April 20, 2012

HARVARD LAW SCHOOL
LL.M. PROGRAM 2012
COMPARATIVE CORPORATE GOVERNANCE CONCENTRATION
LONG PAPER

STRUCTURING CORPORATE GOVERNANCE IN CLOSE FIRMS: LEGAL PROBLEMS AND THEIR PRACTICAL SOLUTIONS

Author: Alexander Zalivako

Supervisors: Reinier Kraakman and Mark Roe

Comparative Corporate Governance: Seminar (Fall 2011)

Empirical Studies in Comparative Corporate Governance: Seminar (Spring 2012)

TABLE OF CONTENTS

Clause	Headings	Page
1.	INTRODUCTION	4
2.	CONFLICT OF INTEREST IN CLOSE FIRMS	10
3.	FAILURE OF THE TRADITIONAL CORPORATE LAW TO REGULATE CLOSE FIRMS	25
4.	TRANSFERABILITY OF EQUITY	31
5.	ADJUSTING THE MANAGEMENT STRUCTURE	47
6.	STRUCTURING EXIT RIGHTS	64
7.	CONCLUSION	76

ABSTRACT

This paper will analyse the main corporate governance conflicts which arise in close firms and explain why traditional corporate law institutions cannot resolve such conflicts. We will argue that the business reality of structuring the relationship between investors and management in close firms requires the contractual modification of each of traditional institutions of corporate governance, because such institutions have been developed in relation to public corporations with dispersed shareholdings and are not adequate for close firms. Generally, such analysis will be achieved by contrasting public firms and close firms and more specifically by analysing two categories of close firms: (i) strategic joint ventures; and (ii) private equity close firms. We will identify legal issues which arise in connection with the application of default principles of corporate law to close firms and will propose practical solutions for such issues.

Key words: corporate governance, close firms, joint ventures, private equity.

1. INTRODUCTION[1]

The US corporate law, in general, and structuring corporate governance, in particular, is dominated by the analysis of public firms.[2] This is not surprising: the overwhelming majority of the largest US corporations are such firms.[3] The key traditional institutions of corporate governance, which have been recognised as contributing to the success of a public firm as a form for the organization of business, include: (i) limited liability of a firm; (ii) unrestricted transferability of stock; (iii) separate legal personality of a firm (entity attributable powers, life span, the corporate duties of the directors' being owed to the firm, rather than to the individual investors);[4] (iv) voting rights being vested in the investors in proportion to their stockholding; and (v) centralised management of the firm which is vested in its board of directors.[5] In summary, traditional institutions of corporate law establish the "separateness" of the firm's interests from the interests of its legal owners and empower the management of the firm with significant independence.

However, as this paper will argue, understanding the conflict of interests in public firms is not sufficient for the efficient structuring of corporate governance in close firms.[6] Close firms and the interests of investors in such firms are fundamentally different from public corporations in two broad respects. First important distinction is that "[r]isk bearing

---

[1] The author is grateful to the professors and the participants of the Corporate Governance Concentration LL.M. class of 2011-2012 for the comments and suggestions which were made in connection with this paper.

[2] *See* WILLIAM ALLEN, REINIER KRAAKMAN, GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION, AT 1-10 (2009).

[3] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Schleifer, *Corporate Ownership Around the World*, 54 Journal of Finance 471, at 492-493 (1999).

[4] We use a generic term – "**investor**" – to refer to any equity participant in the capital of a close firm, being stockholder, partner, member, beneficiary of a trust, etc. Where necessary the paper will distinguish between specific categories of investors.

[5] ROBERT C. CLARK, CORPORATE LAW, AT 761-763 (1986); KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW, AT 5 (2009).

[6] We use a generic term – "**close firm**" – to refer to various legal forms (firms, limited liability companies, business trusts or limited partnerships) in which such close firms can be organised. Where necessary the paper will distinguish between specific forms of organization.

and management are separated in publicly held but not in closely held firms."[7] Second distinction is the absence of liquid capital markets in the equity[8] of close firms which, among other effects, (i) locks in an investor; and (ii) annihilates market balancing effect on the corporate governance mechanics. For these reasons the pillars of corporate law which were developed in respect of public firms are not capable of carrying the burden of corporate governance in close firms. The need to adjust the traditional corporate institutions to the needs of close firms have given rise to contractual modification of such institutions through: "(1) stock transfer restrictions, (2) [investor] pooling agreements, (3) voting trusts, (4) irrevocable proxies, (5) cumulative voting provisions, (6) classification of shares (including provisions for nonvoting or other specialized types of shares), and (7) [investor] agreements."[9]

Close firms are not just curious legal phenomena, which can be discarded as not deserving special attention of a scholar on the basis of being inessential minnows in a large corporate pond. Apart from being the most common form of business entity in the US,[10] such firms play important role in generating economic wealth. For example, Verizon Wireless, a US mobile network operator with more than 108.7 million subscribers,[11] is a close firm with two investors: the US company, Verizon Communications, and the UK company, Vodafone.[12]

---

[7] Frank H. Easterbrook, Daniel R. Fishel, *Close Firms and Agency Costs*, 38 Stan. L. Rev. 271, at 271 (1985-1986).

[8] We use a generic term – "**equity**" – to refer to any form of equity participation in the capital of a close firm. Where necessary the paper will distinguish between specific equity contributions.

[9] WILLIAM H. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING, AT 22 (1984).

[10] Carol l. Kline, *Protecting Minority Shareholders in Close firms: Modeling Czech Investor Protections on German and United States Law*, 23 B. C. Int'l & Comp. L. Rev. 229, at 242 (1999-2000).

[11] http://aboutus.verizonwireless.com/aboutusoverview.html (last visited on March 18, 2012).

[12] http://online.wsj.com/article/SB10001424053111903635604576474662914183744.html (last visited on March 18, 2012).

Accordingly, the analysis of corporate relationships in close firms is the legal brainwork which is not devoid of firm commercial rationale.[13]

Close firms vary enormously in their business objectives. They range from small groceries or laundry enterprises[14] to large joint ventures between public corporations pursuing complex business projects or venture capital start-ups which grow into huge public corporations. Parties to a close firm need to be satisfied that this is the best way to achieve their business objectives. Although the investors in a close firm initially have a common goal, conflicts are likely to emerge as their interests may eventually diverge on certain matters. Accordingly, rather than structuring their business within a close firm the investors may prefer to pursue their business objectives by way of, for example, acquiring the company having necessary experience or entering into contractual relationship which does not lead to the creation of a separate legal entity.

Even if the parties decide to choose a separate legal entity as a structure of their business relationship,[15] they will further need to choose between various available legal forms.[16] Finally, the parties will have to adjust any of such legal forms to meet their specific business situation. Such adjustment will, obviously, depend on the sophistication and financial capabilities of the parties, the complexity of the business project, etc.

Given this diversity of scenarios, it is neither possible, nor practical to set as an objective of this paper the analysis of the business needs of investors in all categories of close firms and to propose practical solutions for the attainment of such needs. This will

---

[13] To address the specific needs of close firms many states have adopted special statutes regulating the corporate relationships in such companies. *E.g., see* DGCL, 341-356.

[14] Page v. Page, 55 Cal. 2d 192, 359 P.2d 41 (1961).

[15] For the detailed analyses of the legal and tax considerations which may determine a particular form of a close firm, *see* F. O'NEAL, R. THOMPSON, O'NEAL'S CLOSE CORPORATIONS, VOLUME 1, PARA. 2.03-2.10 (3RD ED.).

require a degree of generalisation, which may render the analysis and proposed solutions worth useless. Accordingly, this paper will focus on the analysis of two business models of close firms. First business model is a joint venture relationship between strategic partners, where all such partners are active in business and enter into "[an] an association to carry out a single business enterprise for profit; a common enterprise for mutual benefit; [and] a combination of property, efforts, skill and judgment in a common undertaking."[17] An example, of such relationship can be Sakhalin Energy Investment Company Ltd.[18] or the abovementioned Verizon Wireless. We will refer to such close firms as "**strategic joint ventures**."

Second business model is a private equity type of a close corporation, where one or more "passive" parties provide capital to one or more "active" players who assume operational control over the business and supply human capital. Examples of such close firms are Google, Zynga and Wine.com. We will refer to such close firms as "**private equity close firms**".

Many issues which we identify in this paper will apply equally to strategic joint ventures and private equity close firms. However, there are also significant differences between these two categories of close firms which are caused by different investors participating in strategic joint ventures and private equity close firms, different objectives of such investors and different capital structures. Where such distinctions require a

---

[16] Although business organization forms will vary in different states, generally, a "close firm" can be organised as: (i) general partnership; (ii) limited partnership; (iii) limited liability partnership; (iv) limited liability company; (v) C-Corporation; (vi) S-Corporation; or (vii) business trust.
[17] Halloran v. Ohlmeyer Communications Co., 618 F. Supp. 1214, 1218 (S.D.N.Y. 1985).
[18] Sakhalin Energy Investment Company Ltd., the developer of the one of the world biggest oil and gaz projects, is an example of a strategic joint venture between: (i) Gazprom, which holds 50% plus 1 share; (ii) Shell which holds 27.5% of shares; (iii) Mitsui which holds 12.5% of shares; and (iv) Mitsubishi which holds 10% of shares (http://www.sakhalinenergy.ru/en/aboutus.asp, last visited on April 17, 2012).

different approach to structuring corporate governance, we will demonstrate relevant differences.

Finally, although the principles of structuring corporate governance in close firms will, as a general matter, equally apply to the close firms consisting of two investors or multiple investors, sometimes such distinction becomes important. Accordingly, where distinction is important we will consider issues which arise within close firms which have two investors and the close firms which have multiple investors.

One concluding remark on the scope of the paper. Although, the contractual regulation of corporate governance is usually used in regulating corporate relationships in close firms, the issues discussed in this paper also arise in the context of public companies (although, obviously, rarer and in a much limited form). This usually occurs in public M&A transactions when the buyer is providing its equity (or the equity in its publicly-traded parent) as a part of consideration and the seller requires the execution of an investors' agreement with the issuer of such stock to ensure its liquidity and additional corporate governance rights (e.g. special rights for the board representation).[19]

This paper is structured as follows. In chapter 2 (*Conflict of Interests in Close Firms*) and Chapter 3 (*Failure of the Traditional Corporate Law to Regulate Close Firms*), we analyse the main conflicts which arise in close firms and offer our explanation of why traditional corporate law institutions are not adequate to resolve such conflicts. Chapter 4 (*Transferability of Equity*), Chapter 5 (*Adjusting the Management Structure*) and Chapter 6 (*Structuring Exit Rights*) will analyse the key institutions of corporate governance, explain

[19] E.g., *see* the Investor Agreement by and between Deutsche Telekom AG and AT&T Inc dated March 20, 2011 available at: http://www.sec.gov/Archives/edgar/data/732717/000119312511072458/0001193125-11-072458-index.htm (last visited on February 17, 2012).

why they are not workable in respect of close firms and propose practical solutions, which the investors may use to achieve their objectives.

Unless otherwise stated, this paper assumes that the relevant close firms are incorporated in Delaware. This is because:

- “the Delaware General Corporation Law (the “**DGCL**”) is a modern, current and internationally recognized and copied corporation statute which is updated annually to take into account new business and court developments;
- Delaware offers a well-developed body of case law interpreting the DGCL, which facilitates certainty in business planning;
- the Delaware Court of Chancery is considered by many to be the nation’s leading business court, where judges expert in business law matters deal with business issues in an impartial setting; and
- Delaware offers an efficient and user-friendly Secretary of State’s office permitting, among other things, prompt certification of filings of corporate documents.”[20]

Given its limited scope, this paper deals with general commercial and corporate law issues which arise in the context of structuring corporate governance in close firms and does not discuss in detail relevant tax considerations.

---

[20] National Venture Capital Association Model Amended and Restated Certificate of Incorporation, Preliminary Notes (available at: http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136; last visited on April 17, 2012) (hereinafter – “**NVCA Certificate of Incorporation**”).

2. CONFLICT OF INTEREST IN CLOSE FIRMS

General

Commercial motivation behind the establishment of a close firm will, of course, differ in each individual case. The following are examples of situations where a close firm may be preferred as a business structure as opposed to the acquisition of the competing business or undertaking the project independently: (i) the parties are unwilling to bear the entire risk of the project individually; (ii) a combination of expertise / financial resources is required to pursue a project which none of the parties has the ability to undertake entirely by itself; or (iii) an investor seeks additional rewards from his investment by acquiring shares in a start-up company. In each of these typical examples the objectives of the parties will be different and will influence the structure of the close firm, the safeguards desired by each party and the risk which each investor is prepared to accept.

"No close firm is likely to succeed if its structure fails to match the aims and, ideally, the expectations, of the investors."[21] The parties often do not have exactly the same aims and expectations even when they start their business relationship. For example, investors may have differing cultures and business philosophies, which will determine the behaviour of their agents in a close firm. The interests of individuals are unlikely to be the same as those of the firms. Different will be the interests of private equity investors, which will be keen to ensure a pre-agreed / medium term exit from the close firm and are typically less concerned with the long-term interests of the close firm's business, and the interests of a strategic investor incorporating a close firm to enter into a new market, which

[21] SIMMONS & SIMMONS, JOINT VENTURES AND SHAREHOLDERS' AGREEMENTS, AT 19 (2004).

may be willing to sacrifice short-term profits for the purpose of attaining a larger business objective.[22]

Although, it is impossible to describe all conflicts of interest which arise in close firms, it is possible and helpful to set out the most typical conflicts, so that to understand the arising corporate governance issues and to develop the effective mechanisms of their regulation.

