

# Drafting Shareholder Agreements for Venture Capital Investment

Voting and Consent Rights, Transfer Restrictions,  
Drag-Along Provisions, Estate Planning Issues

WEDNESDAY, JANUARY 24, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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# DRAFTING SHAREHOLDER AGREEMENTS FOR VENTURE CAPITAL INVESTMENT

# Introduction

- ⦿ Private Equity (“PE”): Use shareholder agreement (Canada) or stockholder agreement (US) as the main document between the parties that set forth governance for the target.
- ⦿ Venture Capital (“VC”): Has shifted from shareholder agreements to several separate agreements which collectively have the same function function (voting agreement, investor rights agreement, right of first refusal and co-sale agreement (“ROFR/co-sale”), management agreement). Purpose of shift was to simplify the paperwork, increase speed and reduce cost for early stage technology company financings.
- ⦿ Sources for VC:
  - NVCA (National Venture Capital Association)
  - CVCA (Canadian Venture Capital and Private Equity Association)

# US vs. Canada

- ⦿ Due to higher deal volume and size in technology financings, the US VC market is much more mature and evolved.
- ⦿ US has more VC specialized lawyers that understand industry norms, allowing for more efficient negotiation process.
- ⦿ The standard NVCA documents are widely accepted by companies and venture capitalists as the starting point for Seed and Series A transactions.

# Nature of VC Investment: Preferred Stock

- ⦿ Rights and preferences of preferred stock are contractual in nature
- ⦿ Generally, the provisions of the certificates of incorporation govern the rights of preferred stock. Stockholders' agreements may also address preferred stock, but there are some enforceability limitations
- ⦿ Rights will not be presumed or implied
  - Presumption against supermajority voting rights
  - Blocking rights which do not expressly reference mergers may be circumvented by a merger
  - Blocking rights which do not cover subsidiaries do not protect against action taken by subsidiaries
  - Specific preference in a merger is dispositive in an appraisal proceeding
  - "No impairment" clauses are of limited utility

# Nature of VC Investment: Preferred Stock

- ⦿ Are fiduciary duties owed to preferred stockholders?
  - A board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights
  - Preferred stockholders are owed fiduciary duties only when their special contractual rights are not triggered, and instead relying on a right shared equality with the common
  - Preferred stockholders who do not have a special contractual right to a preference in a merger could challenge the allocation of merger consideration as between the preferred and the common in a merger
  - A board's fiduciary duties require that they maximize the value of its undifferentiated equity
  - Generally, it will be the duty of the board to prefer the interests of the common over the preferred

# Preferred Stock

## ⦿ Types of Preferred Stock

- Non Participating: Preferred stock receives the greater of (a) their original issue price or investment amount or (b) the amount they would receive if their preferred shares were converted to common shares at the valuation they invested at.
- Full Participating: Preferred stock first receives their original issue price or investment amount, second preferred holders would be entitled to their pro-rata share of proceeds split with common shares on an as-converted basis.
- Cap Participating: Preferred stock first receives their original issue price or investment amount, second preferred holders would be entitled to their pro-rata share of proceeds split with common shares on an as-converted basis up to a cap of X (2-3) times their original investment.

# Preferred Stock

## Key Attributes of Preferred Stock

### i. Dividends

- This is an amount of interest that accrues on the preferred investment amount annually.
- Typically these amounts are not paid but rather accrued and then converted upon an exit or liquidation.
- Interest ranges from 0-12%. Many deals have zero interest.

### ii. Anti-Dilution

- Weighted Average:  $CP_2 = CP_1 * (A+B) / (A+C)$ 
  - $CP_2$ : Class A conversion price immediately after new issue
  - $CP_1$ : Class A conversion price immediately prior to new issue
  - A: Number of common shares deemed outstanding immediately prior to new issue
  - B: Aggregate consideration received by corporation with respect to new issue divided by  $CP_1$
  - C: Number of shares issued in subject transaction
- Full Ratchet: The conversion price will be reduced to the price at which new shares are issued.
- No Price Based Protection – very unusual in VC world.

