

Strafford

Presenting a live 90-minute webinar with interactive Q&A

Drafting Shareholder Agreements for Private Equity M&A Deals

Structuring Provisions on Board Composition and Duties, Drag-Along, Tag-Along, Information Rights, and More

WEDNESDAY, MAY 20, 2020

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

Today's faculty features:

Stephanie Winer Schreiber, Shareholder, **Buchanan Ingersoll & Rooney**, Pittsburgh

Lisa R. Stark, Partner, **K&L Gates**, Wilmington, Del.

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Drafting Shareholder Agreements for Private Equity M&A Deals

Stephanie Winer Schreiber, Shareholder. Buchanan Ingersoll
& Rooney PC, Pittsburgh, PA
stephanie.schreiber@bipc.com

Lisa Stark, Partner, K&L Gates LLP, Wilmington, DE
lisa.stark@klgates.com

Introduction: Stockholders Agreements

- A stockholders agreement is a contract that structures the relationship among the stockholders of a corporation and sometimes the corporation itself
- Stockholders agreements are typically only seen in the private company context because it is simply not practical in the public company context
- Stockholders agreements allow for private ordering of a corporation's governance structure and often accomplish governance structures that could not be accomplished in a corporation's organizational documents (i.e., the certificate of incorporation and bylaws)

Introduction: Stockholders Agreements

- Stockholders agreements also often contain provisions, such as buy-sell provisions, that do not strictly relate to the management of the corporation, but allow the current stockholders to maintain control over the composition of the stockholder base itself
- Stockholders agreements may also address investor and management concerns related to access to information, confidentiality, and competition

Introduction: Key Provisions of Stockholders Agreements

- Board of directors composition and duties
- Treatment/waiver of corporate opportunities
- Appointment and removal of officers
- Voting rights
- Information rights
- Transfer restrictions
- Resolving deadlock
- Preemptive rights

Key Provisions of Stockholders Agreements

- Amendment and termination of shareholder agreement
- Governing law

Board of Directors Composition and Duties

- Interplay between bylaws and stockholders agreement
- Issues for consideration:
 - Board composition/selection
 - Actual stockholders or designees
 - Who has the right to remove designated directors
 - Does this change in the case of “for cause” removals
 - Alternative quorum provisions

Board of Directors Composition and Duties

- Additional considerations:
 - Restricted nomination rights
 - Staggered board of directors
 - Director fiduciary duty
 - Appointment to committees
 - Board observer positions
 - Tied to percentage ownership
 - Confidentiality considerations

Board of Director Composition and Duties: Delaware 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 stockholders agreement effectively allows individual stockholders or groups of stockholders (i.e., key holders) to be granted director election rights.
 - The director election rights need not be granted on a series or class wide basis.
 - The director election rights must be enforced by an agreement of the stockholder parties to vote in favor of the designees of the stockholder(s) holding the director election rights.

Board of Director Composition and Duties: Delaware Issues

- Per-share versus per-capita designation schemes
- “Designated by the majority of the holders of the Series A Preferred Stock” v. “majority of the shares”
- “Elected by the Key Holders”
- Altering quorum or voting standards for director action
- Duties of directors of Delaware corporations cannot be altered in a stockholders agreement or by certificate of incorporation or bylaw provision

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
- Where a director was elected by the holders of a specific class of stock, removal without cause may be effected only by the holders of that class of stock
- All stockholders are entitled to vote on the removal of a director for cause
- Stockholders agreement can effectively circumvent this Delaware rule in a number of ways:
 - The stockholders may agree that they will not vote to remove a director designed by another stockholder or group of 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

Schroeder v. Buhannic, C.A. No. 2017-0746 (Del. Ch. Jan. 10, 2018)

- Proceeding under Section 225 of the DGCL (which provides a summary proceeding) to resolve disputes over the election and removal of officers and directors of a Delaware corporation
- Holders of a majority of the common stock of TradingScreen Inc. purported to remove and replace the company's CEO from his officer and director position by action by written consent

Schroeder v. Buhannic¹ C.A. No. 2017-0746 (Del. Ch. Jan. 101 2018)

- Section 7.2(b) of the Stockholders' Agreement. The common stockholders agreed to elect and maintain certain persons to the Board, including "three (3) representatives designated by the holders of a majority of the Common Stock, one of whom shall be the Chief Executive Officer."
- Plaintiffs contended that Section 7.2(b) required the common stockholders to maintain the board seat with the CEO selected by TradingScreen's board of directors.
- Defendants, common stockholders of TradingScreen, argued that this provision allowed them to appoint anyone to the board seat and constrained the TradingScreen board in its selection of a CEO.
- Court concludes that plaintiffs' reading is the correct one.

