Decision under this Agreement without the requisite approval; or
- The death or Disability of the Principal.
- Upon the occurrence of a Removal Event and the unanimous action of the Shareholders, other than the Principal who is the subject of a Removal Event, vote to remove such Principal as a Director or Officer, as the case may be, such removal shall constitute for purposes of Section __ above as “Removed.”



Voting Power of Directors

- The general rule is Directors of a Corporation vote per capita, as a group.
- In some instances, Directors vote according to Voting Power. Even if one Director retains a majority of Voting Power, there are plenty of other benefits to have minority Directors on the Board (i.e. access to information, facilitate debate, act as a watch dog).
- The Board of Directors shall take action by a majority of the voting power of the board, which shall be apportioned among the directors as follows: ten percent (10.0%) for each of TJ and MJ or their respective designees, and eighty percent (80.0%) for SP, or SP's designee. The Board of Directors of the Corporation shall initially consist of TJ, appointing himself as director, MJ, appointing himself as director, and SP appointing himself as director. SP shall be the Chairman of the Board of Directors for so long as he is a director. For so long as TJ, MJ and SP remain shareholders of the Corporation, TJ, MJ and SP, or such shareholder's respective designees, may not be removed as directors of the Corporation. In the event SP is unable to act as a director, then SP shall appoint a designee to replace himself on the Board of Directors and such designee shall have the same voting power as SP had before he was unable to act. In the event either TJ or MJ is no longer a shareholder of the Corporation or one of them otherwise ceases to act as a director of the Corporation for any reason whatsoever, that fact, alone, shall not affect the right of the other to continue to act as a director, so long as he is a shareholder of the Corporation. Subject to the foregoing, additional members of the Board of Directors of the Corporation may be added upon the unanimous affirmative vote of the Shareholders of the Corporation.



Appointment of Officers of the Corporation

- The Shareholder Control Agreement may provide for the Appointment of Officers of the Corporation.
- Officers. The following individuals shall be elected by the Board to the officers of the Corporation set forth below and shall serve until this Agreement is either terminated or otherwise amended, or until his death, disability, resignation or removal:

Chief Executive Officer/President:	SP
Vice President:	TJ
Chief Financial Officer/Treasurer:	MJ
Secretary:	MJ

Any other officers of the Corporation shall be elected by unanimous vote of the Board of Directors.



S Corporation Status

- Many Closely held corporations elect pass – through tax treatment under IRC
- S Election. The Corporation has elected to be treated as an S corporation under the Internal Revenue Code, and for so long as the election is in effect during the term of this Agreement, then this section shall be applicable
- Preservation of Status. At any time prior to the revocation or termination of S corporation status, in order to preserve such status, no Shareholder or successor may transfer, and no person may acquire, beneficial ownership of and shares of the Corporation if such transfer or acquisition would cause the termination of the Corporation's status as an S corporation. The S election may be terminated only by the election of all of the Shareholders.
- Distributions. If the distributions to the Shareholders from the Corporation during any calendar year during the term of this Agreement are insufficient to enable the Shareholders to pay his or her federal and state income taxes attributable to the Corporation, then the Corporation shall endeavor to but shall not be required to make a distribution to the Shareholder for that purpose within ninety (90) days after the end of each such calendar year.
- Split Tax Year. If the Corporation's S corporation election is in effect on the date a Shareholder transfers his or her interest in the Corporation, then, if required by the Corporation, the Corporation shall determine its taxable income and all items reportable for tax purposes as of such date. In such event the parties agree that Internal Revenue Code section 1377(a)(2) shall apply; and thus the taxable year of the Corporation shall be treated as if it consisted of two taxable years the first of which ends on the transfer date. All taxable income shall be allocated to and among the Shareholders as of that date. The electing Corporation and the Shareholders shall execute and file such statements, election forms and consents as shall be necessary to implement this Agreement. In all events, the Corporation shall have the right to determine whether or not to make the election pursuant to Internal Revenue Code Section 1377(a)(2).