# VC Concerns

## Consent Rights/Veto

- Future financing with a preferred share that ranks ahead
- Employee Option Plan: 5-20%
- Assume debt over X% for non-approved items in budget
- Non-arm's length transaction
- Corporate commitment/ventures that require more than \$100K
- Board Seat

# Consent Rights: Delaware law Issues

## ◎ *Stockholder Consent Rights*

- Stockholder blocking rights may not be enforceable unless contained in the certificate of incorporation Why?
  - all stockholders have one vote unless the certificate of incorporation otherwise provides
  - the business and affairs is managed by the directors not stockholders unless otherwise provided in the certificate of incorporation
  - provisions requiring for any corporate action, the vote of a larger portion of the stock or any class or series must be contained in the certificate of incorporation
- Stockholders agreements that vest blocking rights in stockholders are generally inconsistent with some or all of these DGCL principles

# Consent Rights: Delaware law issues

## *Director Voting Requirements*

- ⦿ Delaware law provides that, unless otherwise provided in the certificate of incorporation or bylaws, a majority of the votes of the directors present at a meeting at which a quorum is present or the unanimous consent of directors acting by written consent is effective director action
- ⦿ The voting threshold can be raised, but not lowered and only by a certificate of incorporation or bylaw provision
- ⦿ Specified directors may be granted special approval rights, but only in a certificate of incorporation provision (Section 141(d) of the DGCL)
- ⦿ Stockholders' agreement providing for special approval rights for directors may not be enforceable

# VC Concerns

## ⦿ *Founder Commitment*

- Reverse Vesting Founder Shares to protect in the event founders leave. If a Founder resigns or is terminated for cause then such Founder would forfeit their unvested shares. Typically a 24-36 month vesting period with shares released on a monthly basis.
- Restrictive Covenants: Non-Competition/Non-Solicitation
- Key Man Insurance: Insurance in the event the Founder dies or becomes disabled. Typically, this amount is used to repurchase such Founders equity after such event.

# VC Concerns

- ◉ *Ownership of IP*

- “Chain of title” – due diligence. VC will want to ensure that everyone that has contributed to the IP is an employee of the company and has assigned their IP rights to the company.
- Non-disclosure and proprietary rights assignment agreements for founders, employees and consultants.
- Source code, patents, trademarks.
- War Story – cost of diligence on IP chain of title issue was greater than Seed Round. Deal died.

# VC Concerns

## ⦿ *Restrictions on transfer*

### i. ROFR on transfer of company share

- VC will want first right to purchase any shares of company being sold by shareholders to third parties
- Over subscription or over allotment right? If shares to be sold are offered to all shareholders on a pro-rata basis, VC will want right to purchase shares that are not taken by existing holders

### ii. Take-Me-Along for Sale

- If a shareholder wants to sell a block to a third party, and the VC / existing holders don't exercise their ROFR (see above), then the holders will want the right to tag along (or participate) in the sale transaction on a pro-rata basis
- This is a minority shareholder protection, as it prevents large shareholders from selling blocks of shares to third parties
- Typically the parties will negotiate a threshold percentage (10-50%), meaning if someone sells less than the threshold, they would not have to provide other holders the right to participate in the sale
- Consideration - Prefs tagging along into a sale of common shares

# VC Concern

- ◎ *Future Financings/Pre-Emptive Right*
  - VC will want the right to participate on a pro-rata basis in any future equity rounds of the company. This request is always accepted.
  - VC will request that if other shareholders elect to not to participate, the VC should have the right to oversubscribe before the offering is opened to new investors. This is a negotiated item, but typically the Founders will concede this point.
  - Certain exceptions to the pre-emptive right are (i) employee stock options (ii) permitted transfers for estate planning (iii) strategic investors

# Transfer Restrictions: Delaware Law Issues

- Section 202(a) of the DGCL:
  - “A written restriction or restrictions on the transfer or registration of transfer of a security of a corporation or on the amount of the corporation’s securities that may be owned by any person or group of persons, if permitted by this section and noted conspicuously on the certificate or certificates representing the security or securities so restricted... may be enforced against the holder of the restricted security...”
  - “Unless noted conspicuously on the certificate or certificates representing the security or securities ... a restriction, even though permitted by this section, is ineffective except against a person with actual knowledge of the restriction.”
- Section 202(b) of the DGCL:
  - “A restriction on the transfer may be imposed by the certificate of incorporation or by the bylaws or by an agreement among any number of security holders or among such holders and the corporation.”
  - “No restrictions so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.”