Control

Reconciling the control interests of investors is, arguably, the most important and the most difficult issue in structuring an efficient corporate governance mechanism. Except for a two party close firm of equals (i.e. when each of two investors holds 50% of stock), in every close firm one or more parties will be in minority, and, therefore, capable of being outvoted on any occasion. The default rule of corporate law is that the majority rules,[23] and although the law does provide some protection to minority investors,[24] it is not sufficient for their effective protection against the potential abuses[25] from the controlling investors.[26]

In a public firm an independent board ensures the fair and equal treatment of all investors. However, in a close firm when a controlling investor is entitled to appoint the

---

[22] *Ibid.*, *SEE* GENERALLY, AT 19-24.

[23] *See* DGCL, 141(b), 216, 250, 251 and 273 setting out the powers of a controlling investor to pass any decision in a close firm.

[24] *See*, for example: (i) DGCL, 144 which sets out the rules for approving the interested party transactions by the directors; (ii) DGCL, 262 setting out the appraisal rights in merger transactions; (iii) Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) clarifying the fiduciary duties of the controlling investor to the minority investors.

[25] For the comprehensive discussion of various abuse practices, *see* F. O'NEAL, R. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (1985)

[26] The controlling investor includes under the Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1114 (Del. 1994) test: (i) an investor which owns more than 50% of common stock in a firm; or (ii) an investor which exercises actual control over the business affairs of the firm.

board,[27] the board is likely to side with its appointors, rather than to ensure equal treatment of all parties.[28]

Structuring control in a close firm is inevitably a complex issue, which has no clear-cut solutions. It is easy to assume that the party making the biggest investment will call the drums in the management of the close firm, but that is not always the case. The degree of autonomy of the close firm from its investors and the level of control or influence enjoyed by each investor will usually depend on the individual circumstances of the parties and the nature of the business which they want to undertake. For example, in a strategic joint venture, when the investors will typically commit significant assets and expertise to the close firm, each party, even holding a minority stock, will expect to have active involvement in the management of the close firm and extensive veto rights.[29] This can be contrasted with the management structure in private equity close firms, where the passive investors, which provide financing, will typically seek representation on the board and veto rights over the major commercial decisions, but will permit the active investors to retain operative control over the company.[30]

Equity and Debt Financiers

Several structuring considerations inevitably require that the parties provide financing to a close firm not only in the form of common stock, but put in place some sort

---

[27] DGCL, 216.

[28] As a matter of law each director shall protect the interests of a firm as a whole rather than the interests of its appointors, however: (i) the enforcement of directors' fiduciary duties may not always be practical; and (ii) in any case such duties do not protect the investors which invest in the form of debt or quasi-debt (for discussion of these issues, *see* below).

[29] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 22.

[30] METRICK AND YASUDA, VENTURE CAPITAL AND THE FINANCE OF INNOVATION, CHAPTER 11 (2011).

of bifurcated financing, i.e. a mixture of common stock / debt instruments or preferred stock[31] financing. This structure is typical for a number of reasons.

- ***Repayment of original investment***. If the parties do not equally finance the close firm, but such financing is primarily provided by one of the parties (which will be typically the case, for example, in private equity close firms),[32] debt financing permits an investor to redeem its initial investment before sharing the profits generated by the close firm with other investors.[33]
- ***Periodic payments***. If the receipt of periodic payments is essential for an investor, structuring a part of investment in the form of a debt instrument permits to have more flexibility in respect of such payments as compared to any distribution made in the form of dividend, because such payments will not require: (i) a separate resolution of the board;[34] and (ii) the surplus of capital or net profits during any of the two years preceding the payment of dividends,[35] but could be made if the close firm generates a sufficient cash-flow.
- ***Insolvency priority***. Debt financing permits the financier to achieve a better priority in the insolvency of a close firm.
- ***Tax efficiency***. Subject to the common law "thin capitalization rules"[36] and the statutory regulations limiting the deductibility of interest,[37] any payments on debt

---

[31] Stock is typically preferred as to: (i) dividend payment; (ii) liquidation preference; (iii) rights of redemption; (iv) conversion rights; (v) voting rights. *See* Richard Buxbaum, *Preferred Stock – Law and Draftsmanship*, 42 Cal. L. Rev. 243 (1954). Importantly, designating stock as "preferred" will not automatically make it preferred as to any of the above elements. Such preference rights shall be explicitly set out in the certificate of incorporation. Similar principle applies to the voting rights – unless otherwise set out in the certificate of incorporation, each preferred stock will carry one vote (DGCL, 212(a)).
[32] JACK LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY AND ENTREPRENEURIAL TRANSACTIONS, AT 2-10-2-11 (2011).
[33] *Ibid*.
[34] DGCL, 170(a).
[35] DGCL, 170(a).
[36] LEVIN, *SUPRA* NOTE 32, AT 6-10-6-13.

made by a close firm will be tax-deductable to such close firm as an interest expense. Conversely, dividend payments are not tax deductable.

Various other considerations determine the appropriate correlation between the equity / debt financing of a close firm,[38] but what is key for the purpose of understanding the conflict of interests arising in the context of close firms is to underscore the following business reality: in a close firm some investors will usually wear the "hat" of an equity investor and a "hat" of a debt provider, i.e. at least some of the investors will provide funding to the firm not just in the form of equity, but also in the form of debt and/or quasy-debt instruments, such as preferred stock.

This different participation in the capital of a close firm is less important in strategic joint ventures, where the partners will typically be equally involved in the equity and debt financing of a company.[39] Accordingly, in such close firms the capital structure usually will not trigger the misalignment of economic incentives of the strategic partners.

However, understanding the effect of different participation in the capital is essential when structuring corporate governance in private equity close firms, because the business reality of such firms is that debt / quasy-debt financing[40] will be typically provided primarily by the passive investors. This structure creates the conflict of interest between the common investors and preferred investors (debtholders). This conflict relates

---

[37] *E.g.*, Internal Revenue Code (1986 (as amended)) (hereinafter – "**Internal Revenue Code**"), 163(e)(5), 279, 163(j), 163(l); LEVIN, *SUPRA* NOTE 32, AT 6-14-6-24.

[38] For the detailed analysis of such considerations, *see* LEVIN, *SUPRA* NOTE 32, AT 2-5 – 2-14.

[39] This need not always be the case. *E.g.*, in Udmurtneft, a strategic joint venture between a Russian oil giant, Rosneft, and a Chinese oil company, Sinopec, the financing for the acquisition of Udmurtneft was provided by the Chinese bank.

[40] The financing will be typically provided in the form of preferred stock.

to two important aspects of close firm's life: (i) the business strategy of the close firm; and (ii) the preferred exit scenarios of the investors.[41]

In respect of the first area of conflict, the passive investor, which has a large debt exposure, will be interested in the firm generating a steady cash-flow to make interest payments and to repay the principal amount of the loan, whereas an active investor, which exposure is related to common equity, may be more interested in investing all available cash in the growth of the close firm. Debt capital provider and equity capital provider will have different approach to corporate risk. High leverage is in the interests of the common investors' which, with minimum equity contribution, can reap additional returns if the enterprise is successful and will suffer very little losses if the business fails. This creates an incentive for the equity providers to take unjustified risk, which is not in the interest of the debtholders.[42]

In respect of the exit rights, debtholders are more likely to prefer the "liquidation events", rather than to continue the operation of business for the reason that "liquidity events promise a certain payout, much of which the [preferred shareholders and debtholders] can capture through their liquidation preferences. Continuing to operate the firm as an independent company may expose the [preferred shareholders / debtholders] to risk without sufficient opportunity for gain."[43] Conversely, common stock investors may be "inclined to continue and expand their ventures even when their contraction or termination is efficient".[44]

[41] Jesse M. Fried, Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. Rev. 967, at 994 – 998 (2006).
[42] Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Chancery. 1997).
[43] Fried, Ganor, *supra* note 38, at 995.
[44] George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U.Chi.L.Rev. 305, at 308 (2001).

Furthermore, depending on the structure of debt financing, debtholders may have bias in favour of specific categories of exit scenarios.[45] For example, if the debt financing is provided in the form of preferred stock, such stock will typically provide for additional payments due to the preferred investors in respect of their liquidation preference if the sale is the preferred exit. The preferred stock investors will also participate with the common stock investors in any excess sale proceeds.

Conversely, if the IPO is the exit scenario, the preferred stock will be typically converted into common leaving the preferred stock with no liquidation preference up-side.[46] Naturally, this practice creates the bias of preferred stock investors in favour if private sales of the close companies, rather than the public offering of their equity as the preferred exit scenario.

The above risks are exacerbated in the situation when the majority of the directors on board are appointed by the common stock investors (which will be a typical scenario at the initial stage of private equity financing).[47] Such directors do not owe fiduciary duties either to debtholders,[48] or to the holders of the preferred stock.[49] Accordingly, such passive

---

[45] D. Gordon Smith, *The Exist Structure of Venture Capital*, 53 UCLA L. Rev. 315, at 347-348 (2005-2006).
[46] *Ibid.*
[47] Fried, Ganor, *supra* note 40, at 975.
[48] *See* Delaware Court of Chancery setting out in N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla: "*Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.[46] Accordingly, we hold that individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors.*" (N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007).
[49]*See* Delaware Court of Chancery setting out in Equity-Linked Investors, L.P. v. Adams that: "*...the special protections offered to the preferred are contractual in nature. The corporation is, of course, required to respect those legal rights. But, aside from the insolvency point just alluded to, generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the*

investors (preferred stockholders or debtholders) will not be able to rely on the directors' fiduciary duties as leverage for the protection of their investments. The only available remedy for such parties is to negotiate specific contractual rights, which will protect their investments in close firms.[50]

Actives vs. Passives

In a public firm the investors are usually the passive providers of capital. They typically have no involvement in the day-to-day business of the relevant company and often lack any business relations with the firm in which they hold stock. Because the parties usually set up a close firm with a view to pursue their own business objectives, the interaction between the business objectives of the investors and the close firm becomes much more integrated. This carries the risk of potential business conflicts.

Another important area of conflict depends on whether the investors take an active part in the management of a close firm or whether they are passive observers. One of the most important concerns of each party to a close firm is that the other parties should be fully committed to the firm and will not compete with it or appropriate the business opportunities available to the firm. In this respect the distinction between the strategic joint ventures and private equity close firms becomes important.

Typically in a strategic joint venture both parties will be actively involved in the day-to-day operation of the business and will be committed to a joint venture. The reason for this is that in a strategic joint venture all parties will make significant financial commitment to the venture or transfer existing goodwill into the venture and the size and

---

good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict." Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997).

[50] *Ibid*.

nature of the investment means that they will need to work for its success, or face a large loss.[51]

Ensuring the commitment of the active investors is more complicated in the context of private equity close firms, where such contribution by active investors, especially at the onset of the business enterprise, will not be significant to ensure their full commitment. Accordingly, passive investors will have to provide for: (i) strong incentives for the commitment of the active participant to the success of the enterprise; and (ii) relevant non-compete provisions, which will ensure that the active investor will not walk out from the close firm to start the same business but without a passive investor.[52]

Limited protection to the parties is provided by law,[53] but neither general business arguments outlined above, nor such limited legal protection are usually adequate. Accordingly, the parties have to resort to contractual regulation of their relationship and obtain relevant covenants from the counter-parties. There are at least three areas which require detailed consideration of the investors.

Support of a close firm. If a party is providing services, licences or know-how to a close firm (e.g. management or accounting services), the investors must define the scope and duration of such services, licences or know-how. If the services are critical to the close firm's operations, the investors should also address:

- the consequences of one of the investors defaulting under its obligations to provide services, licences or know-how; and
- the consequences of one of the investors leaving the close firm.

---

[51] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 22.
[52] For the description of the complicated vesting provisions which ensure such commitment of an active investor, *see* LEVIN, *SUPRA* NOTE 32, AT 2-13 – 2-24.
[53] *See* Thorpe by Castleman v. CERBCO, Inc., 676 A.2d 436 (Del. 1996); Miller v. Miller, 222 N.W. 2d 71 (Minn. 1974).

***Business opportunities*.** If the close firm's business overlaps with the business of its investors, the parties need to define clearly their respective obligations in relation to business opportunities that fall within the scope of the close firm's business. They may want to require each party to present certain specified opportunities to the close firm and consider allowing the party to pursue only those opportunities turned down by the close firm. Alternatively, they may want to be free to pursue business opportunities without any limitations or restrictions (whether such opportunities are within the scope of the close firm's business or not).

***Non-compete provisions*.** The parties may want to consider restricting the close firm and the close firm's investors from competing with each other and from soliciting each other's employees. For the reasons explained above, non-compete covenants are especially critical in the context of private equity close firms, where it is typical for the passive investor to require that the active investor will: (i) assign all his intellectual property to the close firm; and (ii) undertake not to get engaged in a related business for a certain period of time outside the firm.

Default of an investor. Corporate law does not generally permit to divest the investor of his equity against its will.[54] Such divestiture is not necessary in public firms, because the participation of an investor in a day-to-day business of such firms is not critical to their functioning.

