

# The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions

*By the Corporation Law Committee of the  
Association of the Bar of the City of New York*

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Agreements among two or more shareholders of a corporation are commonly used in connection with private equity and venture capital investments, joint ventures, and other corporate transactions. A shareholders agreement typically grants rights to those shareholders who are party to the agreement that are above and beyond the rights that are inherent in the shares that they own, and is intended to ensure that those shareholders obtain the benefits of the additional rights that they bargained for when making their investments. For example, shareholders agreements may allocate among certain shareholders rights to designate the individuals who will serve on the company's board of directors, grant certain shareholders special voting rights, ensure that certain shareholders have preemptive rights if the company issues additional equity securities, and/or provide rights to limit or participate in transfers of shares by other shareholders, among other things. Although "freedom of contract" is the legal principle that governs many provisions contained in a typical shareholders agreement, there are numerous legal considerations that will affect their enforceability and effectiveness.

The Corporation Law Committee of the Association of the Bar of the City of New York has prepared this Report to highlight many of these legal considerations, with a goal of providing guidance to practitioners drafting these agreements. Many matters addressed by shareholders agreements are governed by, and must comply with, the corporation law of the state of incorporation. Because so many corporations are incorporated in Delaware or New York, this Report will focus primarily on legal considerations arising under shareholders agreements for companies incorporated in these states. If a corporation has been formed in another state, it will, of course, be necessary for the lawyer drafting the shareholders agreement to consider the applicable provisions of the corporation statute of the relevant state. Shareholders agreements are most commonly entered into by shareholders of privately held corporations, so this Report generally discusses agreements among shareholders of a private corporation (unless otherwise indicated). Although agreements among shareholders of close corporations raise similar concerns, the statutory provisions applicable to close corporations are beyond the scope of this Report.

A summary of typical provisions contained in shareholders agreements and certain relevant legal principles and drafting considerations are provided below.

## **I. BOARD OF DIRECTORS**

Shareholders agreements typically seek to establish the agreed-upon composition of the board of directors and related corporate governance matters.

### **A. SHAREHOLDERS' NOMINATION AND ELECTION OF DIRECTORS**

Shareholders with meaningful ownership positions generally want to ensure that individuals they designate will serve on the corporation's board of directors, both to influence the management of the corporation and to ensure timely access to information about the corporation's activities and prospects.

## 1. Certain Legal Principles:

- Both the General Corporation Law of the State of Delaware (the “Del. G.C.L.”) and the New York Business Corporation Law (the “N.Y.B.C.L.”) recognize as valid an agreement between two or more shareholders (if in writing and signed by each) that establishes how the shares held by those shareholders will be voted.<sup>1</sup>
- Whether the corporation is public or private, corporation laws generally require companies to hold annual meetings of shareholders to elect directors, and directors must be elected by the shareholders at these annual meetings.<sup>2</sup>
- Unless otherwise indicated by the corporation’s certificate of incorporation or bylaws, directors of Delaware and New York corporations must be elected by a plurality of the votes cast at a shareholders meeting by the holders of shares entitled to vote in the election.<sup>3</sup>
- Election of directors by written consent of the shareholders is permitted, although the relevant corporation law may limit the utility of this procedure. For example, Delaware law permits an election of directors by written consent in lieu of an annual meeting; however, a written consent satisfies the annual meeting requirement for Delaware corporations only if the consent is unanimous or if all directorships are vacant (which can be accomplished by removing all the directors prior to electing the new board by written consent) and are to be filled by the written consent.<sup>4</sup> New York law does not similarly limit the use of a written consent of the shareholders; however, action by less than unanimous written consent must be specifically authorized in the certificate of incorporation.<sup>5</sup>
- Subject to any reasonable procedures set forth in the bylaws, any shareholder present at the annual meeting may nominate any individual for election as a director.<sup>6</sup> Most modern public corporations and many private corporations have bylaws that require shareholders to comply with advance notice procedures for the nomination of directors, so there are limitations on shareholders’ ability to nominate directors at the annual meeting. N.Y.B.C.L. section 602(d) expressly provides that the bylaws may specify “reasonable procedures for the . . . conduct of a meeting of shareholders, including . . . the procedures and requirements for the nomination of directors.”<sup>7</sup> Del. G.C.L. section 109, which provides that the bylaws may contain provisions relating to the rights and powers of shareholders,

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1. DEL. CODE ANN. tit. 8, § 218(c) (2001); N.Y. BUS. CORP. LAW § 620(a) (McKinney 2003).

2. See DEL. CODE ANN. tit. 8, § 211(b) (2001); N.Y. BUS. CORP. LAW § 602(b) (McKinney 2003).

3. DEL. CODE ANN. tit. 8, § 216(3) (2001); N.Y. BUS. CORP. LAW § 614(a) (McKinney 2003 & Supp. 2010).

4. DEL. CODE ANN. tit. 8, § 211(b) (2001).

5. N.Y. BUS. CORP. LAW § 615(a) (McKinney 2003).

6. See *id.* § 605(a) (requiring notice of purpose for special meetings but not for annual meetings); JANA Master Fund, Ltd. v. CNET Networks, 954 A.2d 335, 344 (Del. Ch. 2008).

7. N.Y. BUS. CORP. LAW § 602(d) (McKinney 2003).

has been interpreted as permitting advance notice bylaws if they do not unduly restrict the stockholder franchise and are applied equitably.<sup>8</sup>

## 2. Drafting Considerations:

- Shareholders agreements often create rights to “designate” or “appoint” directors. However, to conform with legal requirements that directors be “elected” by shareholders, the shareholders agreement should set forth the process by which individuals are *nominated* by the shareholders, as well as the agreement of the shareholders party to the agreement to vote their shares to elect those nominees as directors. The agreed-upon procedures required for those shareholders to nominate directors should also be set forth in the corporation’s certificate of incorporation or bylaws (or incorporated by reference to the shareholders agreement) in a provision that cannot be amended except as permitted by the shareholders agreement. The shareholders agreement may also include a grant of a proxy to the nominating shareholder by the other shareholders to allow the nominating shareholder to vote the other shareholders’ shares in favor of its nominated director(s). Without a proxy, a voting agreement may not be specifically enforceable.<sup>9</sup> As the laws governing the validity of proxies vary from state to state, the draftsperson should confirm when drafting a proxy that it complies with applicable state laws.
- A shareholders agreement may include a provision to reduce or eliminate a shareholder’s right to nominate a director as its ownership interest declines, and a provision for termination of the nomination rights and voting obligations (usually upon an initial public offering, but other circumstances may also terminate these provisions).

## B. REMOVAL OF DIRECTORS

An important corollary to a shareholder’s right to designate a director is its right to remove that director and substitute a successor. Removal is also relevant when a shareholder’s right to designate a director has terminated pursuant to the terms of the shareholders agreement.

### 1. Certain Legal Principles:

- In Delaware, subject to certain exceptions, directors may be removed *without cause* by shareholders owning a majority of the outstanding shares

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8. DEL. CODE ANN. tit. 8, § 109 (2001); see, e.g., *JANA Master Fund*, 954 A.2d at 344; *Accipiter Life Scis. Fund, L.P. v. Helfer*, 905 A.2d 115, 124–25 (Del. Ch. 2006) (“[A]dvance notice bylaws . . . must on their face and in the particular circumstances ‘afford the shareholders a fair opportunity to nominate candidates.’” (quoting *Hubbard v. Hollywood Park Realty Enters., Inc.*, No. 11779, 1991 WL 3151, at \*11 (Del. Ch. Jan. 14, 1991))).

9. See *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, 53 A.2d 441, 447–48 (Del. 1947).

entitled to vote at an election of directors.<sup>10</sup> Under New York law, however, directors may be removed *without cause* by shareholders only if the certificate of incorporation or bylaws so provide.<sup>11</sup>

- For both Delaware and New York corporations, directors may be removed *for cause* by shareholders owning a majority of the outstanding shares entitled to vote at an election of directors.<sup>12</sup> In addition, in New York, directors may also be removed by the board *for cause* if permitted by the certificate of incorporation or a bylaw adopted by the shareholders.<sup>13</sup>
- In Delaware, directors may be removed through written consent (unless prohibited in the certificate of incorporation) by shareholders owning a majority of the outstanding shares entitled to vote at an election of directors.<sup>14</sup> New York corporations can provide for this rule in their certificate of incorporation; otherwise, unanimous written consent is required for removal.<sup>15</sup>
- Removal rights of the shareholders and, in the case of New York corporations, the powers of the board to remove directors may be limited if the board is classified, if the corporation has cumulative voting, or if directors are elected by a class or series of shares.<sup>16</sup>

## 2. Drafting Considerations:

The certificate of incorporation or bylaws, as appropriate, should ensure that shareholders will be able to remove the directors they nominate, with or without cause (in accordance with the shareholders agreement). Each shareholder should agree in the shareholders agreement that it *will not* vote or execute a written consent to remove a director nominated by another shareholder, usually whether with or without cause, unless the shareholder that nominated that director requests the removal. Conversely, each shareholder should agree that it *will* vote or execute a written consent to remove a director if requested by the shareholder that nominated that director. Some agreements may permit other shareholders to remove a director for cause, in which case the standard of conduct that constitutes “cause” should be carefully considered to avoid later disagreements.

### C. FILLING BOARD VACANCIES

The complement of being able to remove a designee is the assurance of being able to install a replacement.

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10. DEL. CODE ANN. tit. 8, § 141(k) (2001).

11. N.Y. BUS. CORP. LAW § 706(a), (b) (McKinney 2003).

12. DEL. CODE ANN. tit. 8, § 141(k) (2001); N.Y. BUS. CORP. LAW § 706(a) (McKinney 2003).

13. N.Y. BUS. CORP. LAW § 706(a) (McKinney 2003). Delaware, on the other hand, does not allow directors to remove other directors.

14. DEL. CODE ANN. tit. 8, §§ 141(k), 228(a) (2001).

15. N.Y. BUS. CORP. LAW § 615(a) (McKinney 2003).

16. DEL. CODE ANN. tit. 8, § 141(k) (2001); N.Y. BUS. CORP. LAW § 706(a), (c) (McKinney 2003).

## 1. Certain Legal Principles:

Unless otherwise provided in the certificate of incorporation or bylaws, the board of directors generally may fill any vacancy itself (including vacancies created by resignation or removal and newly created directorships).<sup>17</sup> In Delaware, this is true whether the director was removed for cause or without cause. In New York, however, a vacancy on the board resulting from a removal of a director without cause must be filled by the shareholders, unless the certificate of incorporation or a shareholder-adopted bylaw gives the board a right to fill such a vacancy.<sup>18</sup>

## 2. Drafting Considerations:

To ensure the efficacy of the designating shareholder's right to select the successor, the shareholders should be given (i) in the certificate of incorporation or bylaws, the exclusive right to nominate and elect directors to fill vacancies; (ii) in the certificate of incorporation or bylaws, the right to call a special meeting of the shareholders for the purpose of filling vacancies; and (iii) in the bylaws, a right granted to the shareholder who designated the director whose seat has become vacant to nominate an individual to fill the vacancy; and the shareholders should agree in the shareholders agreement to vote for the directors so nominated.<sup>19</sup> Of course, this procedure will be effective only if shareholders holding at least a plurality in voting power are parties to the shareholders agreement. In each case, the certificate of incorporation and/or bylaws should require that any such provisions may be amended only by the shareholders whose consent would be required to amend the corresponding provision of the shareholders agreement.

## D. BOARD SIZE, QUORUM, AND VOTING

Shareholders agreements typically address board size, as well as the quorum and voting requirements for decisions by the board. These provisions should work together to ensure that the viewpoints of a sufficient number of shareholder designees are considered before the board takes any action, but without adversely

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17. See DEL. CODE ANN. tit. 8, § 223(a) (2001 & Supp. 2008); N.Y. BUS. CORP. LAW § 705 (McKinney 2003).

18. N.Y. BUS. CORP. LAW § 705(b) (McKinney 2003).

19. Sometimes shareholders agreements provide that vacancies in directorships of designated directors be filled only by other directors nominated by the same stockholder. The validity of this type of provision under the Del. G.C.L. is questionable, unless such directors are constituted as a committee of the board that is empowered to fill such vacancies. Likewise, a provision that commits the board to fill a vacancy with a person nominated by a specific shareholder is subject to the board's fiduciary duties. See *In re Aquila Inc. S'holders Litig.*, 805 A.2d 184, 193 (Del. Ch. 2002) (recognizing that directors owe fiduciary duties when filling vacancies). This issue can be avoided if the right to fill vacancies is vested in the shareholders, with the designating shareholder having the right to nominate the replacement to fill the vacancy and the other shareholders being bound to vote in favor of such nominee. See generally *Campbell v. Loew's, Inc.*, 134 A.2d 852, 857 (Del. Ch. 1957) (stating that the permissive language of Del. G.C.L. section 223(a) "does not prevent the stockholders from filling the new directorships" or other vacancies).

affecting the effectiveness of the board or fostering deadlocks. Potential changes in board size should also be addressed, so the board cannot circumvent the quorum and voting requirements that have been agreed to by the shareholders.

### 1. Legal Principles—Board Size:

Delaware law provides that the certificate of incorporation may fix the number of directors, and unless so fixed, the number shall be fixed by, or in the manner provided in, the bylaws.<sup>20</sup> Delaware case law makes clear that the certificate of incorporation can provide for a range of board sizes, with the exact size within that range fixed by the board of directors.<sup>21</sup> New York law provides that the number of directors may be fixed by the bylaws, by action of the shareholders, or by the board if empowered by a bylaw adopted by the shareholders.<sup>22</sup>

### 2. Drafting Considerations—Board Size:

Board size, whether a fixed number or a range, should be set forth in a bylaw that cannot be amended without the same shareholder approval required to amend the comparable provision of the shareholders agreement. In Delaware, board size alternatively may be set forth in the certification of incorporation. The shareholders should agree in the shareholders agreement that they will not vote in favor of any change to the certificate of incorporation or bylaws that would be inconsistent with any provision of the shareholders agreement.

### 3. Certain Legal Principles—Quorum Requirement:

Generally, a majority of the total number of directors constitutes a quorum.<sup>23</sup> However, both Delaware and New York law permit changes to the quorum requirement, although the requirement cannot be less than one-third of the entire board.<sup>24</sup> For a Delaware corporation, a provision *increasing* the requirement for a quorum may be contained in the corporation's certificate of incorporation or bylaws.<sup>25</sup> A provision *decreasing* the quorum requirement may be contained in the bylaws, unless the certificate of incorporation provides otherwise.<sup>26</sup> For a New York corporation, a provision *increasing* the percentage of the board constituting a quorum must be contained in the certificate of incorporation, while a provision *decreasing* the quorum requirement may be contained in the certificate of incorporation or bylaws.<sup>27</sup>

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20. DEL. CODE ANN. tit. 8, § 141(b) (2001 & Supp. 2008).