Treatment/Waiver of Corporate Opportunities

- Waiver of duty of loyalty with respect to corporate opportunities in stockholders agreements
 - Problem for investors
- Determination of who is a fiduciary under applicable state law
- Narrowly defining scope of corporate opportunity
 - Corporation a party to agreement
- Defining procedures for waiver of corporate opportunities

Treatment/Waiver of Corporate Opportunities: Delaware law issues

- Section 122(17) of the DGCL permits the corporation to renounce in its certificate of incorporation or by action of its board of directors the corporation's interest or expectancy in specified business opportunities or specified classes or categories of business opportunities.
- This enables the corporation to determine in advance whether these opportunities are corporate opportunities of the corporation rather than to address such opportunities as they arise.
- Fiduciary duties of directors, controlling stockholders or fiduciaries cannot be altered with respect to corporate opportunities.

Appointment of Officers

- Stockholders agreements often give stockholders the right to influence the selections of key officers
- Special attention must be given to a state's requirements for bylaw, certificate or board resolution provisions
- Often limited to key officers – President
- Approval rights grants to stockholders
- Tied into removal rights
- Board of directors may retain certain rights such as suspension or removal for cause

Appointment/Removal of Officers: Delaware law issues

- DGCL § 142: “Every corporation under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in the resolution of the board of directors”
- DGCL § 141 (a): “The business and affairs of every corporation ... shall be managed by or under the direction of a board of directors except as otherwise provided in this chapter or in its certificate of incorporation”
- Section 142(e) of the DGCL “[a]ny vacancy occurring in any office . . . shall be filled as the bylaws provide”

Officers: Delaware law issues

- 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

Voting Rights

- Supermajority voting requirements for directors
- Reserve powers for stockholders
 - Usurping the obligations of directors
 - Supermajority provisions
 - Additional rights of stockholders
- May be set forth in a management agreement with the company

Voting Rights

- Voting restrictions and voting rights
- Setting forth provisions that must be contained in bylaws
- Co-sale rights
 - Mechanics
 - Pro-rata sale rights
 - Acknowledgment that may chill sales

Voting or Blocking Rights and Control/Fiduciary Issues

- Blocking rights may give rise to a minority stockholder possessing effective control over the company or a particular transaction and thereby becoming a fiduciary.
 - Veto rights over the company's access to funding may be a strong indicator of control where the stockholder holding the veto right uses it to force the company into a vulnerable position
 - Veto rights when combined with other facts may weigh in favor of a finding of control where they enable the stockholder to exercise power over the company beyond what the holder of a mathematical majority of the voting power ordinarily would possess

Voting Rights

- Drag along rights
 - Who is granted drag along rights
 - Other stockholders' obligation
 - Not dissent or raise objections
 - Sell stock for same consideration and on no less favorable terms (subject to class differentiations)
 - Take all actions reasonable necessary to consummate transaction
 - Remedies for failure to deliver stock
 - Execute documents approved by board
 - Limitations on representations and warranties
 - Limitations on indemnification

Drag-Along: Delaware Law Issues

- *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-a long 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

Information Rights

- Confidentiality concerns
 - Serving as a representative of an investor
 - Board observer rights
 - Dual loyalty – conflict concerns
 - Inclusion of provisions regarding receipt and timing of financial statements (company a party)

Information Rights

○ Inspection rights

- Properties, financial records, business plans, budgets
- To discuss company's affairs, finances and accounts with officers
 - Reasonable times
 - Carve out for trade secrets and confidential information (may be significant carve out)
 - Advance notice, during business hours and in a manner not to unreasonably interfere with business operations

Information Rights: Delaware law issues

- Delaware law recognizes that large investors may be given information rights in stockholders' agreements and that when the stockholder has a designee on the board, the investor is generally entitled to the same information as the director
 - *Kalisman v. Friedman*: "When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director"
 - The ability of a designated director to convey information to the stockholder that placed him on the board is not unfettered