The situation is different in close firms. The involvement of an investor in the day-to-day business of the firm may be essential for its proper functioning. For example, if the close firm was incorporated for the purpose of developing a coal mine, it will not initially

[54] Exceptions to this general rule are the events which affect the life of a firm, such as merger, dissolution, etc., when the investor may be divested of its stock if the majority so decides. In this case, however, the

generate sufficient funds to cover its operation expenses. Accordingly, such close firm will usually submit cash-calls to its investors with a request to provide financing. If one of the investors is not able or is not willing to comply with the relevant cash-call request, this will disrupt the proper operation of the close firm. In addition, although in default, such investor will retain all rights which are related to its equity participation in the capital of a close firm.

Default provisions of corporate law, however, offer little leverage over such defaulting investor. Accordingly, there is a need to limit the control rights of a defaulting investor in a close firm and to regulate contractually the terms of the involuntary "expulsion" of such investor from the close firm.

Long-term vs. Short-term Investors[55]

Another key factor is to determine whether the parties are long-term or short-term investors, or a mixture of the two. Strategic investors are typically long-term investors. Their primary concern is to establish a profitable venture which will provide an acceptable return on the capital they have invested. Accordingly, they wish to operate the venture in such a way that it is not independent of the investors in such close firm. Such investors will not contemplate sale or IPO as a scheduled exit from a close firm.

On the other hand, private equity investors have shorter investment horizons, typically within 10 years.[56] Their primary concern is to achieve capital growth which can be realised by sale, flotation or some other method. Such investors will prefer that a close firm is operated as a stand-alone, independent business and require efficient exit rights.

Corporate Investors vs. Individuals

---

investor will be entitled to the fair market value of its stock, which is not adequate to regulate the exit of a defaulting investor.

[55] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 20-22.

There are significant differences between the objectives of corporates and individuals, acting as investors in close firms, and the risks which will affect the negotiating strategy of each of these investors.

An individual may see the establishment of a close firm as a new career which will provide him with a high income. This may, for example, affect individuals' preferred exit routes from the close firm, because they are more likely to remain in control of the firm if the exit is structured through IPO, rather than through private sale.

An individual investor is also more likely to value other than pecuniary interests in connection with the incorporation and management of a close firm. For example, an important role may play such "shirks" as professional interests, emotional satisfaction, etc.[57]

Finally, the participation of individuals as parties to a close firm requires that the parties cater for the risks which are not relevant in the context of firms. For example, the parties shall reach agreement on what will occur with the stock of such individual in the case of his disability, dearth or termination of employment agreement with the close firm.

Asymmetry of Information

Information asymmetry risks are essential in the context of close firms when an investor buys into an existing firm.

The information asymmetry is usually not an issue for large public companies, because the existence of liquid capital markets generally ensures that all relevant information is reflected in the market price of the equity issued by large public

---

[56] Paul A. Gombers, *Grandstanding in the Venture Capital Industry*, 42 J. Fin. Econ. 133, at 135 (1996).
[57] *See*, for example, Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Chancery. 1997), where, arguably, at least part of the reason for the disagreement between active and passive investors was the willingness of the active individual investor, Dr. Adams, to complete his biotechnological research.

companies.[58] Large public companies typically do not issue equity below current market price[59] and because of the liquid market for the relevant equity, holders of such equity can protect against dilutive transactions by selling it.[60] Finally, in a typical public firm the directors are dissociated from the investors, which ensures the equal treatment of the investors by the board.

Given that in a strategic joint venture the partners will usually start business from the onset, the information asymmetry issue is less acute in such close firms. However, in private equity close firms, when a passive investor typically "walks into" exiting business, such asymmetry is of paramount importance.

In private equity close firms two aspects of the problem shall be noted. First, the interconnection between the management and investors is much tighter in close firms, which exacerbates the information asymmetry for an independent investor. Furthermore, if a close firm is newly incorporated the risks related to its failure are more significant than the same risks in respect of public companies.[61] This further increases the incentives for the management to "bet the company."[62] Second, because of the absence of efficient capital markets to evaluate the stock of a close firm, an independent investor is disadvantaged in comparison with the management and existing owners of a close firm in terms of properly evaluating the company.[63] This gives rise to the risk that such party will

---

[58] Frank Easterbrook and Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1980 – 1981); Aman Srivastava*, Capital Market Efficiency: A Literature Review* (2005), http://ssrn.com/abstract=664861.
[59] David A. Broadwin, *An Introduction to Antidilution Provisions* (Part 2), Prac. Law., at 24 (2004).
[60] *Ibid*.
[61] Michael Klauser and Kate Litvak, *What Economists Taught US About Venture Capital Contracting*, at 9, a chapter of a volume entitled "Bridging the Entrepreneurial Financing Gap: Linking Governance with Regulatory Policy" (2001).
[62] *Ibid*.
[63] Easterbrook, Fishel, *supra* note 7, at 289.

overvalue the firm while making the investment.[64] As a practical implication the risk of such overvaluation means that the passive investor will either need to have contractual assurances that his initial investment will be readjusted upwards upon the discovery of the relevant information or such investor will always discount its investment, which will not permit *bona fide* active investors to raise fair financing.

Return on Investments[65]

Investors may be different in respect of the expected flow of income from a close firm. Some investors may be prepared to sacrifice early profit for growth, in the belief that this will ultimately result in a higher value for their investment. Others will require the combination of an income stream with capital growth. Some capital providers may desire a reasonable commercial income on their money but expect medium-term repayment.

This variety of investors in a close firm is not different from different investors committing capital to public companies. However, the absence of public market in the equity of close firms makes this conflict of interest very important. In a public firm an investor can manage his investment timeline by selling and buying equity in an open market. In a close firm he has to rely on the distributions (e.g. dividends, salary payments, equity redemptions) made by the close firm.[66] This reliance, in the absence of specific contractual provisions, makes a minority investor a hostage of the majority investors' policy, because they will either prefer themselves when distributing earnings (e.g. in the form of salaries)[67] or will retain such earnings to the detriment of a minority investor.[68]

---

[64] Broadwin, *supra* note 54, at 24.

[65] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 20-21.

[66] Easterbrook, Fishel, *supra* note 7, at 275.

[67] *Ibid.*, at 278.

[68] *Ibid.*, at 275; Zenichi Shishido, *Problems of the Closely Held Firms: A Comparative Study of the Japanese and American Legal Systems and a Critique of the Japanese Tentative Draft on Close firms*, 38 Am. J. Comp. L., 337, at 361-363 (1990).

Conclusion

The purpose of this chapter was to describe the most typical conflicts of interest which arise when different investors set up a close firm. Although the conflicts are various all of them can be reduced to three broader issues: (i) management structure; (ii) stock transferability rights; and (iii) exit scenarios. These conflicts have their specific distinctions depending on whether a close firm is a strategic partnership or a private equity close firm.

In a strategic joint venture, where both partners will typically participate equally in the business and the financing of the firm, the parties will want to ensure very detailed operation provisions. They also have to pay more attention to how the business of such company will interact with their general business. Exit regulation, however, is less of an issue in strategic joint ventures, because the parties do not contemplate exit as a primary source of the revenue from the close firm.

The situation is different in the private equity close firms, where the financing partner will not usually get involved into the operation management of the firm, but will prefer a clear exit strategy. This overall objective will determine the brunt of the corporate governance regulation, which will be shifted from the extensive regulation of the operative management of the firm to the preservation of equity value.

3. FAILURE OF THE TRADITIONAL CORPORATE LAW TO REGULATE CLOSE FIRMS

Corporate Governance in Public Firms

The US corporate law has developed with a view of regulating public firms.[69] This approach to corporate law has been recently reinforced by the objective business needs coming from the globalization of business and the transformation of privately-owned companies into global multinational enterprises with highly dispersed ownership structure of capital. Many investors in public firms are, increasingly, portfolio investors with short-term investment horizons. Because of: (i) the lack of professional knowledge; (ii) adequate resources (both time and monies); and (iii) a "free rider" problem[70] the minority investors are neither able nor willing to get engaged into the active management or control of public firms. In addition to the above reasons, there is another factor significantly contributing to the alienation of the investors from the ultimate involvement into the business of the public firms. This is the change of investment technology. Currently, private investors can (and often do) make so-called "index investments", i.e. they buy stock in various companies which comprise a particular index. Such form of investment is easier for an individual to follow, control and comprehend. It is also, at least in theory, more secure as you diversify your risk. From the formal legal perspective, such private individuals own equity in the companies which are selected for the purpose of calculating such index (e.g. S&P 500). However, as a matter of fact, such investors very often may not even know what companies they are investing into.

---

[69] Joseph Edward Olson, *Representing Minority Shareholders in Close firms Under Modern Business Firms Act*, 64 Wash. U. L. Q., 507, at 507 – 513 (1986).

[70] MARK ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE, AT 42 (1994).

A combination of the above factors have essentially turned the investors into, what only can be described as, passive observers with the concentration of the relevant management powers in the board. This transformation found its reflection in law where the general powers of the management of the firms are vested in the directors.[71]

However, the above approach, being perfectly suited for public firms with dispersed ownership, is hardly acceptable to the investors in close firms, which, as a matter of business reality, want to have active involvement in the day-to-day operation of close firms and need the mechanisms which will guarantee such participation. None of the default pillars of corporate governance in public firms are capable of addressing adequately the corporate governance issues which arise in the context of close firms.

Inadequacy of the Traditional Corporate Law to Regulate Close Firms

Unlimited transferability. Unlimited transferability of stock which is essential for a public firm may not be acceptable for the investors in a close firm, because the identity of the participants and the bespoke allocation of the control rights attached to equity is essential in a close firm. Accordingly, the parties will prefer to have control over any disposal of the equity by the co-parties.

Control rights. The default rule of the corporate law that one share carries one vote[72] is usually not acceptable for close firm investors, because this will not provide adequate minority protection. The balance of powers in a close firm cannot be made *pro rata* to the investors' participation in the relevant class of the stock – even minority investors will typically require veto rights over the most important commercial decisions of a firm. Although, multiple class stockholding structures, where different classes of stock

[71] DGCL, 141.
[72] DGCL, 212(a).

carry different votes, are not an unheard phenomenon even in respect of public firms,[73] the right of the investors in a close firm to veto certain most important decisions or a positive right to have the representatives on the board, regardless of a shareholding, becomes of paramount importance.

Deadlocks. Traditional corporate law does not provide any specific mechanisms for the resolution of deadlocks between the investors, because, as a matter of practice, such deadlocks are rare in the context of public firms.

However, in the context of a close firm with equal investors where neither party is prepared to concede, the deadlock is a usual scenario, because no decisions can be made unless they both agree. Deadlock can also arise, when a minority investor has a power to veto certain transactions and repeatedly uses such veto rights. Accordingly, it is desirable to have some mechanism in place for resolving any deadlock when it arises.

Management structure. The standard management structure of a public firm when the management of the firm is vested in the independent board is clearly inadequate for a close firm, because the investors want to have direct involvement in the day-to-day management of the firm and expect that directors will act as "yes men" of their appointors rather than will genuinely consider what is best in the interests of a close firm. This commercial reality requires a careful analysis of the risks related to the potential incompliance with the directors' duties to the close firm.

Furthermore, different approach to structuring management in close firms requires corresponding alterations to structuring the shareholders' and management proceedings, where default rules of corporate law also operate with a view to exclude the investors from the procedural matters and to vest all procedural discretion in the board.

---

[73] *E.g., see* the division of power between Class A and Class B stock in Google prospectus available at:

Exit events and exit mechanics. There is no specific regulation for the exit of investors from the public companies (apart from mergers and dissolutions). There is simply no need for such regulation. In a public firm exiting the capital is not an issue – there is a liquid market for the equity and any investor, which wants to disinvest, may easily sell his equity. There is neither specific need for the regulation of price at which the investor is able to disinvest – this will be the market price for the equity.

The principle difference of the close firm is that there is no liquid market which will: (i) assess the value of the equity; and (ii) will be willing to buy the equity. Accordingly, the investors shall set out clear contractual provisions which will guarantee that there will be no injustice when one of the investors wants to disinvest. Investors shall set out detailed exit rules which will regulate how they may dispose of their investment.

Drafting the rules for the exit mechanics in close firms requires careful consideration of two major issues: (i) which events in the life of the close firm or its investors will trigger the exit provisions; and (ii) how such exit can be effected.

A breach by a party of the agreement regulating their relationship within the close firm, the insolvency or change of control of a party are the typical events, which trigger exit of the investors.

In a multi-party close firm it needs to be considered whether an exit event affecting one party ends the whole business, or disenfranchises only the party which is affected by the exit event.

Payment rights. Negotiating specific payment rights is rare in the context of public companies – an investor will usually rely on the existing dividend policy and the appreciation of stock to receive revenue on his investment. If the investor is not happy with

---

http://www.sec.gov.

the investment policy of a public company, he can simply sell his stock in the open market and receive the economic equivalent of the dividend distribution.[74]

Conversely, structuring payment rights is essential in close firms, because different investors make different monetary contributions to the capital of a close firm for similar control rights. This issue is especially pertinent in the context of private equity close firms, where almost all initial financing is typically provided by a passive investor, whereas the monetary contribution of the active investor / management is minimum.

Given different monetary contributions to the capital of a close firm, different participants will require different payment rights. Parties providing additional financing may require income before the other participants receive any income. To achieve such additional payment rights, private equity investors could be issued with preferred stock carrying the rights to receive a fixed dividend and/or a liquidation preference. This will ensure that the payments rights of such investors will rank ahead of the common stock investors. There are other options to structure earlier or additional payments rights, such as providing a part of financing in the form of debt or entering into a services agreement with a close firm and structuring relevant payment rights in the form of fees or royalties. Individual participants can be given additional income by means of employment compensation (options, bonuses, salary payments). This will ensure that they receive periodic income and also provide working incentives to make the business successful.