21. See *Henley Group, Inc. v. Santa Fe S. Pac. Corp.*, No. 9569, 1988 WL 23945, at \*16–19 (Del. Ch. Mar. 11, 1988).

22. N.Y. BUS. CORP. LAW § 702(a) (McKinney 2003).

23. See DEL. CODE ANN. tit. 8, § 141(b) (2001 & Supp. 2008); N.Y. BUS. CORP. LAW § 707 (McKinney 2003).

24. See *supra* note 23.

25. DEL. CODE ANN. tit. 8, § 141(b) (2001 & Supp. 2008).

26. *Id.*

27. N.Y. BUS. CORP. LAW § 707 (McKinney 2003).



#### **4. Drafting Considerations—Quorum Requirement:**

The number of directors necessary to constitute a quorum of the board should be set forth in the certificate of incorporation or a bylaw that cannot be amended without shareholder approval. If future changes to the quorum requirement are contemplated by the shareholders agreement, the certificate of incorporation or bylaws should provide for such changes. If specified directors are required for a quorum to be present, this provision must be included in the certificate of incorporation.<sup>28</sup>

#### **5. Certain Legal Principles—Voting Requirement:**

Any action by the board of directors generally requires either the approval of a majority of the directors who are present at a meeting at which a quorum is present, or a written consent approved by all directors.<sup>29</sup> For certain items, shareholders may desire a supermajority vote of the directors rather than a simple majority. The voting requirement for the board of directors may be greater (but not less) than the majority requirement established by statute, but only if set forth in the certificate of incorporation or bylaws.<sup>30</sup> In addition, a recent amendment to Delaware law would permit the certificate of incorporation (but not the bylaws) to require that the approval of one or more specified directors is required to take particular actions and/or that one or more directors may have more or less than one vote per director on any matter.<sup>31</sup>

#### **6. Drafting Considerations—Voting Requirement:**

A shareholders agreement alone cannot create or modify the majority voting requirement for actions by the board of directors. Accordingly, if the shareholders agree that the approval of a supermajority of directors should be required to authorize any action, this requirement should be specified in the corporation's certificate of incorporation or a bylaw that cannot be amended without shareholder approval. All shareholders party to the shareholders agreement should agree to vote their shares on any amendment to the certificate of incorporation or bylaws only if consistent with the provisions of the shareholders agreement.

### **E. LIMITING THE POWERS OF THE BOARD OF DIRECTORS**

The corporation law statutes generally grant to the directors broad discretion to manage the business and the affairs of the corporation within the parameters set forth in the certificate of incorporation and bylaws, but the shareholders may

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28. See DEL. CODE ANN. tit. 8, § 141(d) (2001 & Supp. 2008).

29. See *id.* § 141(b), (f); N.Y. BUS. CORP. LAW § 708(b), (d) (McKinney 2003).

30. See DEL. CODE ANN. tit. 8, § 141(b) (2001 & Supp. 2008); N.Y. BUS. CORP. LAW § 709(a)(2) (McKinney 2003).

31. DEL. CODE ANN. tit. 8, § 141(d) (2001 & Supp. 2008).

prefer to retain this power and/or limit the board's discretion and reflect these preferences in the shareholders agreement.

### 1. Certain Legal Principles:

- In New York, directors are able to amend or repeal a bylaw that has been adopted by the shareholders only if there is a specific grant of such authority in the certificate of incorporation or bylaws.<sup>32</sup>
- The Del. G.C.L. has no comparable provision. However, because directors of a Delaware corporation do not have the power to amend the bylaws unless the authority to do so is granted in the certificate of incorporation,<sup>33</sup> a provision in the certificate of incorporation that gives the board the power to adopt, amend, or repeal the bylaws could be drafted to limit the board's ability to amend any bylaws that were adopted by shareholders. In the absence of such a limitation, except in the case of the shareholder-adopted bylaws relating to the vote required to elect directors (which cannot be amended by the board),<sup>34</sup> it is likely that a certificate of incorporation provision granting the board the power to "adopt, amend, or repeal the bylaws" would be interpreted as granting the board the power to amend any bylaws, including those adopted by the shareholders, subject to the board's fiduciary duties.<sup>35</sup>

### 2. Drafting Considerations:

- If the shareholders desire to limit or eliminate the board's powers to address matters that the corporation law statute would allow the board to address if specified in the certificate of incorporation or bylaws, the shareholders should ensure that the certificate of incorporation and bylaws contain express limitations on the board's discretion in the relevant circumstances. Moreover, the shareholders agreement should provide that each shareholder agrees not to vote its shares for any change to the certifi-

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32. N.Y. BUS. CORP. LAW § 601(a) (McKinney 2003).

33. DEL. CODE ANN. tit. 8, § 109 (2001).

34. DEL. CODE ANN. tit. 8, § 216 (2001 & Supp. 2008).

35. See *Bebchuck v. CA, Inc.*, 902 A.2d 737, 743 n.37 (Del. Ch. 2006); *Gen. DataComm Indus., Inc. v. Wis. Inv. Bd.*, 731 A.2d 818, 821 n.1 (Del. Ch. 1999) ("The question of whether a stockholder-approved bylaw may be repealed by a board of directors . . . has not clearly been answered by a Delaware court. However, the Supreme Court's decision in *Centaur Partners* . . . and the views of a learned commentator [Hamermesh] suggest that the affirmative answer may be the correct one."); *In re Nat'l Intergroup, Inc. Rights Plan Litig.*, Nos. 11484, 11511, 1990 WL 92661, at \*7 (Del. Ch. July 3, 1990); *Am. Int'l Rent a Car, Inc. v. Cross*, No. 7583, 1984 WL 8204, at \*3 (Del. Ch. May 9, 1984) ("If a majority of American International's stockholders in fact disapproved of a Board's amendment of the bylaw, several resources were, and continue to be, available to them. They could vote the incumbent directors out of office. Alternatively, they could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question.")

cate of incorporation or bylaws unless the level of shareholder approval set forth in the shareholders agreement is satisfied.

- Although some shareholders agreements purport to require each shareholder to cause its designated director(s) to vote in a particular way on specified matters, this approach will not ensure that the shareholders will realize the benefit of this bargained-for right, because the directors will have fiduciary duties to act in the best interests of the corporation and all of its shareholders, notwithstanding the desires of any particular shareholder. These fiduciary duties cannot be overridden by private agreement. A somewhat better approach is to require in the certificate of incorporation that certain actions cannot be taken except with stockholder approval, as non-controlling stockholders are generally free to vote in their own interest without fiduciary duty constraints.<sup>36</sup> A less effective approach is to require that the corporation be party to the shareholders agreement, with an obligation not to take specified actions except with the consent of a requisite number of shareholders. This is not as effective as a limitation in the certificate of incorporation or a bylaw provision that cannot be amended without the consent of the shareholders, because the corporation would retain authority to take the specified actions. However, the shareholders party to the shareholders agreement would have a claim against the corporation for breach of the shareholders agreement if the board of directors authorizes, and the corporation takes, any of the specified actions without obtaining the requisite shareholder consent. If the shareholders learn of a possible breach in advance, a court might also be willing to grant an injunction to prevent the action from being taken in violation of the shareholders agreement, because damages would be difficult to determine.<sup>37</sup>

## F. BOARD COMMITTEES

Corporation laws generally grant power to the board of directors in its entirety, but they permit boards to delegate authority to committees with respect to certain matters. Although board committees may generally exercise all of the powers of the board of directors, there are limitations.

### 1. Certain Legal Principles:

- A resolution of the board of directors or the bylaws of a Delaware corporation may establish any committee of the board to exercise the power and authority of the board, but a committee of the board of a Delaware corporation cannot have the power to (i) approve or adopt, or recommend to

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36. See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987). *But see Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994) (controlling stockholder owes fiduciary duties to the corporation and minority stockholders).

37. See *Brinati v. TeleSTAR, Inc.*, No. 8118, 1985 WL 44688, at \*4 (Del. Ch. Sept. 3, 1985).

the shareholders, any matter that is expressly required by the Del. G.C.L. to be submitted to stockholders for approval (other than the election or removal of directors) or (ii) adopt, amend, or repeal any bylaw.<sup>38</sup> Shareholders may adopt bylaws that limit the powers that a board may grant to a committee and regulate the process by which a board acts through a committee.<sup>39</sup>

- The power of the board of directors of a New York corporation to establish committees must be granted to the board by the certificate of incorporation or bylaws.<sup>40</sup> With this grant, a resolution of a majority of the entire board of directors can establish a committee that would have the authority of the board.<sup>41</sup> However, a committee of the board of a New York corporation cannot have the power to (i) submit to shareholders any action that requires shareholder approval under any provision of the N.Y.B.C.L.; (ii) fill any board or committee vacancies; (iii) fix director compensation; (iv) amend or repeal the bylaws or adopt new bylaws; or (v) amend or repeal any board resolution that by its terms is not so amendable or repealable.<sup>42</sup>

## 2. Drafting Considerations:

If a shareholders agreement provides that directors who were nominated by particular shareholders must be included as members of specified board committees, it is preferable that this requirement, or a requirement that committees include directors nominated by specified shareholders in order to be validly constituted, also be included in the certificate of incorporation or a bylaw provision that cannot be amended without shareholder approval, to limit clearly the authority of the board to establish a committee with a different composition. An alternative would be to have in place protective quorum and voting requirements for the board in the certificate of incorporation or bylaws so that a significant majority of directors must agree before committee members can be named or replaced. In addition, as noted above, the certificate of incorporation (but not the bylaws) of a Delaware corporation could require the consent of specified directors to constitute or change committee membership. The shareholders agreement may also require that shareholders take all actions necessary to require the board to comply with committee composition requirements contained in the shareholders agreement (requiring shareholders to vote to remove any director that takes any action inconsistent with such requirement).

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38. DEL. CODE ANN. tit. 8, § 141(c)(1)–(2) (2001).

39. See *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1079 (Del. Ch. 2004) (shareholders may adopt bylaws, if equitable, eliminating a board committee after it has been created).

40. N.Y. BUS. CORP. LAW § 712(a) (McKinney 2003).

41. *Id.*

42. *Id.*

## G. BOARD OBSERVER RIGHTS

Many shareholders agreements give one or more shareholders a right to appoint an observer to attend board meetings and receive information that is otherwise sent to directors. These rights may be granted immediately or may arise after the shareholder's ownership falls below the minimum ownership percentage required to designate a director, and they are particularly common when the shareholder is an investment fund seeking to qualify as a "venture capital operating company" under ERISA. An observer does not have the right to vote on matters voted upon by the board. Likewise, because an observer is not a member of the board, the fiduciary duties applicable to board members are not applicable to observers.

### 1. Certain Legal Principles:

Neither the Del. G.C.L. nor the N.Y.B.C.L. expressly references board observers, so they do not have any statutory rights, obligations, or powers.

### 2. Drafting Considerations:

If a shareholders agreement provides for an observer, the agreement should also include provisions to protect the corporation. For example, the shareholders agreement should require that an observer enter into a confidentiality agreement as a condition to the observer's appointment. The shareholders agreement should also allow the corporation to exclude an observer from any meeting where inclusion would cause the corporation to lose a right or otherwise prejudice the corporation: for example, where a meeting involves a discussion of privileged matters and the participation of an observer in such meeting could result in a waiver of the privilege.

## H. INDEMNIFICATION

To assure shareholders that the corporation will provide adequate indemnification for the directors they nominate and elect, shareholders agreements frequently require that the corporation provide directors the maximum indemnification permitted by applicable law. Some shareholders agreements also require the corporation to obtain director and officer liability insurance.

### 1. Certain Legal Principles—Indemnification of Directors Generally:

- Both the Delaware and New York statutes authorize corporations generally to indemnify their current and former directors against expenses (including attorney's fees), judgments, fines, and settlement payments that are reasonably incurred by the director in connection with any threatened, pending, or completed civil or criminal action, suit, or proceeding brought because he or she is or was a director, and permit corporations to pay the director's expenses (including attorney's fees) in defending any

such proceedings, in advance of final disposition, if the director agrees to reimburse the corporation if it is later determined that he or she was not entitled to indemnity.<sup>43</sup>

- Once a director is successful in defending an action, suit, or proceeding, the corporation is required to indemnify that person for expenses (including attorney's fees) that are actually and reasonably incurred.<sup>44</sup> Prior to a successful conclusion, however, this indemnification is not self-executing—i.e., the corporation has the authority, but is not required, to provide such indemnification unless this requirement is expressly provided pursuant to the corporation's certificate of incorporation, bylaws, a resolution of the board of directors, or an agreement between the corporation and the director(s).<sup>45</sup>
- An agreement that obligates the corporation to indemnify or advance expenses to directors beyond what is described in the applicable statute may be enforceable.<sup>46</sup>
- Although the Delaware Court of Chancery recently ruled that a corporation may amend a bylaw provision to deny a former director the right to advancement of expenses, without the consent of the former director, if the amendment was effected in accordance with the bylaws,<sup>47</sup> this case was essentially overruled by a 2009 amendment to Del. G.C.L. section 145(f). This new provision requires that, absent a provision allowing for retroactive elimination or impairment, directors are entitled to indemnification and advancement of expenses as provided in the certificate of incorporation or bylaws at the time the act or omission occurs, even if the provision granting such entitlement is subsequently amended or repealed.<sup>48</sup>

## 2. Drafting Considerations—Indemnification of Directors Generally:

Shareholders should include in the shareholders agreement a requirement that the corporation provide indemnification and advancement of expenses for

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43. DEL. CODE ANN. tit. 8, § 145(a), (c), (e) (2001); N.Y. BUS. CORP. LAW §§ 722, 723(c) (McKinney 2003).

44. DEL. CODE ANN. tit. 8, § 145(c) (2001); N.Y. BUS. CORP. LAW § 723(a) (McKinney 2003).

45. DEL. CODE ANN. tit. 8, § 145 (2001 & Supp. 2010); N.Y. BUS. CORP. LAW § 723(b) (McKinney 2003).

46. See DEL. CODE ANN. tit. 8, § 145(f) (2001 & Supp. 2010); see also *Levy v. HLI Operating Co.*, 924 A.2d 210, 226 n.59 (Del. Ch. 2007) ("Under [section] 145(f), a corporation may provide indemnification rights that go 'beyond' the rights provided by . . . the other substantive subsections of [section] 145. At the same time, such indemnification rights provided by a corporation must be 'consistent with' the substantive provisions of [section] 145 . . . ." (quoting *Waltuch v. Conticommodity Servs., Inc.*, 88 F3d 87, 91 (2d Cir. 1996)) (alterations and ellipses in original)).

47. *Schoon v. Troy Corp.*, 948 A.2d 1157, 1166–67 (Del. Ch.), *motion to vacate denied sub nom. Bohnen v. Troy Corp.*, 962 A.2d 916 (Del. 2008).

48. DEL. CODE ANN. tit. 8, § 145(f) (2001 & Supp. 2010).

directors to the maximum extent permitted by applicable law. In addition, shareholders should ensure that the corporation's certificate of incorporation or bylaws require such indemnification and advancement of expenses *and* that these provisions cannot be amended to adversely affect any director without the consent of that director (at least in the case of a non-Delaware corporation). Alternatively (or in addition), the shareholders should require indemnification agreements between the corporation and each director, which cannot be amended without the consent of the applicable director.