Mandatory Tax Distribution

- Sometimes, Shareholders require mandatory tax distributions from Corporations.
- Distributions. The Corporation shall make Distributions to the Shareholders of the Corporation, in the aggregate, for each fiscal year equal to not less than forty percent (40%) of the “ordinary business income” of the Corporation, for such fiscal year (“Mandatory Distribution”), unless all Shareholders otherwise agree in writing. Each Shareholder of the Corporation shall receive his, her or its proportionate share of the Mandatory Distribution determined based upon such Shareholder’s percentage ownership of the issued and outstanding Shares of the stock of the Corporation. Mandatory Distributions shall be made by the Corporation within sixty (60) days following the last day of each fiscal year. The Shareholders each hereby agree to cast their votes as directors in favor of Mandatory Distributions



Restrictions on Corporate Authority

- Often in Shareholder Control Agreements, Shareholders restrict the powers of the Board or the Officers
- Powers Reserved For Unanimous Action of Shareholders. From the date of this Agreement and notwithstanding any other provisions of this Agreement, neither the Board nor the President or any other officer shall have authority hereunder to cause the Corporation to engage in the following transactions (each a “Major Decision”) without first obtaining the affirmative vote or written consent of all of the Shareholders holding Voting Common Stock of the Corporation:
 - Election of officers and/or directors, except as described in Sections ___ and ___, above.
 - Issuance of any additional shares of the Corporation.
 - Sale, purchase, or redemption of any shares of the Corporation, except as otherwise provided in certain share redemption agreements or share transfer restriction agreements that have been duly executed by the Corporation.
 - Sell, merge, exchange, liquidate or otherwise dispose of any and/or all assets or interests of the Corporation with any Person, corporation, limited liability company or any other entity;
 - All funds of the Corporation shall be deposited in its name in such checking account or accounts as shall be designated by the Board. All withdrawals in excess of \$_____ therefrom are to be made upon checks required to be signed by both _____ and _____;



Restrictions on Corporate Authority - Continued

- Any acquisition (via asset or stock purchase, or merger) of any business, entity, or Person; "Person" shall mean an individual, partnership, limited partnership, corporation, limited liability company, trust, estate, association or any other entity;
- Any sale, purchase or lease of any interest in real property either as seller, buyer, lessee or lessor;
- Any additional or increase in loans, borrowing, pledging or securing of loans with interests in real or personal property (i.e. mortgages security agreements, pledges), or the restructuring or refinancing of any current or future indebtedness, loans, guarantees, or security agreements;
- Any capital expenditure for real or personal property (tangible or intangible) in excess of \$_____;
- Declaration of dividends or other distributions on shares;
- Adoption of annual operating budgets;
- Dissolution or liquidation of the Corporation or filing of a petition for liquidation or reorganization of the Corporation under the federal bankruptcy laws;
- The entry into any service contract or other agreement (except those otherwise expressly permitted under this Agreement) for goods or services in the amount of \$_____ or more;
- Any amendment, change or deviation of the Corporation's Purpose;
- Any confession of any judgment against the Corporation; and
- The formation of any subsidiary of the Corporation



Deadlock

- When Shareholders are unable to agree on important corporate matters, a deadlock in management can follow.
- Sometimes Shareholder Control Agreements can provide a “shoot-out” style deadlock breaking provision.
- Deadlock. In the event that either JT or SP for any good faith reason determine there is a deadlock in the management of the Corporation, then either JT or SP, in their sole discretion may notify, in writing, the other Shareholder that he believes a deadlock in management exists (the “Deadlock Notice”). Upon receipt of the Deadlock Notice, JT and SP shall have a thirty (30) day “cooling off period” where they may attempt to reconcile their differences or otherwise resolve the deadlock. In the event either JT or SP is not satisfied with the resolution, if any, of the dispute after such thirty (30) day period, then either JT or SP, in their sole discretion (the "Electing Shareholder"), may provide the other Shareholder (the “Non-Electing Shareholder”) written notice of his desire to sever ownership in the Corporation. Such written notice shall state a purchase price including the payment terms for which the Electing Shareholder is willing to sell his Shares or purchase the Shares of the Non-Electing Shareholder (the “Offer”). The Non-Electing Shareholder may then elect to sell his Shares to the Electing Shareholder at the proposed price and on the proposed payment terms or to purchase the Electing Shareholder’s Shares at the proposed price and on the proposed terms. Such election shall be made in writing and delivered to the Electing Shareholder within thirty (30) days of receipt of the Offer. If the Non-Electing Shareholder fails to make such election within thirty (30) days after receipt of the Offer, then the Electing Shareholder shall have the option to purchase the Shares of the Non-Electing Shareholder at the proposed price and on the proposed payment terms contained in the Offer. Such an election by the Electing Shareholder shall be made in writing delivered to the Non-Electing Shareholder not more than sixty (60) days after the receipt by the Non-Electing Shareholder of the Offer.