Conclusion

The default provisions of corporate law fail to regulate adequately corporate relationships in close firms. The failures are multiple and they apply to both strategic joint venture and private equity close firms. However, the majority of such multiple failures can

[74] *See* Fischel, *The Law and Economics of Dividend Policy*, 67 Va. L. Rev. 699 (1981).

be generally reduced to three broader issues: (i) management structure; (ii) stock transferability rights; and (iii) exit scenarios.

The adjustments to the management structure shall ensure that the interests of each individual investor are adequately protected both at the level of investors' meeting and at the board level. Reliance on a "majority rules" principle is not sufficient to achieve this objective. Free transferability of stock is also lethal to the viability of close firms, because it will not ensure the necessary degree of intimacy, which the investors in a close firm seek to achieve. Finally, clear rules for the exit mechanics are critical to ensure the liquidity of investment in close firms.

Accordingly, in the next three chapters we will propose the adjustments which have to be made to each of the above institutions to ensure that they meet the commercial needs of the investors in close firms.

4. TRANSFERABILITY OF EQUITY[75]

Unworkability of Free Equity Transferability

Unrestricted transferability of equity is one of the key features of a public firm, because it is essential in facilitating the accumulation of capital by the public firm.[76] Many investors can commit their capital only for a limited time period. In addition, and, more importantly, for many minority investors direct involvement in the management of public firms is not practical. Accordingly, they primarily rely on the exit from the capital of the public company as a means to "vote" for the management of the company.

None of the above reasons for the free transferability of equity are relevant in respect of close firms, where the firm will primarily rely on the funding of its investors and it is the investors who will have an active role in the management of the firm. Furthermore, there are compelling arguments in favour of a different approach, because the regulation of transferability of equity is critical to: (i) preserve the identity of investors and the existing allocation of control rights in the close firm; and (ii) ensure adequate exit mechanics.

The preservation of the investors' identity and the allocation of control rights is essential for any close firm for the following three reasons.

- First, the identity of the investors is of critical importance in close firms, because the partners need certainty over who their co-partners are. The technical expertise and the financial soundness of the investors underpin the likely success or failure of a common enterprise. For example, when one party is able to make a product but lacks the contacts and/or expertise to sell it and, therefore, combines with another party who has the necessary contacts and/or expertise, it is critical for both parties,

[75] *See* O'Neal, *Restrictions on Transfer of Stock in Closely Held Firms: Planning and Drafting*, 65 Harv. L. Rev. 773 (1952).
[76] CLARK, *SUPRA* NOTE 5, AT 14.

before they commit resources to such firms, that their partner will not be able to withdraw voluntarily from the close firm.

- Second, the pre-existing pattern of business behaviour is key to the success of any close firm.[77] As we will show below, structuring the relationship between the investors in a close firm will typically require a veto right granted to each of the investors over the key business decisions. Such veto rights may give rise to deadlocks. Although various deadlock resolution mechanisms will be built in the structure of a close firm to address such situations, they are hardly adequate to find acceptable commercial solutions over all disagreements which may arise in the day-to-day management of a close firm. Resolution of such issues and the ultimate success of the close firm, therefore, becomes, to a considerable extent, dependent on a good-will, exiting relationship and common approach to the assessment of risks between the parties.
- Third, the restriction on transfer of equity is essential to prevent competitors from gaining access to the close firm. Apart from the obvious rationale for the undesirability of such development, the following consideration is essential. In a close firm (unlike in a public firm), the investors will have very broad access rights to the commercially sensitive information related to the day-to-day operations of the firm and very broad management rights. Given this, the parties have additional incentives to close the doors for any outsider.
- Fourth, in a close firm with more than two investors, the control over the equity transfers is essential to preserve the existing balance of power. Such balance may be tipped when, for example, there is no dominating partner and one of the

[77] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 15-16 AND 23-24.

investors disinvests itself by creating a controlling investor capable of imposing its will on the remaining minority investors.

Finally, apart from the above commercial reasons, there is a set of legal and tax reasons, why the restriction on equity transferability may be important in close firms.

- Unless a close firm issues its equity in private placements,[78] to the investors which can "fend for themselves,"[79] it will have to register any issuance with the SEC.[80] Failure to make such registration may permit relevant investors to rescind the sale and purchase transactions entered into in respect of the relevant issuance of equity and claim back the amount of the purchase price.[81]
- From the tax perspective, the status of the chapter S corporation, which may be operated as a pass-through vehicle,[82] is subject to the requirement of having no more than 100 investors.[83]
- Under Delaware law the status of a close firm, which offers more flexibility in structuring bespoke corporate relationships,[84] is accorded only to the firms with fewer than 30 investors.[85] Furthermore, DGCL sets out a specific requirement that in a close firm the equity should be mandatorily subject to the transfer restrictions.[86]

Special regime for the transferability of equity is also essential to enhance the liquidity of equity in a close firm. The commercial reality of close firms is that unless a

---

[78] Securities Act (1993 as amended) (hereinafter – "**Securities Act**"), 4(2).
[79] Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) and Regulation D setting out the safe-harbor rules for the application of a private placement exception set out in Securities Act, 4(2).
[80] Securities Act, 5.
[81] Securities Act, 12.
[82] Internal Revenue Code, 1363.
[83] Internal Revenue Code, 1361.
[84] The status of a close firm permits the investors have further clarity as to: (i) ability of the investors to assume the powers of the board (DGCL, 350 and 351), (ii) the right of each investor to force the dissolution of a close firm (DGCL, 355).
[85] DGCL, 342(a)(1).

minority holder has an agreement under which the majority can be compelled to buy its participation, it is "locked in" unless another investor or the close firm itself agrees to buy it out, or agreement is reached for a third party to acquire the entire capital of the close firm. Such vulnerable position of the minority creates unique opportunities for its exploitation by the majority investor.[87]

Furthermore, the majority investor's equity position may also be illiquid. Such investor may not be able to sell to a purchaser unless it can deliver 100% of the capital of a close firm, because third-party buyers may not be unwilling to acquire a controlling block in a close company with the minority retaining its position in the capital of the close firm.

In summary, the parties to a close firm should better set out explicit exit mechanics to avoid future conflicts. We consider the rules which are essential for the preservation of the investors' identity in this section. In Chapter 6 (*Structuring Exit Rights*) we address the regulation of equity transferability which relates to the structuring of exit rights in a close firm.

General Principles Governing the Equity Transfer Restrictions

Restrictions on equity transferability are multiple and include: (i) outright prohibitions on equity transfer; (ii) consent rights; (iii) put and call option rights; (iv) restrictions permitting transfers only to the qualifying transferees; (v) rights of "first offer" and "first refusal"; (vi) drag-along and tag-along rights, etc. Furthermore, in structuring stock transferability regime in a close firm a combination of these rights will be typically used. Given the variety of options, it is useful to set out first the general legal principles

---

[86] DGCL, 342(a)(2).

[87] Easterbrook, Fishel, *supra* note 7, at 275.

which should be considered when selecting the relevant contractual framework to regulate the transferability of equity in a close firm.

Absolute restriction unlimited in time and not subject to the reasonableness on the transfer of equity is very likely to be invalid.[88] The provision which will make the transfer of equity subject to the consent, which the relevant investors may withdraw at their sole discretion, is not likely to be enforceable either.[89]

However, as a general principle, courts will uphold restrictions which are reasonable in the circumstances of a particular case. This approach is currently explicitly set out in the Delaware law,[90] which "goes far beyond any other American statute"[91] in permitting various limitations in respect of the equity transfers. Courts considered various factors, such as: (i) the size of the firm; (ii) the degree of restraint on the power to alienate equity; (iii) the length of time the restriction is to remain in effect[92] in assessing whether the restriction on equity transfer is reasonable. Essentially they are weighing the benefit of protecting the commercial objectives of the close firm against the benefit of protecting the investors' right to transfer equity.[93]

An important issue shall be considered in respect of stock transfer restrictions. Even if the transfer restriction is valid *inter se,* its validity against third parties has been traditionally conditioned by courts depending on whether a third party was aware of such

---

[88] Morris v. Hussong Dyeing Mach. Co., 81 N.J. Eq. 256, 258, 86 A. 1026 (Ch. 1913).
[89] Grynberg v. Burke 378 A.2d 139, 142-142 Del.Ch. 1977.
[90] DGCL, 202.
[91] EDWARD P. WELCH, ANDREW J. TUREZYN, ROBERT S. SAUNDERS, FOLK ON THE DELAWARE GENERAL CORPORATION LAW, AT 197 (2006).
[92] For the detailed summary of such factors, *see* O'NEAL *SUPRA* NOTE 17, VOL. 2, CHAPTER 7, AT 23.
[93] *Ibid*.

restriction.[94] This requirement is now explicitly codified[95] and, as a matter of practice, in respect of stock is achieved by the relevant inscription on the stock certificate.[96]

Another general issue is the source for documenting the equity transfer restrictions, being: (i) the incorporation certificate; (ii) bylaws; or (iii) the agreement between the investors. There was a historical argument that the best practice is to incorporate the equity transfer restrictions in the certificate of incorporation, because courts subjected them to a more benevolent treatment.[97] However, given that modern statutes explicitly permit to set out such restrictions in any of the above documents,[98] this question today has transferred from the area of legal validity into the area of practicalities, which will typically include: (i) the different regime for amending the certificate of incorporation and the investors' agreement; (ii) the public / private nature of these documents and the importance of ensuring the confidentiality of the relevant information; and (iii) the timing when the restrictions are introduced.[99] If the relevant restrictions are set out in an investors' agreement, it is best practice to make a close firm itself a party to such agreement, because its participation is essential to improve the practical workability of the restrictive equity transfers.[100]

---

[94] For the summary of the relevant case law, *see* Bernard F. Cataldo, *Stock Transfer Restrictions and the Closed Firms*, 37 Va. L. Rev. 229, at 231 - 232 (1951).

[95] UCC, Articles 8-204 and 8-301; DGCL, 202(a) and (b).

[96] The stock certificate cannot, obviously, describe all details of the stock transfer restrictions. It will typically contain a general provision setting out that any transfer of stock represented by the certificate is subject to the restrictions set out in the Constitutional Documents.

[97] For the summary of the case law which justified such approach, *see* Cataldo, *supra* note 88, at 235-238.

[98] DGCL, 202(b).

[99] *E.g.*, DGCL, 202(b) does not permit to impose restrictions in respect of the issued stock, unless all of the relevant investors consent.

[100] See Section (*Completion Mechanics*) of this Chapter for the discussion of such issues.

Another relevant issue of general application is that the courts tend to interpret any limitations on equity transfers restrictively,[101] which makes standard "catch-all" provisions not workable. Parties are well advised to consider carefully and to carve-out specifically any undesirable scenarios which may lead to the alienation of equity, which they want to restrict.

General Prohibitions on Transfer

The typical starting point in structuring equity transferability regime is that the investors will prefer the arrangements under which they cannot sell or otherwise transfer their equity except as permitted by a certificate of incorporation or an investors' agreement (both of these instruments hereinafter referred to as the "**Constitutional Documents**"). Courts have been traditionally reluctant to enforce such restrictions.[102] And even today, when state corporate statues explicitly permit equity transfer restrictions,[103] courts require that the relevant restrictions on equity transfers pass the test of reasonableness.[104] DGCL permits any equity transfer restrictions and makes such restrictions enforceable against third parties, if they are explicitly set out in the certificate issued in respect of the relevant equity,[105] but, as explained above, these statutory provisions should be read in the context of the applicable common law.[106] Importantly, though, the DGCL sets out a list of purposes which will be deemed as a "reasonable purpose" for imposing equity transfer restrictions.[107]

---

[101] *E.g.,* transfer restrictions held to be not applicable to the recapitalisation occurring in a merger, Shields v. Shields, 498 A2d 161 (Del Ch 1985).
[102] CLARK, *SUPRA* NOTE 5, AT 764.
[103] *E.g.* DGCL, 202.
[104] Grynberg v. Burke 378 A.2d 139, 142-142 Del.Ch. 1977.
[105] DGCL, 202(a) and 202(b).
[106] Grynberg v. Burke 378 A.2d 139, 142-142 Del.Ch. 1977.
[107] Such reasonable purposes include, among others, (i) "maintaining any local, state, federal or foreign tax advantage", including the corporate status of a chapter S corporation or (ii) "maintaining any statutory or

Accordingly, even in strategic joint ventures the Constitutional Documents will usually provide that no investor shall: (i) encumber[108] any of its equity or any interest in any of its equity; (ii) sell, transfer or otherwise dispose of, or grant any option over, any of its equity or interest in its equity; or (iii) enter into any agreement in respect of the votes attached to any of its equity, but will make such general prohibition subject to: (1) explicit consent of all investors (or their majority); and (2) specific transfer procedures set out in an investors' agreement. The parties will also tailor bespoke equity transfer exemptions which would be justifiable by being reasonably necessary to advance the business objectives of the close firm. The Constitutional Documents will further provide a list of the "prohibited transferees."[109]

Permitted Transfers

***Right of First Offer*.** Although the parties may be willing to lock-up their equity in a close firm for a certain period of time, the conventional approach is that a party shall be permitted to alienate its equity to a *bona fide* third-party purchaser, subject to the right of first offer granted in favour of the other investors. The right of first offer is explicitly recognised under Delaware law.[110] Options vary in respect of: (i) which events trigger these provisions (e.g. the decision to sell equity, a shareholder's death, termination of the investor's employment); (ii) the means by which the price is determined (e.g. book value, a formula, the price offered by a third party); and (iii) the beneficiary of such right (e.g., the close firm, the investors or a combination of both).