### **3. Certain Legal Principles—Multiple Indemnitors:**

A Delaware court recently held that if an individual serving on a board of directors is indemnified both by the corporation and by a third party (for example, by both the corporation and the shareholder that nominated the individual to serve on the board), neither indemnitor would be solely liable to the individual; instead, each indemnitor is equally liable.<sup>49</sup>

### **4. Drafting Considerations—Multiple Indemnitors:**

When representing a shareholder with a right to nominate a director to serve on the board, counsel should ensure that the director indemnification provisions in the corporation's certificate of incorporation, bylaws, or indemnification agreement with the director specify that the corporation is the primary indemnitor for any claims against the director, and that the director need not pursue other secondarily available indemnification prior to seeking indemnification from the corporation.<sup>50</sup> If the shareholders agreement also includes indemnification of shareholders, counsel should include language in the shareholders agreement that makes it clear that the indemnity of the shareholders includes any amounts expended by a shareholder to indemnify its designated director in connection with his or her service as a director. In this way, the shareholder can avoid sharing the indemnification liability with the corporation.

## **II. CORPORATE OPPORTUNITIES**

Shareholders often seek a waiver of corporate opportunities in shareholders agreements, particularly when the shareholders are investors who may seek

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49. *Levy*, 924 A.2d at 226–27 (when directors have been indemnified by both the corporation and an investment fund, and the investment fund settled claims on behalf of the directors, the directors are not entitled to pursue indemnification claims against the corporation, but the investment fund is entitled to equitable contribution to require the corporation to pay its fair share of the settlement amount).

50. See *Sodano v. Am. Stock Exch. LLC*, No. 3418-VCS, 2008 WL 2738583, at \*14–16 (Del. Ch. July 15, 2008) (when a parent's organizational documents include a prioritization/set-off provision that clearly indicates that its indemnity obligations are secondary to the indemnity obligations of its subsidiary, then the indemnitors are not co-indemnitors with co-equal obligations), *aff'd sub nom.* *Am. Stock Exch. LLC v. FINRA*, 970 A.2d 256 (Del. 2009) (unpublished table decision).

similar investment opportunities or who already hold investments in entities that are in a similar line of business to the corporation. Shareholders agreements often set forth ground rules as to how corporate opportunities are to be treated.

#### A. CERTAIN LEGAL PRINCIPLES

- Under New York law, a corporate fiduciary “may not, without consent, ‘divert and exploit for his or her own benefit any opportunity that should be deemed an asset of the corporation.’”<sup>51</sup> New York courts have held that silence may constitute consent for purposes of the corporate opportunity doctrine.<sup>52</sup> Similarly, under Delaware law, a corporate fiduciary may not seize an “opportunity . . . within the corporation’s line of business” when the corporation has an “interest or expectancy” in that opportunity.<sup>53</sup>
- The key determination as to whether the opportunity should be deemed an asset of the corporation is whether the corporation had a “tangible expectancy” in the opportunity, which has been explained as something “much less tenable than ownership,’ but, on the other hand, more certain than a ‘desire’ or a ‘hope.’”<sup>54</sup>
- There is some authority in New York that supports the contention that a fiduciary cannot be liable for usurping a corporate opportunity where the corporation would have been unable to avail itself of the opportunity—for example, if a third party refused to deal with the corporation or if the corporation was not financially able to take advantage of the opportunity.<sup>55</sup> However, there is other authority in New York suggesting that even if the corporation could not undertake the opportunity for itself, a fiduciary may not then take the opportunity for himself or itself, except with the consent of the corporation.<sup>56</sup> Under Delaware law, the corporation must be “financially able to exploit the opportunity.”<sup>57</sup>

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51. *Young v. Chiu*, 853 N.Y.S.2d 575, 576 (App. Div. 2008) (quoting *Commodities Research Unit (Holdings) Ltd. v. Chem. Week Assocs.*, 571 N.Y.S.2d 253, 254 (App. Div. 1991)).

52. *See, e.g., Ackerman v. 305 E. 40th Owners Corp.*, 592 N.Y.S.2d 365, 367 (App. Div. 1993) (board is estopped from alleging that director diverted a corporate opportunity where he previously disclosed his intention to the board, and the board did not object until several months after the transaction in question was completed).

53. *McGowan v. Ferro*, 859 A.2d 1012, 1038 (Del. Ch. 2004).

54. *Alexander & Alexander of N.Y., Inc. v. Fritzen*, 542 N.Y.S.2d 530, 534 (App. Div. 1989) (citation omitted).

55. *See, e.g., Moser v. Devine Real Estate, Inc. (Fla.)*, 839 N.Y.S.2d 843, 848 (App. Div. 2007).

56. *See Foley v. D’Agostino*, 248 N.Y.S.2d 121, 129 (App. Div. 1964); *see also Bankers Trust Co. v. Bernstein*, 563 N.Y.S.2d 821, 822 (App. Div. 1991).

57. *McGowan*, 859 A.2d at 1038.



- The Del. G.C.L. was amended in 2000 to give a Delaware corporation the power to renounce, in its certificate of incorporation or by board resolution, any interest or expectancy in specified business opportunities or specified classes of business opportunities that are offered to the corporation or one or more of its officers, directors, or shareholders.<sup>58</sup> Accordingly, a Delaware corporation may renounce in a shareholders agreement the corporation's interest in specified business opportunities or classes or categories of business opportunities and thereby permit its officers, directors, and shareholders to pursue opportunities that might otherwise be required to be presented to the corporation.
- Recent case law has suggested that language exculpating directors from liability for keeping corporate opportunities for themselves, or for other affiliates, rather than renouncing opportunities, may not be authorized under Del. G.C.L. section 122(17).<sup>59</sup>

## B. DRAFTING CONSIDERATIONS

If the corporation is a Delaware corporation, Del. G.C.L. section 122(17) permits the corporation to renounce corporate opportunities, but shareholders should recognize that a provision in a shareholders agreement may be insufficient for this purpose, unless the corporation is a party to the agreement. Instead, the shareholders should ensure that the corporation's certificate of incorporation or a resolution of the board renounces specified opportunities or classes of opportunities. Because the N.Y.B.C.L. does not include a provision similar to Del. G.C.L. section 122(17), it is unclear whether a renunciation of corporate opportunities, even if contained in a certificate of incorporation or bylaw, would be effective for a New York corporation.

## III. APPOINTMENT AND REMOVAL OF OFFICERS

Often, shareholders agreements give shareholders rights to influence the selection and removal of key officers of the corporation.

### A. CERTAIN LEGAL PRINCIPLES

- Although officers generally are appointed by the corporation's board of directors, the manner for choosing officers of a Delaware corporation must be prescribed by the bylaws or by resolution of the board of directors.<sup>60</sup> In New York, the corporation's board may elect or appoint officers, but the

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58. See DEL. CODE ANN. tit. 8, § 122(17) (2001).

59. See *Wayne County Employees' Ret. Sys. v. Corti*, No. 3534-CC, 2009 WL 2219260, at \*17-19 (Del. Ch. July 24, 2009).

60. DEL. CODE ANN. tit. 8, § 142(b) (2001).

certificate of incorporation may provide that officers are elected by shareholders instead of the board.<sup>61</sup>

- Under New York law, an officer elected or appointed by the board may be removed by the board with or without cause.<sup>62</sup> An officer elected by the shareholders may be removed with or without cause only by the vote of the shareholders, but any officer's authority to act may be suspended by the board for cause.<sup>63</sup> There is no similar limitation under Delaware law on the board's right to remove an officer.

## B. DRAFTING CONSIDERATIONS

Shareholders may agree in a shareholders agreement upon a manner for selecting officers, such as requiring the consent of a particular shareholder or group of shareholders for the selection of certain officers, but the bylaws (or, in the case of a New York corporation, the certificate of incorporation) should describe the agreed-upon manner. Shareholders should recognize, however, that if they appoint officers, the board of a Delaware corporation retains authority to remove the officers selected by the shareholders, and the board of a New York corporation may suspend an officer for cause. However, the certificate of incorporation could provide that consent of stockholders as a group or specified stockholders is required to remove certain officers.

## IV. SPECIAL VOTING RIGHTS

Shareholders agreements commonly include provisions that prohibit the corporation from taking specified actions unless it obtains the approval of certain shareholders or a percentage of the shareholders and/or the approval of certain directors or a percentage of the directors designated by certain shareholders. The types of action that require this incremental approval level will vary, depending in part on the composition and concentration of the shareholders. For example, a majority shareholder who controls the board may conclude that it does not need contractual approval requirements, whereas a minority shareholder may require the right to approve specified actions as a means of protecting its investment.

### A. CERTAIN LEGAL PRINCIPLES

Board members have fiduciary duties and thus must make decisions that are in the interest of the corporation and all shareholders, even if the shareholder that he or she is representing disagrees with that decision.

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61. N.Y. BUS. CORP. LAW § 715(a), (b) (McKinney 2003).

62. *Id.* § 716(a).

63. *Id.*

## B. DRAFTING CONSIDERATIONS

- Approval rights are often granted to shareholders because, unlike directors, they can vote their shares in their own interest and have no fiduciary duty to other stockholders in exercising their right to vote.<sup>64</sup>
- If the shareholders desire special voting rights, consideration should be given to including those provisions in the certificate of incorporation. If the approval requirement is contained in the corporation's certificate of incorporation and the corporation fails to obtain the requisite shareholder approval, the action will be *ultra vires* and thus not a valid action of the corporation.<sup>65</sup> Simply including the voting provisions in a shareholders agreement to which the corporation is a party may not be as effective.<sup>66</sup> The potential disadvantages of including shareholder approval requirements in the certificate of incorporation include the incremental burden of soliciting and obtaining the necessary consents and of filing the amendment to the certificate of incorporation, particularly if there is a large number of shareholders. The heightened protection of having such rights in the certificate of incorporation should be weighed against the potential inconvenience and cost of amending the certificate of incorporation. Another consideration, which may be an advantage or disadvantage, is the fact that a certificate of incorporation is publicly available, whereas a shareholders agreement typically is not.
- The shareholders agreement (and certificate of incorporation, if applicable) often reduces or eliminates approval rights as the shareholder's ownership interest declines.

## V. INFORMATION RIGHTS

Shareholders agreements often contain rights of the shareholders to obtain certain financial data or other types of information. Shareholders agreements may also provide shareholders with a right of access to the corporation's management and advisors, although such rights are typically granted only to shareholders holding more than a minimum percentage of the outstanding shares. These rights are independent of the right of any shareholder who is also a director to obtain information and interact with management and advisors in his or her capacity as a member of the board.

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64. See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987). *But see Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994) (controlling stockholder owes fiduciary duties to the corporation and minority stockholders).

65. See *Solomon v. Armstrong*, 747 A.2d 1098, 1114 n.45 (Del. Ch. 1999) (voidable acts under the *ultra vires* doctrine include those that are "prohibited by the corporation's charter, for which no implicit authority may be rationally surmised"). *But see Fletcher Int'l Ltd. v. Ion Geophysical Corp.*, No. 5109-VCP (Del. Ch. Mar. 24, 2010) (denying injunctive relief because damages may be adequate remedy for breach of consent rights under certificate of incorporation).

66. See *supra* text accompanying notes 36–37.

## A. CERTAIN LEGAL PRINCIPLES

- Neither Delaware nor New York law restricts the ability of a corporation to furnish information to its shareholders.
- Both Delaware and New York law specifically grant record holders of shares (and certain beneficial holders) the right to inspect the books and records of the corporation for any purpose reasonably related to their interest as shareholders.<sup>67</sup> While access to documents can be restricted by designating them as confidential, confidential treatment requires justification, which may include harm to the corporation and protecting the personal information of participants in corporate activities.<sup>68</sup>

## B. DRAFTING CONSIDERATIONS

Shareholders agreements should permit only limited disclosure and use of confidential information (e.g., with officers, directors, and advisors of the shareholder and its affiliates in connection with their management of the investment; consider also whether shareholders should be permitted to disclose confidential information to prospective transferees of shares), to protect the confidentiality of such information. In addition, the corporation should not be required to provide any such information that is subject to a third party confidentiality agreement or if disclosure would result in the corporation waiving any privilege, such as the attorney-client privilege. The shareholders agreement could reduce or eliminate information rights as the shareholder's ownership interest declines.

# VI. TRANSFER RESTRICTIONS

## A. TRANSFER RESTRICTIONS GENERALLY

Shareholders of private companies often want to restrict transfers of shares by other shareholders for a variety of reasons, including a desire to ensure that they "know who they are investing with," to limit the number of shareholders for administrative reasons, and to ensure that competitors or other "undesirable" parties do not become shareholders and thereby gain access to confidential information about the company.

### 1. Certain Legal Principles:

- *Transfer Restrictions Must Be in Writing.* Both Delaware and New York law permit many types of restrictions on transfers of shares, but in Delaware the restrictions must be in writing, either in the corporation's certificate of incorporation, its bylaws, or in an agreement among shareholders or

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67. DEL. CODE ANN. tit. 8, § 220 (2001 & Supp. 2008); N.Y. BUS. CORP. LAW § 624 (McKinney 2003).

68. See DEL. CODE ANN. tit. 8, § 220 (2001 & Supp. 2008); see also *Amalgamated Bank v. UICI*, No. 884-N, 2005 WL 1377432, at \*5 (Del. Ch. June 2, 2005).

among shareholders and the corporation.<sup>69</sup> While New York does not explicitly require that transfer restrictions be in writing, the requirement is implied by its case law.<sup>70</sup>

- *Shareholders Must Have Notice of, or Share Certificate Must Reflect, Transfer Restriction.* Section 8-204 of the Uniform Commercial Code (the “U.C.C.”), as adopted in both Delaware and New York, provides that a transfer restriction imposed by the corporation, even if otherwise lawful, is ineffective against a person without knowledge of the restriction unless the shares are certificated and the restriction is noted conspicuously on the share certificate or the shares are uncertificated and the registered owner has been notified of the restriction.<sup>71</sup> “Knowledge” as defined in the U.C.C. means actual knowledge of the restriction.<sup>72</sup> These requirements are reaffirmed in Del. G.C.L. section 202(a). Failure to follow the required formalities may result in a third-party purchaser acquiring title to the shares free of the transfer restriction.<sup>73</sup>
- *Permissible Types of Transfer Restrictions.* Del. G.C.L. section 202(c) specifically identifies five categories of permitted transfer restrictions:
  - Provisions that obligate a shareholder to offer to the corporation, other shareholders, or any other person a prior opportunity, to be exercised within a reasonable time, to acquire the shares (for example, rights of first refusal, rights of first offer, or tag-along rights, as discussed below);<sup>74</sup>
  - Provisions that obligate the corporation, any shareholder, or other person to purchase shares that are the subject of a purchase and sale agreement concerning those shares (for example, mandatory sale provisions, as discussed below);<sup>75</sup>
  - Provisions that require the corporation or shareholders to consent to any proposed transfer of shares, to approve a proposed transferee, or to approve the amount of shares that any person or group of persons may own;<sup>76</sup>
  - Provisions that obligate a shareholder to sell or transfer shares to the corporation, other shareholders, or any other person, or cause or result in an automatic sale or transfer of shares to any of them;<sup>77</sup> and

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69. DEL. CODE ANN. tit. 8, § 202 (2001).