Deadlock Continued

The closing of the transaction shall occur within thirty (30) days thereafter. Notwithstanding anything herein to the contrary, the payment terms in the Offer must provide the entire purchase price must be paid in no more than thirty-six (36) months, in equal installments or a shorter amortization, following closing of the Shares and the interest rate must be six percent (6%) if the purchase of the Shares is to be financed. It is further provided, if the purchase price for the Shares is not paid in full at closing, then once the Shares have been transferred to the purchasing party, the transferred Shares shall be delivered by the purchasing party to the transferring Shareholder to be held as collateral security for the payment of said note pursuant to the provisions of a Pledge Agreement reasonably acceptable to the transferring Shareholder which the purchasing party shall execute on the date of closing. The purchasing party shall have the right, while said pledge is effective, to vote the pledged Shares.

- In the event JT or SP purchases the other Shareholder's Shares pursuant to this Article __ then the purchasing Shareholder shall also be obligated to cause the Corporation to repay any obligations due and owing the selling Shareholder. Furthermore, the purchasing Shareholder shall cause the Corporation to use its best efforts to obtain releases of any guaranties the selling Shareholder extended for the benefit of the Corporation.



Dispute Resolution Procedures - Court

- The Shareholder Control Agreement can provide the means and forum to resolve disputes concerning the Agreement.
- Governing Law; Jurisdiction. This Agreement shall be construed, interpreted, governed and enforced in accordance with the laws of the State of Minnesota without regard to its choice of law or conflict of law rules. Each party to this Agreement agrees that the state and federal courts located in Minneapolis, Minnesota, County of Hennepin, shall have exclusive jurisdiction to hear and determine any suit, action or proceeding, and to settle any disputes, which may arise out of or in connection with this Agreement or any of the transactions contemplated hereunder and, for such purposes, hereby consents to jurisdiction of a venue in the United States District Court, District of Minnesota, Fourth Division or in the Minnesota State Court, Hennepin County, Fourth Judicial District. Each of the parties hereto (i) agrees that it shall not attempt to deny or defeat such personal jurisdiction by motion or other request for leave from any such court, and (ii) agrees that it shall not bring any action relating to this Agreement or any of the transactions contemplated hereby in any court other than courts set forth above. Each of the parties waives any defense of inconvenient forum to the maintenance of any action or proceeding so brought and waives any bond, surety, or other security that might be required of any other party with respect thereto.



Dispute Resolution Procedures - Arbitration

- Any controversy or dispute, of whatever nature, between the Shareholders regarding the Corporation, this Agreement, or their relationships as shareholders of the Corporation, shall be finally and conclusively resolved by arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction.
- All questions as to the meaning of this Section or as to the arbitrability of any dispute under this Section shall be resolved by the arbitrators, and their decision on such questions shall be final and binding and not subject to judicial review. All arbitration proceedings shall be conducted in Hennepin County, Minnesota. To the extent it shall become necessary to prohibit any act of a Shareholder which would violate this Agreement, this Section shall not limit the right of a Shareholder to seek and obtain an injunction or other equitable relief by a court of competent jurisdiction.