---

regulatory advantage or complying with any statutory or regulatory requirements under applicable local, state, federal or foreign law" (DGCL, 202(d)).

[108] This may indirectly result in the sale of the relevant stock and, given the general approach of restrictive interpretation of any clog on the transferability of stock, should be explicitly set out in the Constitutional Documents.

[109] *E.g.*, the competitors of the investors, companies incorporated in the countries subject to international sanctions, etc.

[110] DGCL, 202(c)(1).

The right of first offer is usually drafted so that the selling investor shall serve a transfer notice on the close firm and other investors. The notice must state that he intends to sell his equity and give details of the price at which the equity is to be sold and the details of other material terms. The counterparty will usually be entitled to purchase all of the offered equity by delivery of an irrevocable notice of acceptance to the selling investor.

The investors' agreement will further set out the terms for the completion of the sale. Only if the offeree declines to purchase the offered equity, the selling investor shall be free to sell the equity to a third party on terms and conditions no more favourable than the terms offered to other investors. The investors' agreement will also indicate the time period when the selling investor may exercise this right. Furthermore, the investors' agreement will set out that the selling investor may complete the sale of the equity to a third party only if such third party agrees in writing to be bound by all of the terms and conditions of the Constitutional Documents. In the event that the selling investor fails to complete the sale within the relevant time period, any future sale of equity becomes subject to the procedures set out above. The Constitutional Documents should also explicitly allocate the costs, which the parties incur in connection with the transfer.

Such degree of detail is essential to ensure that the relevant provisions are not declared invalid for the reason of vagueness[111] and to minimise the litigation between the parties in respect of practical issues related to completion.

Right of First Refusal. The right of first refusal is similar to the right of first offer, except that the selling investor offers to sell the equity to the other investors after receiving a *bona fide* third party offer. The offer to the other investors must be made on substantially the same terms as offered by the third party. This is a big difference from the right of first

[111] Hardin v. Rosenthal, 213 Ga 319, 98 SE2d 901 (1957).

offer, when the investors do not know the identity of the third party purchaser when deciding whether or not to buy the offered equity. The clause setting out the rights of first refusal makes it very difficult to obtain any interest from third-party purchasers, because the third parties will have to consider the risk of topping bids from the exiting investors.

***Transfer to affiliates*.** It is usual to permit transfers within the group of the transferring investor. There are usually transfer back provisions if the transferee ceases to be part of the group. Where a close firm has individual investors, it is common for its Constitutional Documents to allow them to transfer their equity to their relatives or to trustees of family trusts. Where the close firm has investment funds as investors, it is quite common to provide that their equity may be transferred to other funds under the same management.

Issuance of Additional Equity by a Close Firm[112]

Subject to the certificate of incorporation providing for the sufficient number of authorised equity, issuance of additional securities in a public firm is subject to the directors' discretion.[113] The board may issue equity for cash or any other consideration and, in the absence of actual fraud, the board's judgement as to the value of issued equity is conclusive.[114] Accordingly, the default corporate law regulation permits the investor, which controls the board, to dilute the equity of its counterparty through such corporate actions as equity dividends, equity splits, cheap issuances of additional equity or distributions of cash or property.

---

[112] For the general consideration of this issue, *see* Johnson, *Freezing Out Minority Shareholders Through the Issuance of Additional Shares*, 2 Memphis St. U.L. Rev. 375 (1972).
[113] DGCL, 151(g).
[114] DGCL, 152.

To address the above risk the investors will have to negotiate appropriate anti-dilution provisions.[115] The simplest and, from the minority investors' perspective, the most efficient approach, is to make any of the corporate actions which create the risk of dilution subject to their veto.

Such blunt prohibition may be acceptable for a close firm incorporated to pursue a strategic project, where the relationship between the parties and the amount of the financial commitments may justify such transfer restrictions. However, it will be hardly acceptable in the context of a private equity close firm, were the interests of the private equity investor are limited to the receipt of the return on the investment and, therefore, are not prejudiced if the close firm issues additional equity at a fair market price. Accordingly, in the context of such close firm the parties will have to negotiate bespoke contractual arrangement, which will address the dilution concerns of the private equity investor, but will fall short of giving him a veto right over any new issuances by the close firm and, therefore, will not prevent the close firm from raising additional finance.

Generally, there are two types of such anti-dilution provisions: (i) pre-emptive rights provisions; and (ii) equity adjustment provisions.

Pre-emptive rights allow investors in a close firm to purchase their *pro rata* equity of future equity issuances. The existing investors have very limited default common law protection against the issuance of new equity.[116] In publicly held firms such rights cause practical problems, because they complicate the process of raising capital which is

[115] For a detailed analysis of the typical anti-dilution provisions, see Michael A. Woronoff, Jonathan A. Rosen, *Understanding Anti-Dilution Provisions in Convertible Securities*, 74 Fordham Law Review 129, 2005; R. Bartlett III, *Understanding Price-Based Antidilution Protection: Five Principles to Apply When Negotiating a Down-Round Financing*, 59 Bus. Law (2003-2004).
[116] Don Berger, *Protection of Shareholder Interests in California Closely Held and Statutory Close firms: A Practitioner's Guide*, Pacific Law Review, 1127, at 1132 (1989).

believed to be more important than the protection of the investors' interests.[117] The practical difficulties which may arise in connection with offering equity to multiple investors in public corporations can cause "almost insoluble difficulty."[118] Furthermore, if the proportion of the equity in the entire capital of a public firm is important for an investor, it can simply buy such additional equity in the open market.[119] Accordingly, commonly public firms will dispense with the pre-emptive rights of the exiting investors to purchase stock issued by such firms.[120]

However, in close firms pre-emptive rights to purchase newly issued equity is an important anti-dilution mechanism. The advantage of using these provisions to protect the equity position of the investors against dilution is that it avoids the difficult issue of evaluating the issued equity, which is necessary to adjust the position of the investor if the equity is issued below market and the investor attempts to protect its position relying on the equity adjustment provisions. The investor can simply buy new equity if he believes that such equity is issued at below market price. The downside of pre-emptive rights is that the investor will have to commit further capital, which it may not be able or willing to do.

Accordingly, it is advisable to include into the Constitutional Documents special equity adjustment provisions which will correspondingly increase the amount of equity belonging to the investor which position is adversely affected by the equity dilution.[121] In addition to dealing with the issue of protecting the value of the investment, such provisions

---

[117] O'NEAL, *SUPRA* NOTE 17, VOL. 1, CHAPTER 3, AT 72.

[118] *Ibid*. O'Neal mentions several practical difficulties which a public corporation may experience in connection with the pre-emption rights include: (i) practical difficulties of distributing stock to multiple investors; (ii) difficulties in complying with pre-emption provisions, when the corporation has several classes of stock; (iii) use of stock as employee incentive mechanisms. O'NEAL, *SUPRA* NOTE 17, at 72-73.

[119] O'NEAL, *SUPRA* NOTE 17, CHAPTER 3, AT 73.

[120] *Ibid*., at 1135.

[121] For the typical wording of such provisions, *see* Section 4.4 (*Adjustment to Series A Conversion Price for Diluting Issues*) of the NVCA Certificate of Incorporation.

also permit to alleviate the information asymmetry problem, because they assist in adjusting the value of the original investment in accordance with its effective market price by reference to the new (and potentially lower) price charged by a close firm for a new round of financing.[122]

To ensure further protection of the investors' interests against the prejudicial actions of the board in respect of the capital of the close firm, the Constitutional Documents shall prohibit the reissuance of the treasury equity (i.e. the equity which has been repurchased by the close firm) and shall provide that any such equity shall be cancelled upon its acquisition by the close firm. Otherwise, the directors will have discretion to resell such equity to any party.

Transfer on Default

The Constitutional Documents need a special regime for the transfer of equity which kick start when one of the investors is in default. This is consistent with the general principle of structuring equity ownership – the importance of personal relationship between the investors in close firms. An investor will usually be deemed to commit an event of default if: (i) it does not pay any amount payable by it under the Constitutional Documents or related agreements; or (ii) is insolvent; or (iii) commits a material breach of the Constitutional Documents.

If an event of default is committed by an investor then, the non-defaulting investors will usually be entitled to require: (i) that the defaulting investor shall not exercise its right to attend and vote at general meetings of the close firm or execute written consents; (ii) that any director appointed by the defaulting investor shall be suspended; or (iii) that the defaulting investor transfers his equity in the close firm to non-defaulting parties for

[122] Michael A. Woronoff, Jonathan A. Rosen, *Understanding Anti-Dilution Provisions in Convertible*

market value (subject to any reduction in the value of such equity for the amount of damages that are due from such a defaulting investor in connection with a default).

Completion Mechanics

The Constitutional Documents will need to include detailed mechanics regulating the transfer of equity. Clear regulation of the completion mechanics is essential to the effective functioning of any equity transfer regime. Courts will enforce such provisions and the specific performance,[123] rescission[124] and award of damages[125] are the available remedies. However, as the damages will usually not be an appropriate remedy, the suits of the investors in connection with the breach of corporate governance mechanics in the close firms will typically request for the specific performance as the relevant remedy.[126] The enforcement through courts may not always meet the expectation of the parties in terms of costs and efficiency. In such circumstance, the parties shall structure contractually the enforcement mechanics.[127]

The Constitutional Documents shall be clear and detailed in terms of the actual steps which have to be performed by the outgoing investors to minimize the risks of any future disputes on technicalities. For example, the outgoing investors shall undertake to procure the resignation of the directors appointed by them.

If the transfer is involuntary, the transferor's dissatisfaction with the result of the sale may make it unwilling to complete. It is therefore invariably provided that, if the transferor fails to do so, the directors may appoint someone to execute the transfer on its

---

Securities, 74 Fordham Law Review 129, at 143 – 144 (2005).

[123] Quick v. Campbell, 412 So 2d 264 (Ala 1982).

[124] Tomoser v. Kamphauser, 307 NY 797, 121 NE2d 622 (1954).

[125] Bohnsack v. Detroit Trust Co., 292 Mich 167, 290 NW 367 (1940).

[126] O'NEAL, *SUPRA* NOTE 17, CHAPTER 5, AT. 157.

[127] One of such contractual arrangements can be the placement of "restricted stock" with a third party reputable investment bank which will serve as an escrow agent guaranteeing the practical efficiency of the relevant transfer provisions.

behalf and the close firm may receive the sale proceeds and hold them in trust for the transferor. The directors will simply issue a new equity certificate to the transferee and will record the original one as cancelled.

Although the transferees of equity who are aware of the relevant restrictions shall be typically held bound by such restrictions,[128] and such notification can be accomplished by setting out the relevant inscription on the certificate issued in respect of the equity, it is best practice to make any equity transfer subject to the requirement that the transferee accedes to the documents which set out the contractual agreement in respect of the corporate governance of the relevant close firm.[129]

Conclusion

The general approach to the regulation of equity transferability in a close firm turns the conventional regulation of this institution developed in the context of public firms upside-down. Investors will expect that, as a general principle, no transfers will be permitted unless they are specifically authorised by the Constitutional Documents.

This approach, however, has to be reconciled with the common law doctrine, which has historically adversely treated any clogs on the transfer of equity. Although, the recent case law suggests that the courts have softened their treatment of such arrangements and recognise the specific needs of the investors in close corporations, the outright restriction on equity transfer is still unlikely to be enforceable.

Such blank prohibition, however, is usually not necessary. Even in strategic partnerships, the parties may fall apart and, therefore, need clarity as to how they will be able to divest their equity. Blank prohibition is even less likely to be commercially acceptable in private equity close firms, where the private equity investor will prefer to

[128] O'NEAL, *SUPRA* NOTE 17, CHAPTER 5, AT 156.

have flexibility in respect of exiting the close firm. Accordingly, the typical arrangement starting from the general prohibition for equity transfer provision will provide for multiple options when the investors will be able to sell their equity.

[129] *Ibid*.

5. ADJUSTING THE MANAGEMENT STRUCTURE[130]

Relationship between the Investors and the Board

In a public firm the investors do not usually have direct involvement in its day-to-day management. The investors delegate the management authority to a group of professional managers appointed by the board of directors.[131] The management powers of the investors in a public firm will be essentially limited to the powers to elect directors[132] and to participate in the most important decisions in the life of the firm, such as mergers,[133] amendments of the certificate of incorporation,[134] sale of all of the firm's assets[135] or the dissolution of the firm.[136] Importantly, other than in respect of the election of directors,[137] Delaware law does not generally permit investors even to adopt the above decisions without the involvement of the board. In essence, in public firms the role of the investors has been essentially relegated to the role of the simple providers of capital divested of any meaningful control rights.

There are several reasons why such separation of ownership and control has been traditionally recognised as being instrumental to the efficiency of public firms:

- ***Separation of skills***. The separation of ownership and control permits the firms to hire as managers the professionals who have best managerial skills irrespective of their financial resources.[138] This makes the management more efficient and the corporation more successful.

---

[130] *See*, generally, Joseph Edward Olson, *Representing Minority Shareholders in Close firms Under Modern Business Firms Act*, 64 Wash. U. L. Q., 507.
[131] Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C.Davis L. Rev 407, at 413-424 (2006).
[132] DGCL, 141.
[133] DGCL, 251, 252 and 253.
[134] DGCL, 242.
[135] DGCL, 271.
[136] DGCL, 275.
[137] DGCL, 211(c).
[138] Easterbrook, Fishel, *supra* note 7, at 274.