70. See, e.g., *Rafe v. Hindin*, 288 N.Y.S.2d 662, 663–64 (App. Div.) (restrictive legend on share certificate that reflected the agreement of the parties was a sufficient memorialization of transfer restrictions), *aff'd*, 244 N.E.2d 469 (N.Y. 1968); *Murphy v. George Murphy, Inc.*, 166 N.Y.S.2d 290, 294 (Sup. Ct. 1957) (enforcing a restriction on transfer contained in a contract between shareholders and a corporation).

71. See U.C.C. § 8-204 (1994).

72. U.C.C. § 1-202(b) (2008); see *Agranoff v. Miller*, No. 16795, 1999 WL 219650, at \*13 (Del. Ch. Apr. 12, 1999) (purchaser “need not have actual, clairvoyant knowledge as to how a court will rule on whether a restriction is viable,” only actual knowledge of a potential restriction).

73. See U.C.C. § 8-303 (1994); *Agranoff*, 1999 WL 219650, at \*12–15.

74. DEL. CODE ANN. tit. 8, § 202(c)(1) (2001).

75. *Id.* § 202(c)(2).

76. *Id.* § 202(c)(3).

77. *Id.* § 202(c)(4).

- Provisions that prohibit the transfer of shares to, or ownership of shares by, designated persons or classes or groups of persons, if such designation is not manifestly unreasonable.<sup>78</sup>

New York does not have a statute that recognizes specified types of transfer restrictions.

- *Restrictions on Transfer Must Serve a “Reasonable” Purpose.* In considering the enforceability of transfer restrictions, the Delaware and New York courts seek to balance the concern that “[a]n important incident of the ownership of property is its transferability . . . [so] a general restraint upon alienation is invalid because contrary to public policy,” with a recognition that transfer restrictions may be used to further reasonable corporate purposes.<sup>79</sup>
- Del. G.C.L. section 202(d) identifies several purposes for transfer restrictions that are conclusively presumed to be reasonable, such as maintaining tax advantages for the corporation or its shareholders, including subchapter “S” corporation elections, preserving net operating losses or other tax attributes, qualifying or maintaining status as a real estate investment trust, maintaining statutory or regulatory advantages, or complying with applicable law.<sup>80</sup> However, this list is not all-inclusive: Del. G.C.L. section 202(e) states that “any other lawful restriction” will be permitted.<sup>81</sup>
- Under Delaware common law, restrictions on transfer are generally valid if they are “reasonably necessary to advance the corporation’s welfare or attain the objectives set forth in the corporation’s charter.”<sup>82</sup>
- Since the adoption of Del. G.C.L. section 202 in 1967, “the Delaware courts have been broadly deferential to the decisions of market participants when they decide to place restrictions on [shares],” and have placed the burden of demonstrating that a transfer restriction is unreasonable on the party seeking to contest the restriction.<sup>83</sup>
- Similarly, under New York law, a restriction on transfer of corporate shares is enforceable if it “effectuates a lawful purpose, is reasonable, and is in accord with public policy.”<sup>84</sup>
- *Circumstances in Which Transfer Restrictions May Be Unenforceable.* Analyses of reasonableness are heavily fact dependent. Delaware courts have struck

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78. *Id.* § 202(c)(5).

79. *E.g.*, *Tracey v. Franklin*, 67 A.2d 56, 58 (Del. 1949).

80. DEL. CODE ANN. tit. 8, § 202(d) (2001).

81. *Id.* § 202(e).

82. *Capital Group Cos. v. Armour*, No. 422-N, 2005 WL 678564, at \*5 (Del. Ch. Mar. 15, 2005); *see also, e.g.*, *Grynberg v. Burke*, 378 A.2d 139, 143 (Del. Ch. 1977) (restraint on the free transferability of shares is permissible if it “bears some reasonably necessary relation to the best interests of the corporation”), *rev’d on other grounds sub nom.* *Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1 (Del. 1981).

83. *Capital Group*, 2005 WL 678564, at \*8.

84. *Benson v. RMJ Sec. Corp.*, 683 F. Supp. 359, 371 (S.D.N.Y. 1988) (quoting *Levey v. Saphier*, 388 N.Y.S.2d 644, 645 (App. Div. 1976)).

down transfer restrictions as unreasonable only in limited circumstances in which the transfer restriction at issue was tantamount to an absolute restraint on transfer or when the complaining shareholder did not receive appropriate notice of the restrictions.

- For example, in *Greene v. E.H. Rollins & Sons, Inc.*,<sup>85</sup> a certificate of incorporation granted the corporation the right to purchase, at a formula price, any shares of the corporation that were either transferred without first being offered to the corporation or held by non-employees.<sup>86</sup> The Delaware Court of Chancery noted that the rationale for the provision was “to insure the harmonious conduct of the business and to prevent the introduction of any Common Stockholders for any reason deemed unsuitable,” but found no reasonable business purpose for this rationale.<sup>87</sup> The court also pointed out that the provision at issue could be used to prevent all transfers to persons other than the corporation, or could, to the extent transfers to other persons actually occurred, cause the transferee not to have any certainty as to its investment because of the corporation’s ability to call the shares for repurchase at any time.<sup>88</sup> The “severe and exacting” nature of the restraint and the inability of the court to “discover any basis on which to rest the view that the imposed restraint [was] reasonable” distinguished the transfer restriction from others that had been upheld by the Delaware courts.<sup>89</sup> However, this case was decided before Del. G.C.L. section 202 was adopted, so the result may be different today.
- In addition, in *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*,<sup>90</sup> the U.S. Court of Appeals, applying Delaware law, found that a corporation’s right of first refusal contained in bylaws adopted after a shareholder had acquired its shares was unenforceable against that shareholder because the restriction was broader than reasonably necessary to further a valid corporate purpose, and the shareholder had not received sufficient notice of the restriction to consent to it.<sup>91</sup> Specifically, the right of first refusal was intended to maintain control of the corporation among associated companies, but its price and other terms deviated so markedly from market price and terms that the restriction was held by the court to be broader than necessary to accomplish its objective or to be enforced against the particular shareholder.<sup>92</sup>

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85. 2 A.2d 249 (Del. Ch. 1938).

86. *Id.* at 250–51.

87. *Id.* at 252–54.

88. *Id.* at 253.

89. *Id.* at 254.

90. 490 F.2d 818 (5th Cir. 1974).

91. *Id.* at 826–27. The court’s holding is consistent with the last sentence of Del. G.C.L. section 202(b), which states that a stock transfer restriction will not be binding with respect to shares issued prior to the adoption of the restriction unless the holder of the shares consents to the restriction on such holder’s shares. See DEL. CODE ANN. tit. 8, § 202(b) (2001).

92. *B & H Warehouse*, 490 F.2d at 826–27.

- In New York, as in Delaware, courts apply a reasonableness analysis to transfer restrictions so that they will condemn not “a restriction on transfer . . . but an effective *prohibition* against transferability itself.”<sup>93</sup> An unreasonable restraint on alienation would include a restriction that would remain in force for an indefinite period of time or would prohibit transfers to anyone other than a specified person. For example, in *Lam v. Li*,<sup>94</sup> the court held that an agreement that granted a shareholder and his successors the right to purchase 50 percent of the shares of the corporation for a fixed price of \$10, with no temporal limitation, was unenforceable as an unreasonable restraint on alienation because the option did not have a specified time limit, and “the onerous terms of the option—the \$10 purchase price and the percentage of shares involved—effectively prevent[ed] defendant from transferring the shares to anyone but plaintiff.”<sup>95</sup>
- Similarly, in *Rafe v. Hindin*,<sup>96</sup> two shareholders, each holding 50 percent of the corporation’s shares, included legends on their share certificates that permitted each shareholder to transfer his shares only to the other shareholder, unless the other shareholder consented to a transfer to a third party.<sup>97</sup> The court held that the restrictive legend was void as against public policy because it did not specify a price and enabled either party to withhold consent to a transfer to a third party unreasonably, thereby rendering “the sale of the plaintiff’s stock impossible to anyone except to the individual defendant at whatever price he wishes to pay.”<sup>98</sup>
- *Provisions Requiring Consent to Share Transfers*. When consent of the corporation or other shareholders is required prior to making a share transfer, such consent must not be unreasonably withheld.<sup>99</sup>
- *Limitations on Corporation’s Ability to Exercise Repurchase Rights*. If an agreement gives the corporation a right to repurchase its shares from shareholders, its ability to exercise the right will be subject to state law limitations. For example, a Delaware corporation may not repurchase its own shares if its capital is impaired or if the repurchase will cause its capital to become impaired.<sup>100</sup> A repurchase would impair the corporation’s capital if it would

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93. *Allen v. Biltmore Tissue Corp.*, 141 N.E.2d 812, 816 (N.Y. 1957) (emphasis added).

94. 635 N.Y.S.2d 26 (App. Div. 1995).

95. *Id.* at 27.

96. 288 N.Y.S.2d 662 (App. Div.), *aff’d*, 244 N.E.2d 469 (N.Y. 1968).

97. *Id.* at 663–64.

98. *Id.* at 666.

99. *See, e.g., id.* (declaring a clause that would require consent to transfer shares as void, unreasonable, and against public policy because it did not prohibit the unreasonable withholding of consent); *see also Vardanyan v. Close-Up Int’l, Inc.*, No. CV-06-2243(DGT), 2007 WL 4276670, at \*6 (E.D.N.Y. Nov. 30, 2007), *aff’d*, 315 F. App’x 315 (2d Cir. 2009) (upholding restriction on transfer because contractual measures were in place to prohibit unreasonable withholding of consent (e.g., time limitation and requirement to use best efforts)).

100. DEL. CODE ANN. tit. 8, § 160(a)(1) (2001).



cause the value of the corporation's net assets (i.e., assets minus liabilities) to be less than the aggregate par value of the corporation's shares.<sup>101</sup> Similarly, under New York law, a corporation may not repurchase its shares if the corporation is then insolvent or would thereby be made insolvent, and its shares may be repurchased only out of surplus.<sup>102</sup>

## 2. Drafting Considerations:

- *Documentation and Notice of Transfer Restrictions.* If the shareholders agreement contains restrictions on transfers of shares, a legend should be included on the share certificates stating that the shares are subject to transfer restrictions contained in the shareholders agreement (or notice should be delivered to any transferee if the shares are uncertificated). The restrictions may (but are not required to) appear also in the certificate of incorporation and/or bylaws, but shareholders should understand that this alone may not provide the required notice of transfer restrictions.
- *Reasonableness of Transfer Restrictions.* Restrictions on transfers of shares should be specific and address legitimate purposes of the corporation. If the corporate purposes are not reasonably apparent, an explanation of the intended purposes—for example, in the recitals to the shareholders agreement—may be helpful. The “reasonableness” of transfer restrictions should be considered in light of the specific facts (and, in the case of a Delaware corporation, the permitted categories of, and purposes for, restrictions on transfer described in Del. G.C.L. section 202(c) and (d)). In particular, restrictions may be subject to challenge if they could last indefinitely, would require a sale without any guidance on pricing, would limit transfers to a single beneficiary, or would permit the beneficiary to determine arbitrarily whether or not to permit a transfer with no requirement that consent cannot be unreasonably withheld.
- *Applicability to Transferees.* The shareholders agreement should make clear whether the transfer restrictions apply only to the original shareholders that are party to the agreement or also to their transferees. Most commonly, the shareholders intend to bind transferees, so the shareholders agreement will provide that it is binding on the parties as well as their successors and assigns. To ensure that transferees have notice of the transfer restrictions contained in the shareholders agreement, the transferees should execute a joinder to confirm that they agree to be bound by the terms of the shareholders agreement.
- *Indirect Transfers.* If desired, the parties may want to ensure that the transfer restrictions will apply to direct as well as indirect transfers of shares.

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101. *Klang v. Smith's Food & Drug Ctrs., Inc.*, 702 A.2d 150, 153 (Del. 1997) (citing DEL. CODE ANN. tit. 8, § 154).

102. N.Y. BUS. CORP. LAW § 513(a) (McKinney 2003); *Schlaifer v. Kaiser*, 377 N.Y.S.2d 356, 360 (Sup. Ct.), *aff'd*, 378 N.Y.S.2d 639 (App. Div. 1975).

For example, if a shareholder is a “shell company” whose sole asset is the shares, the same transfer restrictions that apply to a transfer of shares of the corporation should also apply to a transfer of ownership of the shareholder. If any shareholder (or any transferee of shares) owns other assets, however, the remedy that other shareholders should have in the event of a change of control of the shareholder requires careful consideration. One approach that is favorable to the non-transferring shareholders would be to grant them or the corporation a right to purchase the shares of the corporation upon a change of control of a shareholder, although this may create valuation issues. Another less common form of indirect transfer would be a sale of a derivative, such as a total return swap, in which the economic value of the shares is transferred without altering the legal ownership. Although indirect economic transfer provisions are not uniformly included in shareholders agreements, they may be enforceable under the legal standards discussed above and should be considered carefully when drafting a shareholders agreement.

## B. RIGHT OF FIRST REFUSAL/RIGHT OF FIRST OFFER

Shareholders agreements often include a right of first refusal or right of first offer as a means to ensure that the company and/or other shareholders will have an opportunity to purchase any shares that any shareholders desire to sell. A *right of first refusal* (a “ROFR”) requires a shareholder that desires to sell its shares to present an offer made by a potential purchaser that it proposes to accept to the other shareholders and/or the corporation, who then have an opportunity to purchase the shares at the same price and terms. In contrast, a *right of first offer* (a “ROFO”) requires the selling shareholder to first solicit offers from the other shareholders and/or the corporation, and if the selling shareholder prefers to seek higher offers from third parties, it may do so, but it may not sell the shares to a third party at a lower price or on other terms that are less favorable to the selling shareholder than those offered by the other shareholders and/or the corporation. In general, a ROFO is considered to be preferable to a selling shareholder because knowledge that the other shareholders and/or the corporation will have a right to match a third-party offer may discourage potential third-party purchasers from doing the work necessary to make an offer.