# Transfer Restrictions: Delaware Law Issues

- ⦿ Common law reasonableness requirement
- ⦿ Transfer restrictions must be noted on stock certificates
- ⦿ Transfer restrictions are not binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to the agreement or voted in favor of the restriction
- ⦿ Coverage of after acquired shares
- ⦿ Does a merger violate the transfer restriction?
  - Delaware courts have generally held that the statutory conversion of shares in a merger is not a transfer (*Shields v. Shields*)
  - However, if the transfer restriction specifically addresses transfers by operation of law, then restrictions may apply
  - Stockholders agreement should address whether transfer restrictions apply to an approved sale

# Exit Strategies

- ⦿ Common and preferred may not necessarily have the same incentives with respect to exit strategies
- ⦿ Both common and preferred are equity securities which have a desire to maximize the value of the company on exit
- ⦿ Because preferred stock typically has special economic rights, including a fixed liquidation preference upon a sale, the preferred may have an economic incentive to force the sale of the company even if the company is profitable
- ⦿ Venture capitalists operate under a business model that causes them to liquidate even profitable ventures that fall short of their return expectations and which would require investments of time and resources that could be devoted elsewhere
- ⦿ Differences in incentives over exist strategies leads to litigation

# Exit Strategy

## ● Drag-Along

- Gives defined group of shareholders the right to force the sale of the company without the need of effecting a squeeze-out merger.
- Typical Range of Percentages: if 51-75% approve an offer to sell the company, then such group could force the remaining shareholders to sell.
- VC – will typically want a moratorium (1-2 years) before this right can be initiated. In addition, VC will ensure a minimum threshold dollar amount if they are dragged along to ensure they make a certain return on their investment.

# Exit Strategy: Drag-Along

- ◉ *Halpin v. Riverstone*, C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015) (Glasscock, V.C.).
  - “[I]f at any time the Company and/or any Transferring Stockholders propose to enter into any such Change-in-Control Transaction, the Company may require the Minority Stockholders to vote in favor of such transaction, where approval of the shareholders is required by law or otherwise sought, by giving the Minority Stockholders notice thereof within the time prescribed by law and the Company’s Certificate of Incorporation and By-Laws for giving notice of a meeting of shareholders called for the purpose of approving such transaction....”

# Exit Strategy: Drag-Along

- Stockholders agreement provided for drag-along rights with respect to a merger, exercisable either through a participation right requiring the tender of shares the right to require a vote in favor of the merger
- The drag-along required Riverstone to provide notice to the minority stockholders for any “proposed” change-of-control transaction.
- Without providing any prior notice to minority stockholders, the 91% majority stockholder of Riverstone approved the merger.
- Minority stockholders sought appraisal rights
- Riverstone sought to require minority stockholders to consent to the deal after completion
- Court held that minority stockholders had appraisal rights

# Drag-Along: Indemnification Obligations

- ◎ *Cigna Health and Life Insurance Co. v. Audax Health Solutions, Inc.*, 107 A.3d 1082 (Del. Ch. 2014)
  - The plaintiff, Cigna Health and Life Insurance Co., a former preferred stockholder of defendant Audax Health Solutions, Inc., sought some \$46 million in merger consideration arising from the acquisition of Audax by Optum Services, Inc.
  - The merger agreement expressly conditioned receipt of the merger consideration by Audax's stockholders on their execution of a LoT (stockholders who had executed joinders or support agreements prior to closing did not have to sign the LoT). The form of LoT was not attached to the merger agreement.