- ***Pooling of financing and diversification of risks.*** Modern public firms require financing of unprecedented scale.[139] This requires that the firms shall reach out to a very broad group of investors. Some of these investors are not able or willing to participate in the management. Furthermore, many of such investors are not willing to commit significant amounts of their wealth to a particular firm. Separation of ownership and management permits to reach out to such broad group of investors, because they can contribute a small portion of capital required by a firm without taking direct involvement in its management.[140]
- ***Information costs.*** Centralised management overcomes the collective action problem and minimises time and monies costs which arise if multiple parties are involved in the management of the firm. The centralised management structure "is cheaper and more efficient to transmit all pieces of information once to a central place"[141] and to have the central office "make the collective decision and transmit it rather than retransmit all the information on which the decision is based."[142]

Each of the above advantages becomes of limited relevance in respect of the management of a close firm where the investors will usually provide most of financing required for the operation of a close firm and expect to be actively involved in its day-to-day management. This general expectation has at least three ramifications, which need to be considered when structuring management mechanics in a close firm.

- ***Direct involvement in management***. In close firms the investors will usually prefer to have mechanisms which will permit them to make directly the most important

[139] *E.g.,* in the course of the recent IPO the Agricultural Bank of China raised USD19.2 billion http://www.renaissancecapital.com/ipohome/news/Agricultural-Bank-of-China-prices-record-breaking-$19.2-billion-IPO-8244.html (last visited on February 19, 2012).
[140] CLARK, *SUPRA* NOTE 5, AT 14; Easterbrook, Fishel, *supra* note 7, at 274.
[141] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION, AT. 68-69 (1974).

decisions related to the life of the close firm. The list of the issues over which the investors will want to have a say will usually extend beyond those issues which the investors can vote by law. The direct involvement of the investors into the business of a close firm will require the adjustment of the default regulation of the investors' – directors' relationship.

- ***Protection of the minority investors***. The "majority rules" principle is not acceptable for organizing a close firm, because it creates various opportunities for the abuse of the minorities. Accordingly, the minority investor will normally wish to obtain a veto power over the managerial decisions with which it strongly disagrees.
- ***Directors' duties***. In a close firm the investors will expect that the directors comply with their orders, rather than exercise their independent judgement. This comes in conflict with the duties of the directors which are owed to the close firm rather than to the investors. The distinction between board control or investor control can be crucial. For example, the members of the board of a close firm owe their fiduciary duties and obligations to the close firm and the investors as a group[143] and not to the particular investor that appoints them. "The law demands of directors ... fidelity to the corporation and all of its shareholders and does not recognise a special duty on the part of directors elected by a special class to the class electing them ...."[144]. Investors, on the other hand, may act in their own self-interest subject to an

---

[142] *Ibid*.
[143] *E.g.*, Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001).
[144] Phillips v. Insituform of North America, Inc., 13 Del. J. Corp. L. 774, 790 (1987).

obligation to act in good faith and statutory provisions or case law relating to abuse of their majority position.[145]

The aforementioned considerations require the following adjustments to the management structure of a close firm: (i) the powers of the investors shall be expanded; (ii) minority investors shall be granted additional control rights; and (iii) the mechanisms shall be put in place to permit the efficient resolution of the directors' conflict of interest.

Expanding the Role of the Investors

One way that investors can protect their interests, rather than the interests of the close firm, is by removing certain key issues from the general authority of the directors or managers and reserving those issues for resolution by the investors. This is explicitly permitted under the DGCL.[146]

In some close firms such "special concern" matters require the consent of all, or a majority of, directors. However, this approach is likely to give rise to conflicts with directors' duties, which are owed to the close firm and not to the investor who appoints them,[147] and, therefore, is sub-optimal. An investor can exercise his vote at a general meeting in any way that he chooses as he thinks fit and in his own interests, because under Delaware law a shareholder does not owe fiduciary duty to a firm unless it is a majority shareholder[148] or otherwise exercises control over the firm.[149]

Accordingly, the general approach is to reserve to the investors those decisions which: (i) either affect the value of the equity; or (ii) may be potentially conflicted with directors' duties, but not to prevent the board conducting the day to day management of the

---

[145] Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1334 (Del. 1987); Thorpe by Castleman v. CERBCO, Inc., 676 A.2d 436 (Del. 1996).
[146] DGCL, 141(a). See also the special provisions in respect of close corporations: DGCL, 350, 351.
[147] Phillips v. Insituform of North America, Inc., 13 Del. J. Corp. L. 774, 790 (1987).
[148] Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1334 (Del. 1987).

close firm. Normally, it is the most fundamental or contentious matters that are reserved for the investors to decide.

Before setting out such specific matters which shall be subject to the decision of the investors, it is worth addressing the general approach to the allocation of powers, because even the most deliberate draftsman will not be able to set out an exhaustive list of the issues which may be commercially critical and which resolution will require the investors' vote. The watershed for the allocation of rights between the board and investors is inherently linked to the budgetary provisions for the operation of the close firm. Because it is not practical and possible to identify all issues which shall be subject to the investors' approval, many of the restricted activities will be usually identified by reference either to the size of the transaction contemplated, or to something which is not included in the approved budget. Having set out this general division of powers between the investors and the board, the investors' agreement will then also set out specific matters which will always require the investors' approval.

Minority Protection[150]

The position of a minority investor in a close firm is vulnerable due to the risks of: (i) equity / vote dilution, which may occur due to the issuance of additional equity to the majority investor;[151] (ii) "squeeze outs",[152] (iii) asset dilution, which may occur if the close firm disposes its assets below the market price;[153] (iv) claim dilution, which may occur if the close firm incurs long-term liabilities which rank higher or *pari passu* to the investors'

---

[149] Kahn v. Lynch Communication Systems., Inc., 638 A.2d 1110, 1114 (Del. 1994).

[150] *See*, generally, SIMMONS & SIMMONS, *SUPRA* NOTE 21,195 – 202.

[151] J. Fried, Venture Law and Finance, Chapter 3 (*Dilution via Equity Issuances*), lecture materials for the Venture Capital Finance course, spring term 2012.

[152] O'Neal and Derwin, *Expulsion or Oppression of Business Associates "Squeeze-Out" in Small Enterprises*, Sections 1.04, 2.03 and 3.04-3.06 (1961).

[153] J. Fried, Venture Law and Finance, Chapter 4 (*Voting Rights, Protective Provisions*), lecture materials for the Venture Capital Finance course, spring term 2012.

claims; or (v) variance enhancement,[154] which may occur if the close firm changes its business strategy, so that to make the position of an investor riskier.

The default corporate law provisions offer limited protections to the minority investors to control the above risks. If there is sufficient amount of authorised equity, its issuance[155] and the sufficiency of consideration received[156] is decided by the directors. Courts are generally reluctant to limit such powers of the board on the basis that they dilute the minority,[157] unless there is evidence that such issuance is made at a grossly inadequate price or with a view to squeeze out the minority.[158]

Common law regulation of "squeeze out" mergers essentially permits the controlling investor to cash-out a minority, subject to paying a fair price.[159] Apart from not being acceptable for a minority as such, this remedy, in a close firm context, is unlikely to be efficient due to the difficulties of estimating the fair value of stock in close firms. The sale of the corporate assets or the incurrence of liabilities will be generally subject to the business judgement rule protection and, unless amounting to fraud, a minority investor will not be able to challenge the decision of the directors in respect of the completion of such transactions.[160]

Furthermore, in addition to the insufficient protection offered by the default provisions of corporate law, unlike an investor in a public firm, which in the case of disagreement with the management can sell its stock in the open market, a party to a close firm, in the absence of specific contractual protections, is locked in, because there is no

---

[154] *Ibid.*, at 1.
[155] DGCL, 151(g).
[156] DGCL, 152.
[157] Below v. Porter, 201 F2d 429 (CA8, 1953).
[158] Bennett v. Breuil Petroleum Corp., 34 Del. Ch 6, 99 A2d 236 (Ch 1953).
[159] Weinberger v. UOP, Inc 457 A.2d 701 (Del. 1983).
[160] Marks v. Wolfson 41 Del.Ch. 115, 188 A.2d 680 Del.Ch. 1963.

liquid market for the stock in close firms.[161] This illiquidity of stock means that the investors cannot rely on market mechanisms to control the majority investors. This escalates the "unique risk of [minority] exploitation."[162]

Accordingly, it will almost invariably be appropriate for the minority to be afforded some additional contractual protection of their interests which will enhance available default remedies under common law and statutory provisions. The protection will normally take the form of a series of acts which shall not be carried out without the consent of a minority investor. Such vetoes or blocking powers[163] are usually negative in character, i.e. they do not usually enable the minority to force any change of policy, and the majority could not be expected to agree to this. However, as a practical matter, the minority's ability to refuse consent to a particular transaction may permit to insist on the adoption of an alternative.

The minority investors may, however, desire to have some positive rights which may be attached to their participation. For example, such rights may include the ability to appoint a director, or the right to a minimum return on their investment by way of interest and/or dividends. Since, in the absence of contrary agreement, the majority would appoint all the directors, without such agreement the minority cannot even be sure of a voice in the boardroom.

The use of vetoes is not a panacea for the efficient management. The downside of this mechanics is that this right may be abused by the minority, which may threaten to use the veto rights to extract additional benefits from the majority rather than to protect its

---

[161] Easterbrook, Fishel, *supra* note 7, at 275 – 277.
[162] *Ibid*., at 275.
[163] Vetoes can structured in various forms, including: (i) direct vetoes, i.e. the requirement to obtain the consent of a stockholder before passing a specific decision; (ii) "super-majority" votes, i.e. the requirement to

interests.[164] Accordingly, it is critical that the veto rights are granted sparingly and only in respect of the provisions which are critical to protect the interests of the investors, whereas the general management of the close firm shall remain with the board.[165]

Resolution of Deadlocks

Another important (but, presumably, inevitable) downside of reserving control over important decisions to the joint agreement of the parties (either at the level of investors or at the board's level) is the increased risk of deadlock. In the event of deadlock the parties need to have a mechanism for resolving the impasse. There are various methods of resolving deadlocks, with the most common options including the following.

Turn to an independent third party/expert determination. This method of deadlocks resolution can be used to determine matters of fact or good business judgement. It is less appropriate where the dispute relates to contrary interests or different business practices as it is difficult for an outsider to weigh these conflicting elements of self interest. An expert is appropriate to decide a technical issue of fact which he may decide on the basis of his own expert knowledge. This is not a very satisfactory method of resolving an impasse as the disagreement may not turn upon a question of sound business judgement but rather on conflicting interests or business preferences. For example, one investor may not want to invest further funds due to its own financial position but the other may be in a better financial position so willing to provide finance. Realistically an outsider cannot weigh up these conflicting elements of self-interest.

Give a casting vote to a member of the board. This option may have advantages where the director is independent of the parties and familiar with the close firm, although

obtain a higher threshold of vote to pass a corporate decision; (iii) issuing stock with multiple votes, i.e. stock which will carry more than one vote; (iv) supermajority quorum requirements, etc.

[164] O'NEAL, *SUPRA* NOTE 17, CHAPTER 4, AT 52.

the difficulties identified in connection with the resolution of conflicts by way of engaging an expert are still likely to apply. An interesting variation of this option included the issuance by a 50-50 close firm of a third class of stock. This class of stock was given to a long-standing, independent lawyer of a close firm with the sole powers to appoint an independent director on board, who was supposed to resolve the deadlock.[166] The court upheld such arrangements.[167]

Arbitration. Apart from diverse legal risks related to the arbitrability of corporate disputes,[168] arbitration is often not commercially workable for the resolutions of deadlocks, being more appropriate for deciding the legal rights of the parties than for resolving matters of policy. For this reason, it is not commonly used for the resolution of deadlocks.

Buy and sell out. These provisions are the most common way of breaking a deadlock and they essentially assume that in the case of a deadlock, one party will buy-out another party. Their upside is that they permit to preserve business as a going concern and, therefore, to maximise its value. The downside is their manipulative nature and potential abuse by an investor which has better access to funding. The most common of such proceedings are considered in more detail below.

- ***Put and call options***.[169] Under this arrangement, if a deadlock arises, each party may serve a termination notice on the other party. Such notice will require the other party either: (i) to purchase all of the stock of the party which served the notice (put option); or (ii) to sell to such party all stock of the recipient of the notice (call option). The party then becomes bound to either buy or sell as required by the

---

[165] *Ibid*.
[166] Lehrman v. Cohen, 43 Del Ch 222, 222 A2d 800 (1966).
[167] *Ibid*.
[168] *See* O'NEAL, *SUPRA* NOTE 17, AT 9.08 – 9.25.
[169] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 219 – 220.

notice at a price, which will be calculated in accordance with the procedures set out in the investors' agreement. The put and call options mechanics for the resolution of deadlocks will be typically used when such provisions were triggered by one of the investors' being in default of its obligations vis-a-vis the close firm. It will not be typically acceptable, if the deadlock arises due to the commercial disagreement between the parties.

- ***Russian roulette***.[170] This is probably the most common way of breaking a deadlock. It will be usually used where a commercial disagreement of the parties (rather than an exit event effecting one specific party, e.g. the insolvency of a party or the breach of its obligations under the Constitutional Documents) is the reason for exit. It is also most appropriate where there are two investors of roughly equal strength.