### 1. Certain Legal Principles:

- Both Delaware and New York courts have held that ROFRs and ROFOs are enforceable if not unreasonable.<sup>103</sup>

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103. See, e.g., *Martin v. Graybar Elec. Co.*, 285 F.2d 619, 625 (7th Cir. 1961) (“The weight of authority is to the effect that a corporate by-law which requires the owner of the [shares] to give the other [shareholders] of the corporation . . . an option to purchase the same at an agreed price or the then-existing book value before offering the [shares] for sale to an outsider, is a valid and reasonable restriction and binding upon the [shareholders].” (citations omitted)); *Lawson v. Household Fin. Corp.*, 147

- Delaware and New York courts apply strict principles of construction to interpret ROFRs narrowly—the court must be able to ascertain the intent of the parties to a reasonable degree of certainty.<sup>104</sup>

## 2. Drafting Considerations:

- *Share Repurchase Limitations.* If a ROFR or ROFO gives the issuing corporation a right to purchase, the corporation may have insufficient capital at the relevant time to make the purchase. Accordingly, the corporation and shareholders should consider giving the corporation the power to assign its rights or provide that the other shareholders also have ROFR/ROFO rights. If there are multiple beneficiaries of the ROFR/ROFO, the priority and allocation of shares among the beneficiaries should be specified.
- *Form of Consideration Issues.* Typically, a ROFR or ROFO allows a third-party purchaser to purchase the offered shares only on the same terms as, or terms that are no less favorable to the selling shareholder than, the terms offered to the corporation and/or the other shareholders. This requirement raises issues if the offered price includes non-cash consideration such as debt or equity securities of the purchaser. In a ROFO, if a cash offer by the corporation and/or the other shareholders is not accepted by the selling shareholder, must the ROFO be retriggered if the selling shareholder is willing to sell the shares to a third party for non-cash consideration? In either a ROFR or a ROFO, how should non-cash consideration be valued? May the corporation and/or another shareholder offer its own non-cash consideration, or only the cash equivalent? A draftsman should consider whether to include in the ROFR/ROFO provision the permissible form(s) of consideration, and/or how non-cash consideration will be valued.
- *Disparate Economic Power.* Seemingly neutral provisions such as ROFOs and ROFRs can allow parties to behave “strategically” if they have disparate economic power. For example, if one shareholder has substantial

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A. 312, 315 (Del. Ch. 1929) (“Where reasonable restraints founded in considerations which favor the corporate welfare are imposed in favor of the acquisition of a corporation’s [shares] by the corporation itself, the authorities hold that such restraints are not offensive to the general policy of the law which favors the freedom of alienation.”), *aff’d*, 152 A. 723 (Del. 1930); *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 541 (1957); *Penthouse Props. v. 1158 Fifth Ave., Inc.*, 11 N.Y.S.2d 417, 422 (App. Div. 1939) (“[R]estrictions against the sale of shares of stock, unless other [stockholders] of the corporation have first been accorded an opportunity to buy, are not repugnant to” the general rule that the ownership and the right to alienate cannot be vested in different persons.).

104. See *Globe Slicing Mach. Co. v. Hasner*, 333 F.2d 413, 415–16 (2d Cir. 1964) (corporation’s ROFR did not apply to shares transferred to a shareholder’s executor upon the shareholder’s death because the first-offer provision did not clearly state the corporation’s intent to apply it to testamentary transfers); *Julian v. E. States Constr. Serv., Inc.*, No. 1892-VCP, 2008 WL 2673300, at \*8–11 (Del. Ch. July 8, 2008) (offering broad construction of ambiguous terms of a shareholders agreement to reflect that the drafters’ intent was that only employees who are shareholders may enforce a ROFR).

sources of liquidity (such as a “financial partner”) while another does not (such as a “sweat equity partner”), the shareholder with access to liquidity may favor the more restrictive ROFR, while the other shareholder may favor the ROFO. The relative economic interests of the shareholders should be considered when selecting this type of transfer restriction. Similarly, if financing or regulatory approval may be required, a sufficiently long exercise period should be incorporated to ensure that the parties to the shareholders agreement are able to obtain the benefit of the ROFR/ROFO provision.

- *Less than All Offered Shares.* Another issue for the draftsperson is whether ROFR/ROFO rights should be exercisable with respect to less than all of the offered shares. Typically, a corporation and/or shareholders with ROFO/ROFR rights are permitted to exercise the right only if they offer to purchase all of the offered shares, to ensure that the selling shareholder is not left holding a position that is economically too small to sell.
- *Assignability of ROFR/ROFO Rights.* Typically, ROFR/ROFO rights are not assignable. However, the parties should consider whether limited assignability should be permitted. For example, should a shareholder be permitted to assign its rights to an affiliated individual or entity?

### C. MANDATORY SALE PROVISIONS

A mandatory sale provision may be included in a shareholders agreement as a means of maintaining a limited group of shareholders and/or preserving the continuity of ownership of the business. This type of provision requires a shareholder to sell its shares to the corporation (or to other shareholders) in specified circumstances (usually upon death or disability, retirement, or termination of employment).

#### 1. Certain Legal Principles:

- As discussed above under “Transfer Restrictions Generally,” Delaware law specifically allows for a restriction on transfer that would require a shareholder to sell its shares to the corporation or other shareholders.<sup>105</sup> While New York does not have a statute that recognizes specified types of transfer restrictions, New York courts have held that mandatory sale provisions are enforceable, subject to reasonableness tests.<sup>106</sup>
- A disparity between the actual fair market value of the shares at the time of repurchase and a fixed or formula price contained in an agreement granting repurchase rights is usually held not to invalidate the restriction

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105. DEL. CODE ANN. tit. 8, § 202(c)(4) (2001).

106. See, e.g., *Benson v. RMJ Sec. Corp.*, 683 F. Supp. 359, 371 (S.D.N.Y. 1988).

itself.<sup>107</sup> On occasion, courts have adjusted valuations to reflect more accurately the true value of the shares.<sup>108</sup>

- Employee shareholders are often required to transfer their shares to the corporation at the original issuance price upon a termination of their employment. Courts generally respect such provisions, even where there is great disparity between purchase price and true value, because the employee typically has received his or her shares as an incident to employment by the corporation and as an incentive to align his or her interests with those of the corporation.<sup>109</sup>

## **2. Drafting Considerations:**

- The repurchase right or obligation should be required to be exercised within a reasonable time after the occurrence of the triggering circumstance. Shareholders agreements should include clear language about when this right is triggered and anticipate practical obstacles to exercise. For example, in the case of repurchase rights triggered upon the death of a shareholder, the mandatory sale provision should allow sufficient time for the testamentary or probate procedures that would be required before assets of the decedent's estate can be sold.
- The repurchase price is often a key issue in mandatory sale provisions. The repurchase price can be a fixed price, agreed upon at the time the shareholders agreement is entered into, or a price determined later, after the triggering circumstance occurs, by reference to the corporation's book value, a formula or other methodology contained in the shareholders agreement, or by a third-party valuation of the shares.
- The provisions for determining the purchase price must be drafted in detail and with great care. For example, the mandatory sale provision should specify the date at which the shares are to be valued (e.g., the date of the triggering circumstance, the end of the most recently completed fiscal quarter, or some other date), whether deviations from generally accepted accounting principles are permitted in calculating value using a formula based on earnings (and if so, what they are), whether a discount

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107. See, e.g., *Allen v. Biltmore Tissue Corp.*, 141 N.E.2d 812, 816 (N.Y. 1957) (sustaining bylaw provision giving the corporation the right to repurchase shares of a deceased shareholder at the original issuance price). *But see* *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*, 490 F.2d 818, 826 (5th Cir. 1974) (inadequacy of book value, the fixed price in the agreement, was an important factor in holding the restriction invalid).

108. See, e.g., *Aron v. Gillman*, 128 N.E.2d 284, 288–89 (N.Y. 1955) (adjusting the book value of the stock to reflect the value of the corporation's inventory and its tax liability); see also *Benson*, 683 F. Supp. at 371 (remaining shareholders might have breached their fiduciary duty when the value of a deceased shareholder's equity was grossly in excess of the amount his estate received from the remaining shareholders pursuant to a forced sale provision).

109. See, e.g., *Martin v. Graybar Elec. Co.*, 285 F.2d 619, 625–27 (7th Cir. 1961) (applying New York law); *Gallagher v. Lambert*, 549 N.E.2d 136, 137–38 (N.Y. 1989).

for minority ownership, lack of liquidity, or other factors should be applied, and any other matters deemed relevant to the valuation.

- Other terms governing the repurchase should be addressed with specificity. If life or disability insurance is required to be maintained to fund repurchases triggered by death or disability, then appropriate provisions should be included to address the requirement. In the case of a mandatory sale resulting from disability, the definition of “disability” should be clearly defined, and the agreement should identify the person(s) who will make the determination that the shareholder has in fact become disabled. Lastly, due to the frequency of disputes concerning mandatory sale provisions, particularly valuation disputes, the draftsperson should consider whether to include a dispute resolution provision that applies specifically to this provision.

#### D. DRAG-ALONG RIGHTS

A drag-along provision gives one or more shareholders a right to force other shareholders to sell their shares at the same price and upon the same terms as the shareholder exercising the drag-along right. These provisions may also force sale transactions such as mergers and sales of substantially all of the corporation's assets. A drag-along right can be attractive because it effectively grants shareholders an option to sell a larger stake of the company than they own, and thereby realize a higher sale price, without adhering to certain legal and procedural requirements normally associated with such sales. Prospective acquirers of a corporation also view drag-along rights favorably, as they facilitate the acquisition of all or significant blocks of the corporation's outstanding shares.

##### 1. Certain Legal Principles:

- While Del. G.C.L. section 202(c)(4) specifically permits a restriction on transfer that would require shareholders to sell their shares to the corporation, other shareholders, or any other person, case law concerning the enforceability of drag-along rights is scarce. In one instance, the Delaware Court of Chancery ruled that the terms of a drag-along provision applied to a transaction, although neither party specifically challenged the enforceability of the provision.<sup>110</sup> The court has also mentioned in dicta that a shareholders agreement that would force investors to sell their shares in the event of a merger would be enforceable.<sup>111</sup> No New York court has addressed the enforceability of drag-along rights.

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110. See *Minn. Invc of RSA #7, Inc. v. Midwest Wireless Holdings LLC*, 903 A.2d 786, 799 (Del. Ch. 2006) (ruling that majority interest holder's right to “drag along” a minority interest holder in a proposed sale inherently conflicted with the minority holder's ROFR, and that the former right should govern).

111. See *Shields v. Shields*, 498 A.2d 161, 168 (Del. Ch. 1985).

- To the extent that drag-along rights are enforceable, the shareholders exercising these rights may be able to force the other shareholders to sell their shares while sidestepping legal protections, such as appraisal rights, disclosure obligations, and procedural requirements, that would be applicable in the context of a merger. Arguably, the same protections afforded to minority shareholders in a merger, such as appraisal rights, should also be applicable in a drag-along sale. However, Delaware does not recognize the “practical merger” or “de facto merger” doctrine in the same manner as other states, whereby a different form of transaction, such as a sale of substantially all of a corporation’s assets, can be viewed as the equivalent of a merger, thereby triggering the statutory protections afforded to mergers.<sup>112</sup>
- Unlike Delaware, New York does recognize the “de facto merger” doctrine,<sup>113</sup> so the statutory protections afforded to mergers could apply to sales pursuant to drag-along rights. On the other hand, New York courts have applied the principles of case law on voting trusts in considering the validity of provisions contained in shareholders agreements.<sup>114</sup> These courts have suggested that statutory protections, such as appraisal rights, may be unavailable in connection with a sale of the company if a shareholder has agreed to a voting trust provision that has this outcome. For example, in *In re Bacon*,<sup>115</sup> the holder of a voting trust certificate sought to exercise statutory appraisal rights after the voting trustees voted in favor of the sale of the assets of the corporation.<sup>116</sup> The New York Court of Appeals commented that “the decisive question . . . is whether the depositor of [shares] under the voting trust agreement has authorized the voting trustees to vote his [shares] and thereby to give consent in his behalf to the proposed sale.”<sup>117</sup> Similarly, a minority shareholder can be said to have authorized the sale of a company when it has granted another shareholder drag-along rights in a shareholders agreement.
- Courts generally enforce waivers of appraisal rights when the shareholder waiving such rights is fully informed of all material facts relating to such waiver.<sup>118</sup> Neither New York nor Delaware courts have explicitly ruled whether a waiver of appraisal rights in the context of a drag-along sale

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112. See *Hariton v. Arco Elecs., Inc.*, 188 A.2d 123, 125 (Del. 1963); *Heilbrunn v. Sun Chem. Corp.*, 150 A.2d 755, 757 (Del. 1959).

113. See, e.g., *AT & S Transp., LLC v. Odyssey Logistics & Tech. Corp.*, 803 N.Y.S.2d 118, 120 (App. Div. 2005).

114. See, e.g., *In re Dissolution of Penepent Corp.*, 750 N.E.2d 47, 50 (N.Y. 2001); *Manson v. Curtis*, 223 N.Y. 313, 319–20 (1918).

115. 38 N.E.2d 105 (N.Y. 1941).

116. *Id.* at 106–07.

117. *Id.* at 107; see also *In re Bowman*, 414 N.Y.S.2d 951, 953 (Sup. Ct. 1978).

118. See *Arnold v. Soc’y for Sav. Bancorp.*, 650 A.2d 1270, 1289 (Del. 1994) (describing the standard for waiver in Delaware).

is enforceable. A waiver of appraisal rights does not preclude, however, a shareholder from bringing an equitable action for breach of fiduciary duty.<sup>119</sup>

## 2. Drafting Considerations:

- *Specificity*. Because the enforceability of drag-along provisions is uncertain, especially in states such as New York, special care should be taken to draft the provisions with specificity, because a court is more likely to enforce these provisions if it can be shown that minority shareholders clearly consented to the sale process that is being challenged. For example, drag-along provisions should specify the shareholders entitled to exercise the drag-along rights; whether they must have a minimum ownership position at the time of exercise; whether shareholders can be required to sell in a sale of less than 100 percent of the company; whether a drag-along sale requires any minimum triggering price or rate of return; and the time period within which the drag-along right would be exercisable. The drag-along provision should also include specific waivers of appraisal rights and disclosure obligations and require shareholders to vote their shares to approve any matters that must be submitted to shareholders to effect the proposed sale.
- *Other Sale Procedures*. The shareholders agreement should specify whether the shareholders that are being “dragged along” will be obligated to pay their pro rata shares of transaction expenses (at least if the drag-along sale is completed), must make any representations and warranties to the purchaser (e.g., more than representations regarding their title to the shares and authority to sell) in connection with the sale or will be subject to the indemnification obligations, post-closing purchase price adjustments, or other potential liabilities, if any, for which the other selling shareholders, including shareholders selling pursuant to the drag-along right, may be responsible, and whether other procedures will be followed in exercising the rights and implementing the sale process. The drag-along provision should obligate all shareholders to deliver their share certificates, ideally prior to the proposed sale date, with a power of attorney authorizing one shareholder or the corporation to deliver the shares to the purchaser at the closing. As the laws governing the validity of powers of attorney vary from state to state, the person drafting the power of attorney should ensure that it complies with applicable state laws.
- *Multiple Classes of Shares*. Shareholders often desire a right to force a sale of all classes of the company’s equity securities, to ensure that the sale can

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119. See, e.g., *Turner v. Bernstein*, 776 A.2d 530, 545 (Del. Ch. 2000) (valid waiver of appraisal rights did not preclude shareholder from bringing a claim of breach of fiduciary duty when the waiver specifically referred only to appraisal rights).



be structured in the way that is most attractive to the purchaser and thus likely to maximize the sale price. When multiple classes of equity securities are subject to a drag-along right, the provisions can become quite complex. In these cases, the obligation to participate “pro rata” among multiple classes with different priorities and the mechanism for ensuring that shareholders sell at the “same price” and on the “same terms and conditions” must be carefully considered and drafted. These issues can be particularly difficult if the aggregate purchase price does not cover the waterfall of the various preferred classes of securities in full and as such there are classes or series of securities that may not be entitled under the waterfall to receive any consideration for their shares. It may also be appropriate to require holders of options and warrants to participate in the sale, without requiring the exercise of the options and/or warrants prior to the closing.