# Drag-Along: *Cigna Health and Life Insurance Co. v. Audax Health Solutions, Inc.*

- The LoT sent to Audax's former stockholders post-closing required them to agree to: (1) release Optum for any claims associated with the merger, (2) indemnify Optum for breaches of Audax's representations and warranties, and (3) appoint a stockholders' representative
- There was no drag-along right in place requiring stockholders to sign the release or indemnity
- Cigna did not execute a joinder or support agreement pre-closing and refused to sign the LoT post-closing, but demanded its merger consideration
- Cigna successfully argued that the release was unenforceable for lack of consideration for the LoT and that the indemnification obligations violated the DGCL because they rendered the amount of merger consideration indeterminable to the extent uncapped and applied indefinitely

# Exit Strategy

## ● Put/Force Sale Process

- Often VC's will ask for the right to 'put' their shares back to the company after a certain period of time (5-7 years). The rationale for the VC is that this aligns with their funds investment cycle and their investors expectation of timing around returns. The provision would include the right for the VC to force the company to repurchase their shares after the 5-7 years at Fair Market Value, and if the company did not have sufficient funds to do so (which is often the case with tech companies), then the VC could force the company to engage an investment banker and run a sale process for the company.
- These types of Put Rights are heavily resisted by Founders, as the Founders do not want a VC investor to be able to force their hand in connection with a sale of the business

# Put Rights: Conflict between Investors and Founders

- *Frederick Hsu Living Trust v. ODN Holding Corp.*, C.A. No. 12108-VCL (Del. Ch. Apr. 24, 2017)
  - Plaintiff filed suit against ODN, its directors, officers and Oak Hill, its controlling stockholder, in connection with the redemption of \$85 million of \$150 million of Oak Hill's preferred stock
    - Complaint alleged that defendants breached their fiduciary duties by engaging in a de facto liquidation of ODN to maximize the value of Oak Hill's redemption right
    - In 2008, Oak Hill invested \$150 million in ODN preferred stock which carried a mandatory redemption right exercisable in 2013
    - In 2011, ODN's board and stockholders took steps to stockpile cash to fund Oak Hill's upcoming redemption right and ODN granted its officers bonuses contingent upon the redemption of at least \$85 million of Oak Hill's preferred stock
    - From 2012-2014, ODN sold off its primary business lines at substantial discounts and redeemed \$85 million in stock
    - By 2015, ODN's revenue had fallen to \$11 million from \$141 million four years' prior

# Put Rights: *Frederic Hsu Living Trust v. ODN Holding Corp.*

- The court found at the pleading stage that it was reasonably conceivable that by stockpiling funds through divestitures instead of managing ODN with a view towards long-term value generation, the directors engaged in unfair transactions in breach of their duties of loyalty to the undifferentiated equity
- The court also held that plaintiff stated a claim that ODN's officers breached their fiduciary duties by adjusting their estimate of ODN's necessary cash for operations to fund Oak Hill's redemption and generating a business plan that resulted in the sale of ODN's revenue generating assets
- The court held that plaintiff stated a claim that Oak Hill breached its fiduciary duties as a controller by causing ODN to stockpile cash to fund the redemption of Oak Hill's preferred stock

# Voting Agreement

## VC Concerns

- Board:
  - i. Would like a seat on the board and would prefer addition of independent directors
  - ii. Founder group will typically retain control of board in Seed Round, but as company grows and the rounds increase in size their will be pressure to have an independent board to ensure corporate governance standards
- No liability for Directors:
  - i. Directors and officers ("D&O") insurance
  - ii. Indemnification from company
- Drag-Along: Limit liability of the VC to stand behind the business of reps and warranties relating to the company

## Founder Concerns

- Want to retain control of the decision making process of the business
- Concern over cost of D&O insurance

# Election of Board: Delaware Law Issues

- Under Section 141(d) of the DGCL, a certificate of incorporation may confer director election rights on any class or series of stock, but not on individual holders of such class or series of stock
- The voting agreement effectively allows individual stockholders or groups of stockholders (i.e., key holders) to be granted director election rights
- Unlike a charter provision, the director designation rights set forth in a voting agreement need not be granted on a series or class wide basis. Rather, a voting agreement may grant individual holders director designation rights
- Consider per capita versus per share scheme
- Include irrevocable proxy which survives until termination of the voting rights