  This exit mechanism operates as follows. Either party may serve a notice on the other party. Such notice may either require the recipient to sell its stock to the server or buy the server's stock at a price which is specified in the notice. The recipient can accept the terms of the transaction or serve a counter-notice with a requirement that the server shall complete the reverse transaction. The server then becomes bound by the counter-notice.

  The advantage of this procedure is that (unlike, for example, in the case of a put option, when the party may not be able to comply with its obligations if it has insufficient funds) each party can always comply with its obligations under these provisions, because the mechanism of a counter-notice ensures that the party will never be obliged to buy stock if it has no resources to do so.[171] It also ensures a reasonable mechanism of determining a fair price for the stock, because given the

[170] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 220.

threat of its own equity divestiture, each investor is incentivised to price equity at a fair price. This avoids the need for a valuation and involves the risk that the valuer will determine a price which does not fairly represent the value of the equity and will not be satisfactory to the investors.[172]

However, Russian roulette also involves a degree of uncertainty and is open to manipulation, because an investor may be caught in a liquidity trap. This may happen if one investor knows that the other investor is in financial trouble and triggers the Russian roulette provisions. Such investor will be able to offer to sell its equity to such investor at a low price. The other investor being not able to raise finance to buy the initiating investor's stock will have to sell equity at a price which is less than its market value.

- ***Shoot-out or Dutch auction***.[173] The shoot-out whereby a party can notify the other that he wishes to buy the other's equity, and the other party within a specified time may serve a counter-notice either agreeing to sell or stating that he, instead, wishes to buy the equity of the first party. If both wish to buy, a sealed bid system is put in place and the person submitting the higher bid is entitled to buy the equity of the other. This, again, can be arbitrary and is really workable only where the investors are roughly of the same financial standing.

Winding-up. Traditionally courts will refuse to dissolve a solvent firm merely because its investors are in disagreement over the management.[174] This general approach, however, is subject to a number of exceptions. These exceptions are

---

[171] *Ibid*.
[172] *Ibid*.
[173] *Ibid*., AT 222.
[174] Drob v. National Memorial Park, Inc. 28 Del Ch 254, 271, 41 A2d 589, 597 (Ch. 1945).

numerous,[175] but, broadly, the courts may permit such dissolution if the deadlock jeopardizes the efficient operation of a close firm. Given the vagueness of this criteria and the discretion of the courts in its application, all states have now enacted statutes which explicitly regulate the procedures for dissolving the firms.[176]

DGCL[177] explicitly permits for the court to order the dissolution of a firm in the case of a deadlock between the parties. In respect of close firms the regime is even more flexible, essentially permitting any investor to dissolve a close firm in any circumstances agreed in the Constitutional Documents.[178] Accordingly, parties have much flexibility in terms of utilising this option (or the threat of its utilisation) as a means to resolve the deadlocks. Having said that, it should be noted that the dissolution is generally an option of very last resort, because it destroys the going concern value of the business.

Adjusting the Investors' Proceedings

General. Default DGCL rules governing corporate governance are flexible to meet the interests of the investors in a close firm. In particular, they permit: (i) the investors[179] and directors[180] to pass their relevant decisions by a written consent; (ii) to hold the meetings of the board by telephone;[181] and (iii) to waive any procedural notices in respect of the directors' and investors' meetings.[182]

---

[175] H. Fales, *Judicial Attitudes Towards the Rights of Minority Investors*, 22 Bus. Law. 459 (1966-1967); Howe, *Corporate Divorce: Deadlock in the Close Firm*, 22 Bus Law. 469 (1967).
[176] Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 Chi. L. Rev. 778, at 788 (1952).
[177] DGCL, 228.
[178] DGCL, 355.
[179] DGCL, 228
[180] DGCK, 141(f).
[181] DGCL, 141(i).
[182] DGCL, 229.

However, certain adjustments to the corporate procedures will still be required, because Delaware law sets out the primacy of the board not only in the substantive issues (i.e. in the issues related to the actual authority to make decisions) but also in respect of the corporate procedures.[183] Accordingly, a degree of "democratization" of such procedures will be necessary to permit the investors to use their substantive rights effectively.

Calling an investors' meeting. Amendments to the certificate of incorporation shall be made, so that to ensure that each of the investors is authorised to call for an investors' meeting. The default rule in Delaware is that such authority is reserved only to the board of directors[184] with the rationale for such approach being that giving such right to the investors creates the risk of abuse and the unnecessary interference in the management powers of the board. However, in a close firm the likelihood of such abuse is insignificant and, in any event, the investors need to have a mechanism for the direct participation in the management of a close firm.

Quorum and voting majority. The default quorum provisions set out that a ½ of the outstanding stock will constitute a quorum and an affirmative vote of ½ of the stock constituting quorum is sufficient for a valid decision of an investors' meeting, apart from any vote in respect of the directors' election where the plurality voting is the default rule.[185] Quorum and voting requirements apply individually to each class of stock.[186] The default rules are subject to any modifications set out in the certificate, subject to a minimum quorum requirement of 1/3rd of the outstanding stock.[187]

---

[183] DGCL, 211.
[184] DGCL, 211(d).
[185] DGCL, 216.
[186] DGCL, 216.
[187] DGCL, 216.

These default rules will be usually modified in respect of a close firm, where quorum requirements for the investors' meeting will usually provide that the quorum must contain the representatives of each investor, regardless of its stockholding. If investors are in dispute, one party may seek to refuse to attend either investors' or directors' meetings in order to prevent these being quorate. If the investors have fallen out to this degree, it is usual then to operate the deadlock provisions.

Information rights. Default provisions of Delaware corporate law offer limited information rights to the investors.[188] Essentially, the law permits the investors to have unlimited access to the list of the investors.[189] Access to any other documents requires that the investor shall demonstrate a valid business purpose.[190]

There are no good reasons why the access of the shareholders to the information in a close firm shall be subject to the same restrictions. On the opposite, since the investors will have extensive involvement in the management of the business of a close firm they shall be granted very broad information and inspection rights.[191]

Board Representation

Structuring the board. The traditional composition of the board in a public firm is based on the principle of the direct relationship between the equity split and the split of the representation on the board of the firm. The controlling investor will usually be permitted to elect the majority of directors and, therefore, impose his control over the board. Such structure is not acceptable for close firms, where usually there is no relationship between

---

[188] DGCL, 219 and 220.
[189] DGCL, 219.
[190] DGCL, 220.
[191] For the scope of such rights, see Clause 3 (*Information and Observer Rights*) of the National Venture Capital Association Model Investors' Rights Agreement. (available at: http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136; last visited April 19, 2012).

the equity split and the boards' seats split, because there is limited guarantee that otherwise the board will act for the benefit of all investors. Accordingly, even minority investors in close firms will typically seek a representation on the board, regardless of the contribution to the capital of the firm.

As with vetoes, there are two methods which are generally used to confer a right on a minority to appoint a director. First, the right may be contained in an investors' agreement, and will provide that each investor can nominate and remove its own appointees to the board by giving notice to the close firm and the other investors.

The second method is to set out the right to appoint directors into the certificate of incorporation as a equity class right.[192] The appointor is issued with a special class of stock (which may be identical to all other stock apart from the right to appoint one or more directors). The class right gives the appointor the right to appoint one or more directors, up to the allowed number. The person appointed then becomes a director. Removal is effected in a similar manner. Class voting shall be protected, i.e. the certificate shall be amended so that without the consent of the class no amendments will be permitted which will: (i) eliminate such class vote; (ii) increase the size of the board; or (iii) result in issuance of more equity of the relevant class.

Operation of the board.[193] When considering the operation of the board one is faced with a considerable divergence between the law and the practical reality. The appointed director owes duties to the close firm and these take precedence over the duties which the director owes to his appointor,[194] who should not therefore assume that his appointee will

---

[192] DGCL, 141(d); Israels, *The Close Corporation and the Law*, 33 Cornell LQ 488, at 495 (1948); For the example of such provisions, *see* Sub-section 3.2 (*Election of Directors*) of the NVCA Certificate of Incorporation.
[193] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 208 – 209.
[194] Phillips v. Insituform of North America, Inc., 13 Del. J. Corp. L. 774, 790 (1987).

always be able to conform to the appointor's directions as to how he will vote in a board meetings.

The practical reality is that in nearly all cases the investor and its representative on board will assume that such directors' function on the board is to represent the investor interests in relation to the close firm and the director will normally follow the instructions of the investor, which appointed him. The reason for this is simple: the investor can always replace its director in case of his incompliance with investors' orders.

In the vast majority of cases, this divergence of the law and practice has no practical implications, because the interests of the appointor very often do have a strong correlation with those of the close firm.[195] This however is not always the case and the investors / their directors shall find a solution to how to reconcile directors' fiduciary duties with the commercial need of the investors. One approach to deal with such conflict is to ensure that the interested director does not participate in voting on a conflicted matter. Another option is to delegate the matter to the specially established independent committee. Finally, investors can always reserve conflicting matters for the resolution at the investors' meeting.

Conclusion

Default corporate law provisions fail to address two critical issues which are important for the investors in the close firms. First, they provide limited options for the direct involvement of investors in the management of the company. Second, they generally leave the lot of the minority investors to be decided by the majority inventors or, to be more precise, the directors appointed by the majority investor. If the minority disagrees with the relevant decisions, it most effective remedy in public firms is to sell the equity.

---

[195] SIMMONS & SIMMONS, *SUPRA* NOTE 21,AT 208 – 209.

Both of the above institutions have to be modified in close firms, because the investors will usually operate such firms as their *alter egos*, expecting to be able to have day-to-day management access. The absence of liquid capital markets in the equity of the close firms does not permit the minority to rely on their disciplining effect. Accordingly, the parties have to enter into the relevant contractual arrangements which will adjust management institutions to meet their objectives.

6. STRUCTURING EXIT RIGHTS

Detailed contractual regulation of exit rights is essential for any close firm. The reason for this is that it is very difficult to foresee in advance all the circumstances which may adversely affect the long term relationship between the parties and seek one of them to divest. This may happen even to very sophisticated parties, which ensure careful long term planning and commit a lot of capital, know-how and reputation to the success of a close firm. For example, in 2011 Sony decided to exit its decade long strategic joint venture with Ericsson[196] related to the manufacturing of smartphones by purchasing out the stake of Ericsson in a strategic joint venture for £1.05bn. This step was allegedly supposed to permit Sony to achieve better integration of the smartphone business with its general operations, permitting "to cut costs and better synchronize mobile-device development".[197]

However, if the parties decide to exit the close firm, this may be difficult to achieve in practice. Unlike in a public firm, the investor in a close firm cannot freely sell its stock in a public market. Accordingly, in the absence of explicit exit contractual arrangements, such investor will have no chance to cash out, unless at a fire sale price.

Although the practical reasons when the exit rights may be triggered are various, they can be broadly summarised around the following typical scenarios.[198]

- ***Scheduled exit***. Investors may agree that they will exit a close firm on the happening of a specified event. If, for example, the close firm was established to carry out a particular project, it is likely that the investors' agreement will provide

---

[196] *Sony takes full control of Sony Ericsson joint venture*, The Guardian, October 27, 2011 (available at: http://www.guardian.co.uk/technology/2011/oct/27/sony-takes-full-control-sony-ericsson; last visited on April 19, 2011).

[197] *Sony Itches to Return to Mobile Arms Race*, The Wall Street Journal, October 7, 2001 (available at: http://online.wsj.com/article/SB10001424052970204294504576614830784818082.html; last visited on April 19, 2011).

[198] *See*, generally, SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 215 – 219.

for the exit at the end of the project. Scheduled exits are also critical in private equity financing, when the parties will set up a close firm with a view to grow business and sell it either to a third party or in public market within a pre-agreed time frame.[199]

- ***Early exit***. A variation of scheduled exit is the grant of the early exit rights. These rights are especially important in private equity close firms, where the investors providing financing will typically expect that they will be able can cash out of the close firm within a set period of time regardless of whether the close firm became "ripe" for an IPO or private sale or not. Accordingly, if the close firm does not reach the scheduled exit, the private equity investors expect that they will be able to "put" their equity on the close firm, which will redeem their investment.
- ***Deadlock***. Where there are two equal investors in a close firm, an unresolved deadlock is usually made a ground for triggering exit mechanics. A deadlock can also arise in a close firm with multiple investors, if some of the investors persistently uses veto rights.
- ***Breach***. The investors' agreement will almost invariably provide that a breach is not a ground for termination unless it is "material" and not until the defaulting party has been served with a notice requiring it to remedy the breach within an agreed period.
- ***Change of control***. A change of the control of a party is often made a ground for termination. This is consistent with the general principle of structuring corporate governance in close firms – the importance of ensuring "privacy" between the parties. This privacy is put at risk by the change of control occurring to the

[199] For the general discussion of exits in private equity transactions, *see* LEVIN, *SUPRA* NOTE 32, CHAPTER 9

investors, because if, for example, the change of control is to a competitor of the close firm, or of one of the investors, the new controlling party could acquire useful information concerning its competitor and by the use of voting powers or veto seriously disrupt the business of the close firm.

- ***Bankruptcy***. Commencement of insolvency proceedings directly affects the ability of an investor to meet its obligations owed to the close firm and other investors. This carries the risk of disrupting the operations of a close firm. Accordingly, these events will be invariably a ground for termination.