- *Alternative Structures.* Drag-along provisions should be drafted expansively to allow the sale to be consummated not only by a sale of shares but also by means of a merger or sale of substantially all of the corporation’s assets (and require the shareholders to vote all of their shares to approve any such transaction and waive any appraisal rights).

## E. TAG-ALONG RIGHTS

Tag-along provisions typically require that shareholders who propose to sell any of their shares offer the other shareholders an opportunity to sell a pro rata portion of their shares to the same purchaser on the same terms and conditions. Typically, a selling shareholder must provide notice of the proposed sale to the other shareholders, who then have a period of time to elect whether to exercise their tag-along rights. Tag-along provisions are generally used to (i) give minority shareholders an opportunity to share in any control premium that may be available if a controlling ownership position is sold and (ii) protect shareholders from being “left behind” when other shareholders are able to realize a liquidity event.

### 1. Certain Legal Principles:

- *Control Premium.* As a general matter, shareholders who sell a dominant or controlling position should be able to realize a control premium for those shares.<sup>120</sup> A tag-along right effectively forces the controlling shareholder (or group of shareholders selling a control position) to offer the other shareholders an opportunity to share in the control premium.
- *Enforceability.* Tag-along rights are not mentioned in Del. G.C.L. section 202(c), and case law concerning tag-along rights is scarce in both Delaware

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120. See *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1087 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005); *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387, 388 (N.Y. 1979).

and New York. Courts in these states have not ruled on the enforceability of these rights, but they have discussed tag-along rights in various contexts without raising questions regarding their enforceability.<sup>121</sup>

- *Indirect Transfers.* In *Hollinger*, a controlling shareholder granted other shareholders a tag-along right that penalized the controlling shareholder if it sold any shares without ensuring that the purchaser offered the other shareholders an opportunity to sell their shares on the same terms.<sup>122</sup> A minority shareholder claimed that the tag-along provision was triggered by a sale of the controlling shareholder itself by virtue of an implied covenant of good faith and fair dealing.<sup>123</sup> Although the court addressed this issue only through dicta, it described the claim as “facially weak” given the clear wording of the tag-along provision.<sup>124</sup>

## 2. Drafting Considerations:

- *The Formula to Determine Pro Rata Participation.* Careful consideration should be given to drafting the provision for “pro rata” participation in a tag-along sale. Common variations include:
  - Each shareholder is entitled to sell the same percentage of the total number of shares that it owns, up to the maximum number of shares that the purchaser is willing to purchase, and if any shareholders elect not to participate, either the original selling shareholder may sell additional shares or those shareholders that do elect to participate may sell additional shares (with each shareholder having a right to sell the same percentage of the number of shares that it owns).
  - The selling shareholder will specify a number of shares that it wishes to sell (and that a purchaser is willing to purchase), and each other shareholder will have the right to substitute some of its shares based on a formula that typically follows one of two paradigms: either (a) the tagging shareholder may substitute a number of its shares based on its percentage ownership of the total outstanding shares or (b) the tagging shareholder may substitute a number of its shares based on its percentage ownership of the shares held by all shareholders who will participate in the tag-along sale.

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121. See, e.g., *Parrott v. Pasadena Capital Corp.*, No. 96 Civ. 6243 (JFK), 1997 WL 13205, at \*4 (S.D.N.Y. Jan. 15, 1997) (monetary award could fully compensate the plaintiff for the loss of his tag-along rights); *Seidensticker v. Gasparilla Inn, Inc.*, No. 2555-CC, 2007 WL 1930428, at \*5–6 (Del. Ch. June 19, 2007) (refusing to find a tag-along right when the plain and unambiguous language of a contract did not support such an interpretation); *Adams v. Banc of Am. Sec. LLC*, No. 602297/04, 2005 WL 1148693, at \*7 (N.Y. Sup. Ct. Mar. 31, 2005) (inferring that certain class members’ tag-along rights remained enforceable and were not affected by a tortious interference claim).

122. 844 A.2d at 1031–32.

123. *Id.* at 1086.

124. *Id.*

- *Time Periods and Information.* The notice period and information required to be delivered to the other shareholders in connection with a tag-along sale should also be carefully considered. A lengthy notice period or a cumbersome information requirement (e.g., an obligation to deliver the purchase agreement with the notice) can make it difficult to find a purchaser who is willing to comply with these requirements without knowing which shareholders will participate in the sale. Conversely, a brief notice period and more limited information may force the other shareholders to make their sale decisions with inadequate information or analysis. The maximum time period for the completion of the sale is also important because participating shareholders will be unable to sell their shares to another purchaser during this period.
- *Other Sale Procedures.* The shareholders agreement should specify whether the shareholders that are “tagging along” will be obligated to pay their pro rata shares of transaction expenses, must make any representations and warranties to the purchaser (e.g., more than representations regarding their title to the shares and authority to sell) in connection with the sale or will be subject to the indemnification obligations, post-closing purchase price adjustments, or other potential liabilities, if any, for which the other selling shareholders will be responsible, and whether other procedures are to be followed in exercising the rights and implementing the sale process. The provision should obligate all shareholders to deliver their share certificates, ideally prior to the proposed sale date, with a power of attorney authorizing one shareholder or the corporation to deliver the shares to the purchaser at the closing. As the laws governing the validity of powers of attorney vary from state to state, the person drafting the power of attorney should ensure that it complies with applicable state laws.
- *Terms of Sale.* A draftsman should consider whether differences in the nature of the shareholders may mean that a requirement that all shareholders must participate on the “same terms and conditions” will be difficult to implement in practice. For example, a purchaser may insist upon non-competition provisions from certain shareholders (in particular, members of management), which may not be appropriate (or acceptable) to other shareholders. Similarly, it may not be appropriate to require minority shareholders to make the same representations and warranties to the purchaser that would be given by a controlling shareholder.
- *Substitution of Consideration.* Shareholders should consider whether there are any circumstances in which it would be appropriate for different shareholders to receive different forms of consideration. For example, a purchaser may want to substitute cash consideration for certain shareholders in lieu of the non-cash consideration that it proposes to pay generally, without giving each shareholder a right to receive cash consideration (e.g., if certain selling shareholders are not accredited investors, an issuance of

securities of the purchaser to such shareholders may require registration). Alternatively, a selling shareholder may want to insist on cash as consideration for any incremental obligations that it must bear (e.g., if an earn-out is contingent on the continued efforts of that shareholder). In either case, the value of any non-cash consideration should be addressed in the shareholders agreement.

- *Multiple Classes of Shares.* When shareholders holding multiple classes of equity securities are party to a shareholders agreement, the tag-along provisions can become quite complex if a sale of one class (or multiple classes) of shares will give shareholders owning other classes a right to participate in the sale. In these cases, the allocation of rights to participate and the mechanism for ensuring that shareholders sell at the “same price” and on the “same terms and conditions” must be carefully considered and drafted. It may also be appropriate to permit holders of options and warrants to participate in a sale of common shares by another shareholder, ideally without requiring the holder to exercise its options and/or warrants prior to the closing.
- *Permitted Transfers.* The shareholders agreement should allow shareholders to make certain “permitted transfers” (typically to family members or affiliates, or for estate planning purposes) without triggering the tag-along right for other shareholders, so long as the transferee agrees to be subject to the tag-along rights. However, such a transfer should not allow a shareholder to circumvent the tag-along right through a two-step process—by transferring the shares to a newly formed affiliate, and then selling the newly formed affiliate to a third party. This can be prevented by requiring the transferee to transfer the shares back to the original shareholder if it ceases to be a “permitted transferee.”

## VII. MECHANISMS FOR RESOLVING DEADLOCK

Dissension among shareholders can lead to deadlock. This is especially true when the board of a corporation is comprised of an even number of directors, and no single shareholder or group of shareholders has the voting power to elect a majority of the directors and effectively control the board. Deadlock can also result in cases where a minority shareholder has bargained for veto rights over significant corporate decisions.

### A. CERTAIN LEGAL PRINCIPLES—DELAWARE LAW

- The Delaware corporation law statute includes several provisions to address deadlocks. Upon the application of any shareholder of a Delaware corporation, the Court of Chancery may appoint one or more persons as a custodian (and, in case of an insolvent corporation, receiver) of and for the corporation when: “(1) At any meeting held for the election of directors,

the stockholders are so divided that they have failed to elect . . . directors . . . ; (2) The business of the corporation is suffering or is threatened with irreparable injury because the directors are so divided respecting the management of the affairs of the corporation that the required vote for action by the board of directors cannot be obtained and the stockholders are unable to terminate this division; or (3) The corporation has abandoned its business and has failed within a reasonable time to take steps to dissolve, liquidate or distribute its assets.”<sup>125</sup> A custodian appointed under Del. G.C.L. section 226 has all the powers of a receiver appointed under Del. G.C.L. section 291, but, with certain exceptions, the authority of the custodian is to continue the business of the corporation and not to liquidate its affairs and distribute its assets.<sup>126</sup>

- As discussed below,<sup>127</sup> New York law provides for dissolution as a remedy for deadlock in certain circumstances. For a Delaware corporation that is not a close corporation, dissolution is not the default remedy for deadlock because dissolution generally requires a board resolution approved by a majority of the directors and either approval of shareholders owning a majority of the outstanding shares or consent in writing of all of the shareholders entitled to vote thereon.<sup>128</sup> However, special dissolution arrangements to address a deadlock, such as tie-breaking votes for directors or stockholders, could be included in a corporation’s certificate of incorporation.
- The Delaware statute also includes a narrowly drawn provision that applies only to joint-venture corporations in which two shareholders each own 50 percent of the shares. In this case, unless prohibited by the certificate of incorporation or a shareholders agreement, either shareholder may petition the Court of Chancery to discontinue the joint venture and dispose of the corporation’s assets if the shareholders are unable to agree on the desirability of discontinuing the joint venture.<sup>129</sup>

## B. CERTAIN LEGAL PRINCIPLES—NEW YORK LAW

- New York’s statute expressly addresses the possibility of deadlock in N.Y.B.C.L. section 1104(a), which provides that, unless otherwise indicated in the certificate of incorporation, the holders of shares representing

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125. DEL. CODE ANN. tit. 8, § 226(a) (2001). In deciding whether the “business has been abandoned,” courts will make an independent judgment, rather than give business-judgment-rule deference to the board of directors. See *Giancarlo v. OG Corp.*, No. 10669, 1989 WL 72022, at \*4 (Del. Ch. June 23, 1989). Delaware also authorizes the appointment of a custodian for a deadlocked “close corporation” on two additional grounds. See DEL. CODE ANN. tit. 8, §§ 226(a), 352(a) (2001).

126. See DEL. CODE ANN. tit. 8, § 226(b) (2001).

127. See *infra* text accompanying notes 130–36.

128. DEL. CODE ANN. tit. 8, § 275 (2001).

129. *Id.* § 273.

50 percent of the votes entitled to be cast in an election of directors may petition for the corporation's dissolution on the grounds: "(1) That the directors are so divided respecting the management of the corporation's affairs that the votes required for action by the board cannot be obtained[;] (2) That the shareholders are so divided that the votes required for the election of directors cannot be obtained[;] [or] (3) That there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders."<sup>130</sup> A court may deny the request if it believes the facts do not warrant dissolution.<sup>131</sup> Under New York law, corporate dissolution may not be denied merely because a business has been profitable.<sup>132</sup>

- If a New York corporation's certificate of incorporation requires a supermajority of shareholders to elect directors, or a supermajority of directors for board action, then N.Y.B.C.L. section 1104(b) provides that a petition for dissolution may be brought by the holders of shares representing *more than one-third* of all outstanding shares entitled to vote on non-judicial dissolution under N.Y.B.C.L. section 1001.<sup>133</sup>
- N.Y.B.C.L. section 1104(c) provides that, notwithstanding any provision in the certificate of incorporation, *any* holder of shares entitled to vote at an election of directors may present a petition for dissolution on the ground that the shareholders are so divided that they have failed to elect directors for a period that includes at least two consecutive annual meetings.<sup>134</sup>
- The New York statute also allows a corporation to alter the statutory dissolution requirements by including a dissolution provision in its certificate of incorporation.<sup>135</sup> The existence of such a provision should be noted conspicuously on the face or back of every certificate for shares issued by the corporation.<sup>136</sup>

### C. DRAFTING CONSIDERATIONS

Drafters should discuss with the shareholders whether provisions should be included in the shareholders agreement (or certificate of incorporation) to address the possibility of deadlock, as an alternative to the appointment of a custodian (in the case of a Delaware corporation) or dissolution (in the case of a New York cor-

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130. N.Y. BUS. CORP. LAW § 1104(a) (McKinney 2003).

131. *Wollman v. Littman*, 316 N.Y.S.2d 526, 527–28 (App. Div. 1970) (delaying dissolution pending the results of a related breach of fiduciary duty claim).

132. *Tavlin v. Munsey Candlelight Corp.*, 415 N.Y.S.2d 438, 440 (App. Div. 1979).

133. N.Y. BUS. CORP. LAW § 1104(b) (McKinney 2003).

134. *Id.* § 1104(c).

135. *Id.* § 1002(a).

136. *See id.* § 1002(c).

poration), particularly in light of the fact that preservation of the corporation as a going concern is usually, but not always, a preferable result for the shareholders.

- *Mandatory Arbitration or Mediation.* One alternative to consider is an arbitration or mediation provision, as arbitration and mediation proceedings can be (but are not always) quicker, less expensive, and more confidential than litigation. New York courts have ordered stays of dissolution proceedings instituted under N.Y.B.C.L. section 1104 pending arbitration of disputes covered by an arbitration agreement.<sup>137</sup>
- *Buy-Sell Arrangements.* Buy-sell arrangements can break a deadlock by eliminating one or more factions of shareholders. This solution preserves the entity as a going concern and is designed to provide a fair price to the shareholder(s) being bought out. One drawback, however, is the risk of manipulation by a shareholder that wishes to squeeze out another shareholder by creating and prolonging a deadlock to trigger the buy-sell provision. As a form of transfer restriction, the existence of a buy-sell provision should be noted conspicuously on the face or back of every certificate of shares issued by the corporation.<sup>138</sup> Shareholders should be aware that the use of a buy-sell provision generally supersedes the right to compel a judicial dissolution of a New York corporation.<sup>139</sup>
- *Voluntary Dissolution Provisions.* Shareholders should consider including special dissolution provisions in the corporation's certificate of incorporation to enable shareholders to force a dissolution in the event of a "deadlock" (in the case of a New York corporation, in more circumstances than those addressed by N.Y.B.C.L. section 1104(a)). The types of "deadlock" that can trigger the dissolution requirement should be carefully considered.
- *Tie-Breaking Vote.* Under recent amendments to Delaware law, the certificate of incorporation can give one director (often the CEO) a tie-breaking vote in the event of a deadlock on a matter that is of fundamental significance to the corporation's ability to conduct its business.<sup>140</sup>

## VIII. PREEMPTIVE RIGHTS

Preemptive rights give some or all of the shareholders a right to purchase additional shares and/or other types of equity securities that the corporation thereafter proposes to issue.