Conflict Acknowledgment and Waiver

- Often times the Corporation's general counsel is asked to draft the Shareholder Control Agreement. This creates a possible conflict of interest between the Shareholders and the Corporation. Often times this conflict is waived.
- Each of the parties to this Agreement acknowledges that _____ ("LAW FIRM") has represented the Corporation with respect to the negotiation, execution and enforcement of this Agreement. LAW FIRM may have represented parties to this agreement with respect to their individual interests in other matters, which may include matters connected with this Agreement. Representation of multiple parties in such a transaction raises potential conflicts of interest which may arise at a later time if the parties are not represented by separate legal counsel to advise them regarding the terms and conditions of an Agreement such as this one. Each party agrees that LAW FIRM has adequately disclosed that potential or actual conflicts of interest may exist among the parties and in LAW FIRM's representation of the Corporation, which each fully understands, (a) each hereby consent to LAW FIRM's representation of the Corporation and the negotiation, execution and enforcement of this Agreement, (b) that each party is encouraged to seek separate counsel, and (c) each party hereby waives any claim of any kind and nature whatsoever that LAW FIRM's representation of the Corporation in connection with the negotiation, execution and enforcement of this Agreement is a conflict of interest or any way affects the enforceability of this Agreement.



MESSERLI & KRAMER

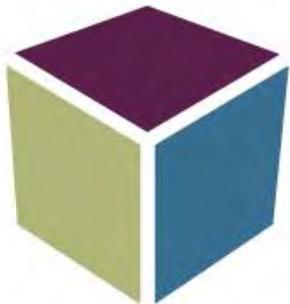
Shareholder Control and Operating Agreements: Enforceability Issues

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Brett M. Larson

- Brett Larson is a shareholder in the corporate group who focuses his practice in the areas of corporate organization and reorganization, contract negotiation, and succession planning for businesses.
- Litigation experience
 - Served as lead counsel to a minority shareholder pursuing claims totaling \$136 million. The ten-day trial resulted in a judgment against one of the defendants in favor of the Firm's client.
 - Served as lead counsel to an established Minnesota law firm and its founding shareholder in a lawsuit brought by a shareholder of the law firm. After motion practice the matter was resolved for less than 2% of the claimed damages.
 - Numerous State and Federal Court cases and AAA Arbitrations



Shareholder Control and Operating Agreements

- Agreements between owners of a Corporation (Shareholder Control Agreement) or LLC (Operating or Member Control Agreement)
- Governance structure
 - Owner managed, board managed, or officer/manager managed
 - Relative roles and responsibilities in management
- Financial rights
- Buy-sell provisions



Context of Enforcement

■ Shareholder litigation

- Breach of fiduciary duty
- Unfairly prejudicial conduct case
 - Return on Equity (Fair Value Buyout)
 - Triggered by “unfairly prejudicial conduct” regardless of buy-sell agreement triggering events
 - Fair value opposed to fair market value
 - $FMV = FV - 35\%$ discount for lack of marketability and lack of control
 - Return on Labor (reasonable expectation of life time employment)
 - A shareholder in a close corporation has a reasonable expectation to continue to be employed by his company for the remainder of his career (main economic value of owning a small business). *Pedro v. Pedro*, 489 N.W.2d 798 (Minn. 1992).
 - A shareholder may be fired for cause, however, expectation to continued input in management is still a protected expectation that can give rise to a forced buyout. *Pooley v. Mankato Iron & Metal, Inc.*, 513 N.W.2d 834 (Minn. 1994).
 - A shareholder employee may have a reasonable expectation to lifetime employment even if he has an at will employment agreement. *Gunderson v. Alliance of Computer Prof.*, 628 N.W.2d 173 (Minn. Ct. App. 2001).

■ Friendly buyout under buy-sell agreement



What Law Applies?