Information Rights: Delaware law issues

- Designated directors must act in the best interests of all stockholders, i.e., no constituency directors
- Directors owe a duty of confidentiality to the corporation
- Directors owe a duty of disclosure to their fellow directors
- Disclosure to designating stockholder is unlawful if it would harm the corporation
- The directors right to information generally extends to privileged material

Confidentiality Provisions: Delaware law issues

- Confidentiality provisions versus fiduciary duties
- Screening: Limit dual fiduciary's access to competitive confidential information that may be of interest to the designator and harmful if disclosed to the designator
 - As a practical matter, screening is very difficult, particularly, if the director plays a significant role in the management of the day-to-day affairs of the corporation

Transfer Restrictions

- Often key component of stockholders agreements
 - Reasonableness of restrictions
 - Initial period restricting transferability
 - Are transferees bound by further transfer restrictions
 - Use of joinders
 - Definition of term transfer
 - Purchase price considerations:
 - Use of promissory notes
 - Fair market vs. fair value
 - Formula for purchase price

Transfer Restrictions

- Permitted transfers may include:
 - Individual stockholders
 - Permissible transferees may include:
 - Estate or executor
 - Immediate family members (defined)
 - Trusts and other tax planning vehicles
 - Institutional investors
 - Permissible transferees may include:
 - Owners (current and retired)
 - Affiliates
 - Related parties (including side by side funds)

Transfer Restrictions

- Stockholder agreement may set forth other sale and purchase obligations:
 - Death
 - Incapacity
 - Termination of Employment (Differing Purchase Price)
 - For Cause
 - Not For Cause
 - Disability
 - Retirement
 - Bankruptcy
 - Divorce

Transfer Restrictions: Delaware law issues

- Common law reasonableness requirement
- 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
- When the definition of a transfers covers “indirect” transfers, a sale of the shares of the corporation’s parent and the parent’s parent are restricted
- 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 the restrictions apply

Resolving Deadlock

- Stockholders agreement may provide alternative dispute mechanisms
 - Escalating dispute procedures
 - Mediation obligations
 - Non-binding arbitration
 - Typically at the stockholder level
- Call rights
- Put rights
- Shoot it out provisions

Resolving Deadlock: Delaware law issues

- Stockholder agreement provisions purporting to vest power to break deadlock at board level in a particular board member or other individual are not likely enforceable
 - Charter provision vesting one particular director with super votes on deadlock might work
- DGCL provides a procedure by which any stockholder may petition the court of chancery to appoint a custodian in cases of deadlock at both the board and stockholder level

Preemptive Rights

- Interplay between organizational documents and stockholders agreements
 - Only if in organizational documents
 - Preemptive rights unless otherwise specified in organizational documents
- Exceptions to preemptive rights
- Grants only to certain stockholders
- Rights and remedies for stock issued in violation of preemptive rights
- Waiver of preemptive rights

Preemptive Rights: Delaware law issues

- DGCL Section 102(b)(3) provides that no stockholder of a Delaware corporation shall have any preemptive right to subscribe to additional issues of stock unless the certificate of incorporation expressly so provides
- In 2005, the Delaware courts confirmed that preemptive rights could be granted by contractual agreement
- Contractual preemptive rights may be broader than preemptive rights created by a certificate of incorporation provision

Amendment and Termination of Stockholders Agreements

- Amendment
 - All current stockholders/majority/supermajority
 - Bifurcation of approval requirements
 - In making determination – consider the types of provisions contained in agreement
 - Non-competition provisions
 - Restrictions on transfer
 - Mandatory sale provisions

Amendment and Termination of Stockholders Agreements

- Termination of stockholders agreements
 - Certain triggering events:
 - Initial public offering
 - Registration rights survival
 - One remaining stockholder
 - Selective termination
 - Ownership below certain percentage
 - Change of control
 - Stated date

Amendment and Termination of Stockholders Agreements: Delaware law issues

- Stockholders' agreement does not automatically terminate by operation of law upon a change in control
 - Transfer restrictions
 - Right of first refusal
- Amendments to transfer restrictions by less than unanimous consent
- Prospective and retrospective amendments

Governing Law

- Typically state of incorporation
- If other state – question of enforceability
 - Parties subject to jurisdiction – consent in agreement
 - Some relationship to transaction
 - Conflicts of law provisions
 - Internal affairs doctrine

Governing Law: Delaware law issues

- Delaware versus other jurisdictions
- Choice of law principles: will the choice of law be given effect