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137. See, e.g., *Myers v. Leibel*, 107 N.E.2d 512, 512 (N.Y. 1952); *Moskowitz v. Surrey Sleep Prods., Inc.*, 292 N.Y.S.2d 748, 749 (App. Div. 1968).

138. See N.Y. U.C.C. LAW § 8-204 (McKinney 2005); DEL. CODE ANN. tit. 6, § 8-204 (2005); see also DEL. CODE ANN. tit. 8, § 202(a) (2001).

139. See, e.g., *Johnsen v. ACP Distrib., Inc.*, 814 N.Y.S.2d 142, 147 (App. Div. 2006).

140. DEL. CODE ANN. tit. 8, § 141(d) (2001 & Supp. 2008).

### A. CERTAIN LEGAL PRINCIPLES<sup>141</sup>

- *Delaware Law*. Del. G.C.L. section 102(b)(3) reverses the historic common law presumption that preemptive rights are mandatory, by granting shareholders of a Delaware corporation preemptive rights only if the certificate of incorporation specifically provides for such rights.<sup>142</sup> Preemptive rights of corporations that were in existence on July 3, 1967, remain in effect (even if not provided for in the certificate of incorporation) with respect to all additional issues of shares or convertible securities until such rights are explicitly changed or terminated.<sup>143</sup>
- Delaware courts will enforce preemptive rights agreed to in shareholders agreements or other contracts even when they are not provided in the certificate of incorporation. In *Garza v. TV Answer, Inc.*,<sup>144</sup> the Delaware Court of Chancery interpreted Del. G.C.L. section 102(b)(3) as not eliminating preemptive rights altogether, but as eliminating the common-law rule that shareholders have a preemptive right to subscribe for newly issued shares, while leaving unaltered the ability of a corporation and its shareholders to enter freely into contractual agreements relating to any offering of shares issued in the future.<sup>145</sup>
- Delaware courts have also shown a willingness to interpret broadly the authority of directors to issue shares with preemptive rights. In *Benihana of Tokyo, Inc. v. Benihana, Inc.*,<sup>146</sup> the court held that a board that possessed blank-check authority to issue preferred stock had the power to issue such stock with preemptive rights, despite the fact that the certificate of incorporation specifically denied common law preemptive rights.<sup>147</sup>
- Although the Del. G.C.L. does not specify particular categories of transactions as exempt from preemptive rights, some such categories have been established in Delaware case law.<sup>148</sup>
- *New York Law*. N.Y.B.C.L. section 622(b) provides that shareholders of a New York corporation incorporated on or after February 22, 1998, do not have preemptive rights unless expressly provided for in the articles of

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141. Unlike many jurisdictions outside of the United States, most modern corporation statutes in the United States do not impose preemptive rights unless these rights are expressly granted in the certificate of incorporation.

142. DEL. CODE ANN. tit. 8, § 102(b)(3) (2001).

143. *Id.*

144. No. 12784, 1993 WL 77186 (Del. Ch. Mar. 15, 1993).

145. *Id.* at \*3-4.

146. 906 A.2d 114 (Del. 2006).

147. *Id.* at 121.

148. See, e.g., *Am. Gen. Corp. v. Cont'l Airlines Corp.*, No. 8390, 1988 WL 7393, at \*8 (Del. Ch. Jan. 26, 1988) (a merger transaction did not violate preemptive rights, notwithstanding the fact that the provision as drafted did not contain this exclusion), *aff'd*, 575 A.2d 1160 (Del. 1990).



incorporation.<sup>149</sup> In the case of corporations incorporated prior to February 22, 1998, preemptive rights do not attach automatically; rather, shareholders retain preemptive rights only if the issuance would adversely affect any unlimited dividend rights or voting rights they possess, unless the certificate of incorporation provides otherwise.<sup>150</sup> The N.Y.B.C.L. also specifically exempts certain types of transactions from express or implied preemptive rights, such as share issuances for consideration other than cash, issuances to effectuate a merger or consolidation, issuances of treasury shares, issuances of options and shares to employees of the corporation, and the sale or option of shares authorized in the certificate of incorporation within two years of incorporation.<sup>151</sup>

- *Remedies.* Few Delaware cases address remedies for the breach of preemptive rights, but a requested cancellation of the shares issued in violation of preemptive rights has been explicitly rejected.<sup>152</sup> In New York, shareholders whose preemptive rights have been violated are entitled to seek an appraisal,<sup>153</sup> and some New York courts have invalidated shares issued in violation of shareholders' preemptive rights.<sup>154</sup>

## B. DRAFTING CONSIDERATIONS

- If preemptive rights for all shareholders are desired, they should be included in the corporation's certificate of incorporation, even if the corporation is party to a shareholders agreement that sets forth the preemptive rights. If only certain shareholders are being granted preemptive rights, their rights can simply be included in a contract.
- Following *Benihana of Tokyo*,<sup>155</sup> if the certificate of incorporation of a Delaware corporation grants the board of directors blank-check authority to issue preferred stock, drafters who wish to prohibit the inclusion of preemptive rights in the terms of the preferred stock should include this limitation on authority in the certificate of incorporation.
- In a corporation with multiple classes of voting shares, the issuance of shares of one class may dilute the voting rights of another. When preemptive rights are granted, the certificate of incorporation or the shareholders agreement should include a clear definition of a shareholder's "pro rata share" and should make explicit whether issuances of shares of certain

149. N.Y. BUS. CORP. LAW § 622(b)(1) (McKinney 2003).

150. *Id.* § 622(b)(2).

151. *Id.* § 622(e) (providing full list of statutory exemptions).

152. *Superwire.com, Inc. v. Hampton*, 805 A.2d 904, 911 (Del. Ch. 2002).

153. *Carroll v. Seacroft Plaza, Ltd.*, 529 N.Y.S.2d 588, 589 (App. Div. 1988).

154. *See, e.g., Hyman v. Behar*, 241 N.Y.S.2d 625, 626–27 (Sup. Ct. 1963); *Tabulating Card Co. v. Leidesdorf*, 223 N.Y.S.2d 652, 657–58 (Sup. Ct. 1961).

155. *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114, 121 (Del. 2006).

classes should trigger preemptive rights for other classes. The definition should be clear as to whether it takes into account the ownership of options, warrants, convertible securities, and other rights to acquire shares and whether the issuance of equity-linked securities triggers preemptive rights or only the issuance of shares upon the exercise of such securities.

- The preemptive rights provisions should address whether a waiver of preemptive rights must be in writing, or whether inaction by the shareholder for a specified time period will be deemed a waiver.
- The preemptive rights provisions should address whether shareholders who have elected to exercise their preemptive rights will also have rights to purchase any shares that will not be purchased by other holders of preemptive rights who have elected not to exercise their rights in full.
- Advance notice requirements, decision periods, and “pro rata share” participation mechanics can cause delay and undue expense for a corporation trying to issue new shares. When drafting a preemptive rights provision, the practical implications of granting preemptive rights should be considered:
  - Exceptions to the preemptive rights provisions, even where already provided for by statute or case law, should be included to avoid the application of preemptive rights when their implementation would be particularly challenging for the corporation (e.g., when securities are issued in the corporation’s initial public offering or after the initial public offering, or when securities are issued upon exercise of options, warrants, or convertible securities, when securities are issued as consideration in a business-combination transaction or for other non-cash consideration).
  - In certain circumstances it may be desirable to grant preemptive rights only to a subset of the shareholders or in certain circumstances (e.g., only when shares are issued to an insider or majority shareholder, to avoid exploitation of minority shareholders). It may also be desirable to require certain shareholders (e.g., those with relatively small holdings) to wait to exercise their preemptive rights until after the triggering issuance. This may be particularly useful when a corporation needs to issue shares quickly. Consideration should be given in such situations to the pro rata calculations used to determine each shareholder’s right to purchase such shares.
  - The offer and issuance of shares upon exercise of preemptive rights are an offer and a sale of securities requiring either registration under, or exemption from, the Securities Act of 1933 and applicable state securities laws. If any of the shareholders holding preemptive rights are not accredited investors, the issuer must consider whether a registration exemption is available and, if no such exemption exists, the implications of failing to honor the preemptive rights granted to such shareholders.

## IX. AMENDMENTS AND TERMINATION OF SHAREHOLDERS AGREEMENTS

### A. CERTAIN LEGAL PRINCIPLES

- The N.Y.B.C.L. and Del. G.C.L. are silent regarding the minimum consent required to amend or terminate a shareholders agreement.

### B. DRAFTING CONSIDERATIONS—AMENDMENTS

- A shareholders agreement should specify the approval requirement for an amendment or waiver of any of its provisions. During the negotiation of the shareholders agreement, the shareholders and their counsel should consider whether amendments of certain provisions should require the approval of all of the shareholders (or at least, the holders of a high percentage of the shares held by all of the shareholders party thereto), whereas other amendments may require a simple majority or lower “supermajority” threshold. Drafters should also consider whether the consent of specified individual shareholders should be required for amendments of provisions that grant special rights to those shareholders (e.g., board nomination rights). Class voting may also be appropriate.
- Ideally, shareholders agreements should clearly identify the level of approval required for amendments. Simply requiring the approval of a shareholder when an amendment would “adversely affect its rights” can create uncertainty as to what approvals for a particular amendment will be required. To avoid this uncertainty, the parties should consider including in the shareholders agreement a list of specific matters for which amendments would trigger supermajority, class, or individual approval rights. Because it is hard to predict in advance all of the possible amendments that may be sought, the shareholder may also want to include a right to approve any other amendment that adversely affects its rights or, at least, that adversely affects its rights relative to other similarly situated shareholders. Again, this formulation can create challenges if there are disagreements among shareholders regarding the application of this standard to a particular amendment. Moreover, notwithstanding a provision in a shareholders agreement that may allow amendments to transfer restrictions, an amendment that would impose transfer restrictions on shares of a Delaware corporation will not be binding against any holders of shares that do not vote in favor of the restriction or against the transferees of such shares.<sup>156</sup>

### C. DRAFTING CONSIDERATIONS—TERMINATION

- While shareholders agreements can be drafted to terminate upon the occurrence of any number of events, the most common triggers are the

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156. DEL. CODE ANN. tit. 8, § 202(b) (2001).

consummation of an initial public offering of the corporation or the acquisition of all the outstanding securities of the corporation by an outside party. If registration rights are in the shareholders agreement, the termination provision should allow for their survival after the initial public offering. Other provisions may survive the initial public offering, but this is less common.

- Shareholders agreements may also selectively terminate with respect to certain shareholders upon the occurrence of specified triggering events, such as when the shareholder's ownership percentage falls below a specified threshold.

## X. GOVERNING LAW OF SHAREHOLDERS AGREEMENTS

### A. CERTAIN LEGAL PRINCIPLES—CHOICE-OF-LAW

- *Selection of Delaware or New York as Governing Law.* Delaware and New York statutes allow parties to a contract involving specified minimum monetary amounts to agree that the contract will be governed by the laws of that State:
  - If a contract involves at least \$100,000, the parties to such contract may agree that it will be governed by Delaware law if the parties are subject to the jurisdiction of the Delaware courts and may be served there with legal process.<sup>157</sup>
  - If a contract involves at least \$250,000 and it does not relate to personal, family, or housing services, the parties to such contract may agree that the contract will be governed by New York law.<sup>158</sup>
- When determining whether the monetary threshold is met, courts generally analyze the basic consideration inherent in the contract at the time of bargaining.<sup>159</sup> In analyzing such consideration, courts may refer to the basic consideration in each contract containing the clause, the consideration in all connected transactions, or the potential or actual contract damages.<sup>160</sup>
- *Selection of Other States as Governing Law.* Other choice-of-law provisions may be enforced. Delaware requires that the chosen state “bear some material relationship to the transaction.”<sup>161</sup> Delaware will not enforce foreign

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157. See DEL. CODE ANN. tit. 6, § 2708 (2005).

158. See N.Y. GEN. OBLIG. LAW § 5-1401 (McKinney 2010).

159. See Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999, 1003–04 & n.17 (1994); *Cambridge Nutrition A.G. v. Fotheringham*, 840 F. Supp. 299, 302 (S.D.N.Y. 1994) (enforcing a New York choice-of-law provision when the amount in controversy was less than the statutory threshold because the underlying agreement had an aggregate value in excess of the threshold).

160. See Ribstein, *supra* note 159, at 1003 n.17.

161. *Pharmathene, Inc. v. Siga Techs., Inc.*, No. 2627-VCP, 2008 WL 151855, at \*7 (Del. Ch. Jan. 16, 2008).

laws “in a manner repugnant to the public policy of Delaware,” but a “mere difference between the laws of two states” will not necessarily justify non-enforcement of the foreign law.<sup>162</sup> In New York, the choice of another state’s law is also enforceable, but the chosen law must “bear[ ] a reasonable relationship to the parties or the transaction.”<sup>163</sup> New York will not apply foreign laws, however, if they “violate some fundamental principle of justice” and are “truly obnoxious.”<sup>164</sup>

- Parties often invoke the following formulation: “This Agreement and any claim, controversy, or dispute arising under or related to this Agreement, shall be construed in accordance with and governed by the laws of the State of [New York] [Delaware] *without regard to conflicts-of-laws principles.*”
- This formulation is intended to ensure that the contractually stipulated substantive law will be applied and enforced, specifically by discouraging the application of the doctrine of *renvoi* (under which a court would apply the whole law of the foreign jurisdiction, including that jurisdiction’s conflicts-of-laws principles, so that the court might in the end apply its own substantive law if the foreign conflicts-of-laws rules so dictate).<sup>165</sup> However, both New York and Delaware courts generally disfavor this doctrine, and therefore the italicized portion of the above formulation is not necessary when selecting the law of either jurisdiction as the governing law.<sup>166</sup>
- Delaware courts interpret this formulation as a selection of the chosen jurisdiction’s substantive law;<sup>167</sup> however, they may continue to apply Delaware law to procedural matters.<sup>168</sup> New York courts uniformly interpret this formulation as a selection of the substantive law of the chosen jurisdiction, although they also may apply a different jurisdiction’s law to answer procedural questions.<sup>169</sup>
- *Internal Affairs Doctrine.* Application of the “internal affairs doctrine” may override contractual choice-of-law provisions.
- Under the internal affairs doctrine, certain matters “peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders” must be governed by the internal laws of

162. J.S. Alberici Constr. Co. v. Mid-West Conveyor Co., 750 A.2d 518, 520 (Del. 2000).

163. Welsbach Elec. Corp. v. Mastec N. Am., Inc., 859 N.E.2d 498, 501 (N.Y. 2006).

164. *Id.* at 501 (quoting Cooney v. Osgood Mach., Inc., 612 N.E.2d 277, 284–85 (N.Y. 1993)).