- State of incorporation generally determines the state law that applies to governance and interpretation of rights between owners and company
- Venue and jurisdiction provisions in agreement can name a court that is different than the state of incorporation
- Dispute resolution provision can choose arbitration instead of court to resolve any dispute
 - Cost savings?
 - Rules for arbitration (eg. AAA)
 - Panel or single arbitrator
 - Bound to apply law?
 - Scope of arbitration?
- Attorney fee provision and statutory basis for fees
 - Contract – reasonable fees to prevailing party
 - Statute – vexatious litigant pays fees to prevailing party



Corporations: Default

- Duty of care and loyalty owed by owners, directors, and officers
 - MBCA
 - Directors and officers – common law and statutory duty to discharge duties in accordance with good faith business judgment of the best interest of the corporation (BJR)
 - Shareholders – highest duty of good faith and fair dealing owed between partners
 - Delaware – Business Judgment Rule. *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275, 286 (Del. Ch. Ct. May 28, 2003).
 - Where the director has a financial interest in the contested action, the “entire fairness” standard applies – looks to ensure fair dealing and fair price.
- Fair Value Buyout Claim
 - MBCA – state specific – frustration of reasonable expectations
 - Delaware – does not exist
- Dissenters Rights
 - MBCA – FV buyout on merger, plan or exchange etc.
 - Delaware – does not exist



Corporations: Modifying the Default Through Shareholder Control Agreements

- Ability to modify duty of care through a SCA
 - MBCA – States vary widely on what level of modification will be upheld to statutes authorizing any modification that does not eliminate liability for willful misconduct or knowing violation of criminal law.
 - Delaware – Can be eliminated except to authorize a breach of the duty of loyalty, intentional misconduct or knowing violation of law, or any transaction from which the actor derives an improper personal benefit. 6 Del. Code § 102(b)(7).
- Fair Value Buyout Claim
 - MBCA – Define and carve out specific “reasonable expectations”
 - Delaware – does not exist
- Dissenters Rights
 - MBCA – Carve out
 - Delaware – Does not exist



ReULLCA Adoption

- The following 12 U.S. jurisdictions have adopted ReULLCA:
 - Alabama,
 - California,
 - District of Columbia,
 - Florida,
 - Idaho,
 - Iowa,
 - Minnesota,
 - Nebraska,
 - New Jersey,
 - South Carolina,
 - Utah, and
 - Wyoming.



LLC: Default

- Duty of care and loyalty owed by owners, directors, and officers
 - ReULLCA – Defined by business judgment rule.
 - Delaware – Defined by business judgment rule.
Wood v. Baum, 953 A.2d 136 (Del. 2008).
- Fair Value Buyout Claim
 - ReULLCA – state specific – frustration of reasonable expectations
 - Delaware – does not exist
- Dissenters Rights
 - ReULLCA – state specific – Minnesota does not exist
 - Delaware – does not exist



LLCs: Modifying the Default Through Operating Agreements

- Ability to modify of duties of care, good faith and fair dealing and duty of loyalty duty through an OA
 - ReULLCA
 - GFFD – May modify, define, and eliminate aspects of fiduciary duty subject to “manifestly unreasonable standard”
 - Loyalty – May not completely eliminate, but may define conduct that breaches and conduct that breaches and conduct that does not.
 - Delaware – May limit liability for breach of duties or eliminate the duties entirely.
- Fair Value Buyout Claim
 - ReULLCA – OA may carve out fair value buyout remedy
- Dissenters Rights
 - ReULLCA – state specific – if necessary carve out in OA



Manifestly unreasonable

- The Court is to look to the facts known or knowable at the time the agreement was entered.
- Manifestly unreasonable if:
 - Term accomplishes an unreasonable objective
 - Term is an unreasonable means to achieve an objective
- Term is borrowed from the UCC
 - “clearly unreasonable”
 - “on the spectrum of reasonableness somewhere between unreasonable and unconscionable”



Goals of SCA/OA: Clarity and Certainty

- Create certainty that buy-sell agreement will be enforced for fair market value on agreed upon triggers
 - Eliminate dissenters' rights if applicable as a default
 - Eliminate fair value buyout claim if possible
 - Clearly define duties and expectations
- Clearly define duties of controlling individuals
 - Modify duty of loyalty and define conduct that does not breach
 - Modify and define duty of care and of good faith and fair dealing
- Create certainty that employment agreement will govern all employment matters
 - At will employment agreements
 - SCA/OA waive reasonable expectation to life time employment