# Removal of Board: Delaware Law Issues

- ⦿ Under Delaware law, unless a corporation has a staggered board or cumulative voting, directors can be removed with or without cause by stockholders holding a majority of the outstanding voting power
- ⦿ Voting agreements can effectively circumvent this Delaware rule in a number of ways:
  - The stockholders may agree that they will not vote to remove a director designated by another stockholder or group of stockholders unless the stockholder or stockholders that designated the director requests the removal
  - Each stockholder may agree that it will vote to remove a director if requested by the designating stockholder
  - Each stockholder may agree that it will not vote to remove a director designated by another stockholder or group of stockholders absent cause

# Non-Founder Shareholders

- ⦿ Ensure that there is tag-along provision. Prevents them from being left behind in secondary share sales
- ⦿ Negotiate to include that minority holders will provide limited representations, warranties and indemnities in the purchase agreement when the company is sold

# Investors' Rights Agreement

## VC Concerns

- ⦿ Registration Rights/Lock-Up
- ⦿ Reporting
- ⦿ Pre-Emptive Right
- ⦿ Insurance

## Founder Concerns

- ⦿ Minimal, cost effective (no audit)

# Demand Registration Rights

- In re Molycorp, Inc., Shareholders Litig., C.A. No. 7282–VCN (Del. Ch. May 27, 2015)
  - Court considered claims that a board breached its fiduciary duties by not exercising its right to delay a registration right
  - VC investors possessed the right to require Molycorp to register their shares for a secondary offering.
  - The demand registration right was subject to certain conditions, such as Molycorp’s ability to delay action for up to ninety days based on a good faith judgment of the board and its counsel that: “it would be materially detrimental to the corporation or its stockholders for such Registration Statement either to become effective or to remain effective”
  - Court notes: “Of course, the Registration Rights Agreement did not permit any fiduciary to breach its fiduciary duties”; but dismisses complaint

# Management Rights Letter

## VC vs Founder Concerns

- ⦿ Reporting Requirements
  - Financial statements – audited versus unaudited
  - Quarterly dashboards
- ⦿ Registration Rights – this is a US concept that enables a trade of securities to be registered under a registration statement to permit shares to be publicly tradeable. These rights are much less important in Canada because once a company is public in Canada, shareholders are generally free to sell their shares publicly without filing requirements. Canadian venture deals that don't include a US investor will generally not include registration rights.
- ⦿ Lock Up Agreement – will be required by underwriter of public offering and usually set at 180 days for an IPO. Because principal investors will almost certainly be required to provide lock-up agreements, the value of including a lock up provision in the financing documents is often to ensure that the small holders of shares are held to similar lock up restrictions.

# Management Control: Officers and Directors

- ◎ Officers
  - Directors appoint and remove officers
  - Certificate of incorporation provision granting preferred stockholders a blocking right over the removal and replacement of officers is probably enforceable
  - Common Stockholders/Founders resist stockholder blocking rights over appointment and removal of officers and day to day operating matters
- ◎ Directors
  - Common stockholders may be granted rights to elect specified number of directors
  - Certificate of incorporation is a better place for the director election right
  - Certificate of incorporation could confer more than 1 vote on common directors, but provision needs to be contained in the certificate of incorporation
  - Directors may not remove other directors

# Management Control

- ◎ *Gorman v. Salamone*, C.A. No. 10183-VCN (Del. Ch. July 31, 2015)
  - Company's majority stockholder purported to amend the bylaws to provide that "[a]ny officer may be removed, with or without cause, at any time by the Board or by the stockholders"
  - Court's holding: Bylaws that purported to grant stockholders the authority to remove officers violated Section 141(a) of the DGCL
  - Stockholders' right to remove officers for any (or no) reason would unduly constrain the board's ability to manage the company

# Other Considerations

- Estate planning transfer provisions - VC and other shareholders will want to ensure they can transfer their shares to other entities controlled by them for tax planning purposes without having to through ROFR provisions

# Conclusions

- ⦿ As the VC market continues to mature and evolve the early seed stage documents are becoming more standardized. Less cost and increase in speed.
- ⦿ Big Law Firms in the space have all developed Founder/Company friendly startup packages to ensure that the companies are properly represented against VCs