165. 16 AM. JUR. 2d *Conflict of Laws* § 5 (2009).

166. See Cooper v. Ross & Roberts, Inc., 505 A.2d 1305, 1307 n.3 (Del. Super. Ct. 1986); Jean v. Francois, 642 N.Y.S.2d 780, 781 (Sup. Ct. 1996).

167. See, e.g., LHO New Orleans LM, L.P. v. MHI Leasco New Orleans, Inc., No. 05C-04-214 SCD, 2006 WL 1134723, at \*3 (Del. Super. Ct. Apr. 11, 2006).

168. See Maloney-Refaie v. Bridge at Sch., Inc., 958 A.2d 871, 879 n.16 (Del. Ch. 2008).

169. See, e.g., Cohen v. S.A.C. Capital Advisors, LLC, No. 112479/05, 2006 WL 399766, at \*5 (N.Y. Sup. Ct. Jan. 3, 2006).

the corporation's state of incorporation,<sup>170</sup> even if the parties provide generally that the shareholders agreement will be governed by the law of a different state. The doctrine only encompasses those allegations that "could [not] have arisen between two parties with no corporate relationship."<sup>171</sup>

- Both Delaware and New York courts have held that the internal affairs doctrine can apply to disputes regarding agreements among shareholders of a corporation formed in the applicable state, even if the agreement includes a choice-of-law clause to which all disputing parties have agreed.<sup>172</sup> In general, New York's commitment to the internal affairs doctrine is less than Delaware's.<sup>173</sup>
- *Absence of Choice-of-Law Provisions.* If a "choice-of-law" provision is not explicitly included in a shareholders agreement, and the internal affairs doctrine (as described above) does not apply, both New York and Delaware will apply the substantive law of the jurisdiction that has the most "significant contacts" or the most "significant relationship" to the matter in dispute.<sup>174</sup>
- *Non-Contractual Subject Matters.* Under New York law, in order for a choice-of-law provision to apply to a non-contractual claim (e.g., tort), the express language of the provision must be "sufficiently broad" as to encompass the entire relationship between the contracting parties.<sup>175</sup> Delaware courts generally enforce a choice-of-law provision when the non-contractual claim arises out of the contractual relationship of the parties.<sup>176</sup>

## B. CERTAIN LEGAL PRINCIPLES—GOVERNING FORUM

- As a general matter, forum selection clauses that result from arm's-length negotiation by sophisticated parties will be upheld absent "fraud, undue influence, or overweening bargaining power."<sup>177</sup>

170. *In re Topps Co. S'holders Litig.*, 924 A.2d 951, 958 (Del. Ch. 2007) (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982)); *Hart v. Gen. Motors Corp.*, 517 N.Y.S.2d 490, 493 (App. Div. 1987) (quoting *Edgar*, 457 U.S. at 645).

171. *PTI Enters. (U.S.), Inc. v. Del Monte Foods Co.*, No. 99 Civ. 3794(BSJ), 2003 WL 22118977, at \*18 (S.D.N.Y. Sept. 11, 2003).

172. *See, e.g.*, *BBS Norwalk One, Inc. v. Raccolta*, 60 F Supp. 2d 123, 129 (S.D.N.Y. 1999), *aff'd*, 205 F.3d 1321 (2d Cir. 2000); *Rosenmiller v. Bordes*, 607 A.2d 465, 469 (Del. Ch. 1991).

173. *Compare In re Dohring*, 537 N.Y.S.2d 767, 769 (Sup. Ct. 1989) (describing New York's internal affairs doctrine as an issue of "convenience and discretion"), with *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) (describing Delaware's internal affairs doctrine as one mandated by constitutional principles).

174. *Am. Int'l Group v. Greenberg*, 965 A.2d 763, 818 (Del. Ch. 2009); *see, e.g.*, *Playtex Family Prods., Inc. v. St. Paul Surplus Lines Ins. Co.*, 564 A.2d 681, 688 (Del. Super. Ct. 1989); *In re Allstate Ins. Co.*, 613 N.E.2d 936, 940 (N.Y. 1993) (using conventional contracts analysis); *Auten v. Auten*, 124 N.E.2d 99, 102 (N.Y. 1954) (same).

175. *See Krosk v. Lipsay*, 97 F.3d 640, 645 (2d Cir. 1996).

176. *See ABRV Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1046–50 (Del. Ch. 2006).

177. *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 12 (1972).

- *Delaware Law.* Although Delaware has no statutory provision akin to N.Y. General Obligations Law section 5-1402 (discussed below<sup>178</sup>), forum selection clauses are nonetheless “prima facie valid.”<sup>179</sup> Such clauses will be enforced unless they are “unreasonable under the circumstances,”<sup>180</sup> or when fraud or overreaching is present.<sup>181</sup>
- *New York Law.* New York courts must adjudicate actions that arise under agreements that require New York as its governing law, contain valid forum selection clauses, and pertain to transactions worth at least \$1,000,000.<sup>182</sup> Forum selection clauses are “prima facie valid” and will be enforced unless “unreasonable or unjust . . . such that a trial in the contractual forum would be . . . gravely difficult and inconvenient” to the challenging party.<sup>183</sup> Even when the transaction is worth less than \$1,000,000, or when the parties have not selected New York law, one can argue that a valid forum selection clause operates as a waiver to objections based on personal jurisdiction or forum non conveniens.<sup>184</sup>
- *Arbitration.* Instead of selecting a particular court to govern disputes, parties sometimes select arbitration as a forum. When doing so, parties will often agree that the rules of a designated governing body, such as the American Arbitration Association or the International Court of Arbitration, will govern the proceeding, and that the proceeding will occur in a particular jurisdiction.<sup>185</sup>
  - When interpreting an arbitration clause to determine whether parties consented to arbitration, Delaware courts presume that “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.”<sup>186</sup> Courts will dismiss a court action in favor of arbitration, however, only when arbitration is mandated by the agreement, not simply permitted by it.<sup>187</sup>

178. See *infra* text accompanying note 182.

179. *Hornberger Mgmt. Co. v. Haws & Tingle Gen. Contractors, Inc.*, 768 A.2d 983, 987 (Del. Super. Ct. 2000).

180. *Aveta, Inc. v. Colon*, 942 A.2d 603, 608 n.7 (Del. Ch. 2008); see, e.g., *Eisenmann Corp. v. Gen. Motors Corp.*, No. 99C-07-260-WTQ, 2000 WL 140781, at \*8 (Del. Super. Ct. Jan. 28, 2000) (refusing to enforce forum selection clauses in individual contracts where plaintiff’s claim related to the failure of General Motors to bundle all contracts).

181. See *Hornberger*, 768 A.2d at 987.

182. See N.Y. GEN. OBLIG. LAW § 5-1402 (McKinney 2010).

183. *Harry Casper, Inc. v. Pines Assocs., L.P.*, 861 N.Y.S.2d 820, 821 (App. Div. 2008) (quoting *Sterling Nat’l Bank v. E. Shipping Worldwide, Inc.*, 826 N.Y.S.2d 235, 237 (App. Div. 2006)).

184. See *Indosuez Int’l Fin. B.V. v. Nat’l Reserve Bank*, 774 N.E.2d 696, 701 (N.Y. 2002) (discussing personal jurisdiction); *Shah v. Shah*, 626 N.Y.S.2d 786, 788–89 (App. Div. 1995) (discussing forum non conveniens); *A.C.E. Elevator Co. v. V.J.B. Constr. Corp.*, 746 N.Y.S.2d 361, 363–65 (Sup. Ct. 2002) (discussing venue).

185. See, e.g., *McLaughlin v. McCann*, 942 A.2d 616, 619 (Del. Ch. 2008).

186. *Id.* at 621 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985)).

187. See, e.g., *Willie Gary LLC v. James & Jackson LLC*, No. 1781, 2006 WL 75309, at \*9–11 (Del. Ch. Jan. 10, 2006), *aff’d*, 906 A.2d 76 (Del. 2006).

- Before dismissing a matter in favor of arbitration, New York courts will ensure that “the dispute falls clearly within that class of claims which the parties agreed to refer to arbitration.”<sup>188</sup> However, courts take a more deferential posture when interpreting broadly worded arbitration clauses.<sup>189</sup> Like Delaware, New York will allow arbitrators to decide questions of arbitrability when the arbitration agreement “*clearly and unmistakably so provide[s]*.”<sup>190</sup> However, courts are less deferential to an arbitrator’s determination of arbitrability when the arbitration clause contains a carve-out of certain subject matters.<sup>191</sup>
- Federal law as set forth in the Federal Arbitration Act<sup>192</sup> similarly reflects a “national policy favoring arbitration,”<sup>193</sup> based on Commerce Clause jurisprudence to preempt state laws that would otherwise interfere with the intent of parties to arbitrate a dispute.<sup>194</sup>

### C. DRAFTING CONSIDERATIONS

- Shareholders agreements should include a choice-of-law provision. To achieve maximum certainty, the provision should select the law of the state of incorporation of the corporation so that the internal affairs doctrine will not cause a court to deviate from the parties’ choice of law. This point is especially relevant if the parties expect disputes surrounding the shareholders agreement to involve questions of fiduciary or corporate law.
- Whichever state’s law is selected, the choice-of-law provision should specify the types of claims the parties’ choice of law is intended to cover. For example, if the parties intend for their chosen law to apply to tort claims that are related to the shareholders agreement, then the choice-of-law provision should so indicate or the parties take the risk that a court would confine the provision to contractual or fiduciary claims.
- Shareholders agreements should also include a choice-of-forum provision, as well as a waiver of any claim of forum non conveniens relating to the

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188. Primavera Labs., Inc. v. Avon Prods., Inc., 747 N.Y.S.2d 16, 17 (App. Div. 2002).

189. See, e.g., State v. Philip Morris Inc., 813 N.Y.S.2d 71, 75 (App. Div. 2006) (finding that the phrase “relating to” evinces an extremely broad scope), *aff’d*, 869 N.E.2d 636 (N.Y. 2007); Hirschfeld Prods., Inc. v. Mirvish, 630 N.Y.S.2d 726, 728 (App. Div. 1995) (inquiring as to whether the “allegations of the complaint bear a reasonable relationship to the subject matter governed by the [broadly worded] arbitration agreement”), *aff’d*, 673 N.E.2d 1232 (N.Y. 1996).

190. Smith Barney Shearson Inc. v. Sacharow, 689 N.E.2d 884, 887 (N.Y. 1997) (quoting AT&T Techs., Inc. v. Commc’ns Workers of Am., 475 U.S. 643, 649 (1986)).

191. See Eaton Vance Mgmt. v. ForstmannLeff Assocs., LLC, No. 06 Civ. 1510(WHP), 2006 WL 2331009, at \*4 (S.D.N.Y. Aug. 11, 2006).

192. 9 U.S.C. §§ 1–16 (2006).

193. Preston v. Ferrer, 552 U.S. 346, 346 (2008) (citing Southland Corp. v. Keating, 465 U.S. 1, 2 (1984)).

194. See generally *id.* at 360–63 (when two parties agreed to arbitrate all disputes arising out of a contract, the Federal Arbitration Act superseded a California law that would have adjudicated a dispute under that contract in an administrative forum).



selected forum. Forum selection clauses address the “inconvenient forum” objection to proceeding with a lawsuit in a particular jurisdiction. The concern is that this objection can be used for strategic instead of logistical reasons (as it was intended).

- Forum selection clauses can be highly specific. The parties can, for example, select the state court system to the exclusion of the federal court system. However, courts cannot enforce a selection of federal courts to the exclusion of state courts unless federal subject matter jurisdiction requirements are met. For this reason, a forum selection clause that specifies *either* state or federal courts may result in a state court proceeding.
- Compromises in which the parties agree to one state’s laws but another state’s forum should be considered carefully. Such a compromise may make it less likely that the forum will respect the parties’ choice of law, as a forum may not enforce laws of a foreign state that are against such forum’s public policy. Finally, parties face increased uncertainty when courts interpret foreign laws with which they are naturally less familiar.
- Consideration should also be given as to whether a forum selection clause is permissive or exclusive. A permissive forum selection clause will address the “inconvenient forum” objection, while allowing some flexibility to determine the most appropriate forum for a particular dispute; however, it may result in a proceeding in a state that is different from the governing law, creating the issues described above in the immediately preceding bullet point.
- Parties can also select arbitration as a forum for resolution of disputes. An arbitration clause would typically involve an agreement to submit disputes arising under the shareholders agreement to arbitration pursuant to the rules of a selected governing body, such as the American Arbitration Association or the International Chamber of Commerce. In addition, Delaware has recently adopted rules permitting judges of the Delaware Court of Chancery to arbitrate cases.<sup>195</sup>
  - A starting point for drafting an agreement to arbitrate should be the model clause recommended by the governing body in question, which would typically have a broad sweep.
  - Perceived advantages of arbitration are confidentiality, more limited discovery, and somewhat expedited results.
  - Excluding various subjects from arbitration could cause a court to be less deferential when considering whether to compel arbitration of interrelated subjects or whether certain questions should be decided in the first instance by a court or an arbitrator.

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195. DEL. CT. CH. R. 96, 97 & 98.

- In addition to selecting the rules to govern the arbitration, an arbitration provision should specify the selection and number of arbitrators, the venue (the procedural rules of which will govern any court intervention and the availability of provisional remedies in aid of the arbitration, such as attachment and injunctive relief), and can also deal separately with provisional relief, the allocation of costs, consolidation of similar claims, the timing of the award, the content of the award, the availability of relief from the award, and, depending on the parties involved, the language of the arbitration and the nationality of the arbitrators.

## **XI. CONCLUSION**

The shareholders agreement provisions outlined above are typical but not simple; careful consideration should be given to the legal principles underlying these provisions and the drafting required to effect them. Based on the needs of the shareholders, an agreement may not require each of the above provisions, may require additional provisions, or may be better suited to a governing law other than Delaware or New York. The preferences and objectives of each shareholder and each corporation are unique, and care should be taken in drafting a shareholders agreement to ensure that it comports with the intent of the parties.

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OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK\*

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\* This Report was substantially completed when the following were also members of the Committee: James T. Bentley, Felix J. Bronstein, Jordan A. Costa, Richard De Rose, Stephen P. Farrell, Kenneth L. Rothenberg, and Leo Silverstein. The Committee expresses its appreciation to C. Stephen Bigler and Megan R. Wischmeier of Richards, Layton & Finger, P.A. for their review and contribution to this Report.