The investors' agreement will usually set out a combination of exit provisions which will come into play depending on the circumstances which triggered the exit of investors from the close firm. For example, put and call options, Russian roulette and shoot out provisions, which were discussed in Chapter 5 (*Adjusting the Management Structure*), are the most common exit mechanics which are used if the exit rights are triggered by a deadlock. Scheduled exits will be typically achieved by way of a scheduled private sale or an IPO. Drag-along or tag-along rights are another exit mechanics used to ensure a sale of 100% stock in a close firm in response to a third-party offer. Repurchase of stock will be typically used in the context of private equity financing with a view to ensure early exit rights for private equity investors. This is also a typical exit right granted to a minority investor with a view to ensure the liquidity of its investment.

Private Sale / Merger[200]

This exit mechanics typically provides that the parties will negotiate in good faith to achieve the sale of the whole issued equity of the close firm to a third party or the merger of the close firm with the third party. In the latter scenario, the exit provisions will

---

(*EXIT STRATEGIES: STRUCTURING IPO OR SALE OF PE/VC-FINANCED PORTFOLIO COMPANY*).

be typically coupled with the dissolution of the close firm: if the parties do not sell the close firm by the stated time, the parties will be obliged to place the close firm in liquidation.

The merger mechanics is, obviously, the commercial equivalent of selling 100% of close firm's stock, which can be effectuated by a majority investors' vote.[201] The use of this mechanics to structure the exit rights of private equity investor, however, will have to address the following wrinkle. In the current ruling of the Delaware Court of Chancery in *Trados* case*,* the court put a question mark over the unrestricted ability of the board controlled by the preferred investors to effectuate the merger of the close firm without considering the specific duties owed to the common stock investors.[202] Accordingly, private equity investors may wish to avoid board's participation in connection with the sale / merger of the close firm and to effectuate the private sale of a close firm by means of: (i) drag-along rights; or (ii) stock redemption provisions.

Private sale / merger mechanics is typically used in two circumstances. First, it may be the targeted strategy of the parties, which they agreed to pursue before the incorporation of a close firm as a way to ensure the return on their investments. This will be typical for private equity close firms and less common in strategic joint ventures, where the investors will usually rely on the cash flow generated by a close firm to return their investments.

Second, a co-ordinated private sale or its commercial analogy, merger, may be a preferred alternative to the buy-out provisions which we discussed in the context of the resolution of deadlocks. In the latter case, a private sale / merger exit is particularly appropriate if the termination does not flow from the events arising due to the fault of a

---

[200] *See*, generally, SIMMONS & SIMMONS, *SUPRA* NOTE 21, 249 – 257.
[201] DGCL, 251.

particular party (e.g. insolvency of such party or its breach of the Constitutional Documents) but from the general disagreement between the parties.

The upsides of these exit techniques are several. First, each of these sale mechanics ensures that the business is sold as a going concern, which maximises the return to the investors. Second, no investor is put under any commitment to buy or sell and, therefore, any manipulations which may arise in connection with the application of a "Russian roulette" or "Texas shoot-out" provisions will be avoided. All the pressure is imposed by the liquidation deadline. Since liquidation will destroy the going concern value of a close firm, it is the solution least likely to suit any of the parties. The investors may wish to set out elaborate provisions regulating their cooperation to achieve the exit, but this is unlikely to be necessary: the prospect of liquidation within the stated time should be a sufficient incentive to arrive at one.[203]

Any sale of the stock to the third party will have to be registered,[204] or comply with one of the exemptions available under the Securities Act.[205] Typically, this shall not be an issue, as the investors will either comply with the relevant holding periods[206] or sell to sophisticated buyers.[207]

Offer from a Third-Party – Tag[208] and Drag Rights[209]

---

[202] SV Inv. Partners, LLC v. ThoughtWorks, Inc., C.A. 2724-VCL, 2010 WL 4598108 (Del. Ch. Nov. 10, 2010) aff'd, 107, 2011, 2011 WL 5547123 (Del. Nov. 15, 2011) and judgment entered, SV Inv. Partners, LLC v. Thoughtworks, Inc., 2724-VCL, 2011 WL 305074 (Del. Ch. Jan. 2011).

[203] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 249 – 250.

[204] Securities Act, 5.

[205] *See*, *supra* note 72.

[206] SEC Rule 144.

[207] *See*, *supra* note 72.

[208] For the example of such provisions, see Section 2.2 (*Right of Co-Sale*) of the NVCA Model Amended and Restated Voting Agreement (available at: http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136; last visited on April 17, 2012).

[209] For the example of such provisions, *see* Section 3 (*Drag-Along Right*) of the NVCA Model Amended and Restated Right of First Refusal and Co-sale Agreement (available at:

Another typical exit mechanics is a sale of the whole issued equity in the close firm in response to an offer received from a third party, whether unsolicited or engineered by a investor who wishes to sell. This is achieved by, so called, tag-along and drag-along provisions. The purpose of these provisions is two-fold:

- tag-along rights permit the minority investor to cash out when the majority decides to sell its equity to a third party and to ensure that the minority investor does not need to deal with a party it does not know without its consent; and
- drag-along rights ensure that the majority investor can sell 100% of the equity without running the risk of blackmail from the minority investor.[210]

Both of these provisions are explicitly permitted under Delaware law.[211]

Under the tag-along provisions if a selling investor proposes to transfer on a *bona fide* arm's length basis any of its equity to a third party, it shall afford the other investors the opportunity to participate in such transfer in accordance with the provisions of the investors' agreement. The other investors will have the right to transfer, upon identical terms and conditions as the proposed transfer, their equity. The mechanics will usually provide that prior to any such proposed transfer the selling party shall give notice to the other parties setting forth the terms of the sale.

If the tag-along rights protect minority, drag-along rights serve the interests of the controlling investor, because they allow a majority party selling all of its equity to a third party to force the minority investors to sell all of their equity. This may be critical, because the buyers often want to purchase 100% control. The drag-along rights will usually not be absolute but will kick-in only when the selling investor decides to transfer to a *bona fide*

---

http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136; last visited on April 17, 2012); *See* also, generally, SIMMONS & SIMMONS, *SUPRA* NOTE 21, 249 – 252.

[210] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 251.

third party all of its stock and when such third party purchaser desires to acquire more stock than those owned by the selling investor for a price per stock equal to or exceeding an amount set out in an investors' agreement. This will guarantee that the majority investor cannot abuse these rights by selling the equity at a price which is below the market or is otherwise not consistent with the original expectations of the minority investor.

Floatation[212]

The advantages of a private sale / merger are lower cost and the ability to cash out 100% of the participation in stock. The disadvantage is the possible management opposition, who may be unhappy to work with the buyer or will afraid that the buyer will put in place new management. If a sale / merger is unsuccessful, confidential information released during due diligence may become available to a competitor.

One advantage of a flotation for the management is that they will usually be able to retain their positions afterwards and by retaining all or some of their stock they may be able to reap further capital appreciation. The disadvantages of a flotation are the high costs and complexity involved, the risk of failure should the flotation be badly timed. Another important downside is the difficulty of achieving a clean exit: public sale is unlikely to produce the whole value of the close firm in immediate cash, whereas a sale / merger can be expected to do so. This is because the underwriters will usually insist that the principal investors enter into "lock-up" agreements under which there are limits on the amount of equity they may sell for a period after the public sale. Such agreements are imposed to ensure an orderly market after the public sale by avoiding the steep drop at once. Apart from a failure to cash-out, the equity provider may find itself in a disadvantage: it will be left holding a substantial stake in the floated company which is subject to a "lock up"

[211] DGCL, 202(c)(4).

agreement, but will lose the special rights and protections for its stockholding built into the Constitutional Documents.[213]

The public sale of securities will require their registration under the Securities Act.[214] Such registration means that the firm will acquire the status of a registered company.[215] This will entail considerable restrictions on its operation. For example, the company will have to comply with periodic reporting requirements,[216] it will have to prepare proxy statements in connection with its investors' meetings,[217] ensure that insiders do not trade in securities on the basis of non-public material information,[218] comply with corporate governance and audit requirements set out in the Sarbanes-Oxley Act ("**SOX**").[219] The directors of the close firm at the time of the issue of the prospectus or admission document will in any case assume personal liability to investors for the accuracy of their contents and selling investors may also incur such liability.[220] Finally, the public sale may run contrary to the business intentions of the management, which may be willing to raise capital for the close firm as such (by means of primary offering), rather than to permit the investors to cash-out.

In summary, there are various considerations, why a public sale of securities may not be supported by all parties to a close firm. Importantly, the investor cannot register the

---

[212] SIMMONS & SIMMONS, *SUPRA* NOTE 21, AT 256 – 257.

[213] The venturers will typically have to give up their special protections prior to the public offering, because otherwise the public investors are unlikely to invest into the company. *See*, *e.g.,* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Expertise*, 55 Stan. L. Rev. 1067, at 1084-1085 (2003).

[214] Securities Act, 5.

[215] Exchange Act, 12.

[216] Exchange Act, 13.

[217] Exchange Act,14.

[218] SEC Rule 10b-5.

[219] Such requirements include, among others: (i) certification of periodic statements (10-Ks and 10-Qs) by the CEO of the company (SOX, 302); (ii) forfeiture of bonus in the case of restatement of the financial statements (SOX, 304); (iii) prohibition on loans to executives (SOX, 402); and (iv) real time disclosures of material facts (SOX, 409).

stock by itself, but will require the co-operation of the close firm's board and executive management.[221] Accordingly, if the public sale is the preferred exit mechanics, the relevant parties shall set out up-front the regime when the investors will be permitted to demand from the close firm the registration of securities.[222] Such contractual regime will be helpful even if the investor controls the close firm, because it may, for example, permit the investor to ensure that the close firm will pay all expenses in connection with such registration.

Repurchase of Equity by the Close Firm

General rationale for application. This exit option serves two business purposes. First, in private equity close firms the equity redemption exit route permits the private equity investor to "extract the original investment from the company that seems unlikely to succeed"[223] or to have "leverage over the entrepreneur based on the credible threat of withdrawal."[224]

Second, stock redemption is one of typical exit techniques which will be negotiated by a minority investor.[225] The relevant repurchase provisions in the Constitutional Documents will be typically linked to the failure of the controlling investor to achieve the exit by means of a private sale or IPO by a stipulated deadline.

---

[220] Securities Act, 11.
[221] *E.g., see* rules regulating the required statutory signatories of the prospectus in Securities Act, 6.
[222] For the example of such provisions, see see the Investor Agreement by and between Deutsche Telekom AG and AT&T Inc dated March 20, 2011 available at: http://www.sec.gov/Archives/edgar/data/732717/000119312511072458/0001193125-11-072458-index.htm (last visited on February 17, 2012).
[223] Smith, *supra* note 45, at 348.
[224] *Ibid*, at 349.
[225] See standard redemption provisions at Section 6 of National Venture Capital Association Model Amended and Restated Certificate of Incorporation.

The redemption provisions may be structured as: (i) mandatory redemption provisions (rare); (ii) discretionary put option provisions (typical); and (iii) discretionary call option provisions (rare).[226]

Legal restrictions for equity repurchase – statutory provisions. As a general rule a close firm is permitted to repurchase its stock only to the extent its capital is not impaired.[227] A repurchase impairs capital if the funds used to repurchase equity exceed the amount of the firm's "surplus", which is equal to the excess of net assets over the par value of the firm's issued stock." [228] "Net assets" is defined as the amount by which total assets exceed total liabilities.[229] Furthermore, the Delaware law permits to redeem stock out of capital if two conditions are met: (i) such stocks shall be retired on redemption; and (ii) the capital of the firm is reduced in accordance with Sections 243 and 244."[230] Section 244, essentially, permits to reduce the capital until the assets of the company exceed its liabilities.

Legal restrictions for equity repurchase – common law. It should be noted, though, that the above statutory flexibility is subject to various restrictions imposed by common law. The origin of such restrictions is the extended definition of "insolvency" under Delaware law which includes in addition to the asset-balance test the cash-flow test (i.e. the inability of the close firm to pay its debts).[231] Common law does not permit the close firm to repurchase its equity if such close firm is insolvent.[232] Accordingly, even if

---

[226] *Ibid*, at 348.
[227] DGCL, 160(a)(1).
[228] DGCL, 154.
[229] DGCL, 154.
[230] DGCL, 160(a)(1).
[231] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007).
[232] SV Inv. Partners, LLC v. ThoughtWorks, Inc., C.A. 2724-VCL, 2010 WL 4598108 (Del. Ch. Nov. 10, 2010) aff'd, 107, 2011, 2011 WL 5547123 (Del. Nov. 15, 2011) and judgment entered, SV Inv. Partners, LLC v. Thoughtworks, Inc., 2724-VCL, 2011 WL 305074 (Del. Ch. Jan. 2011).

the firm has sufficient net assets, it may not use them all to repurchase the stock, if as a result of such transaction it will not have sufficient funds to operate as a going concern.

The Court of Chancery[233] has further restricted this exit mechanics by setting out that the question of what amount of funds is sufficient for the firm to operate as a going concern shall be subject to the business judgement of the board and any decision of the board setting out the sufficiency of funds will be second-guessed by the court only if it is proved in court that the directors acted: (i) in bad faith; (ii) relied on unreliable data; or (iii) made determination so far off the market that the actual / constructive fraud was committed.[234] Accordingly, this interpretation leaves broad discretion to the board in allocating the funds which will be used to comply with the repurchase obligation of a close firm. Therefore, reliance on these provisions as an exit mechanics may be problematic in practice.

Where a company has issued redeemable stock it is often appropriate for class rights to attach to them to the effect that the holders may veto transactions which will reduce the distributable profits and so make redemptions more difficult. Without such a provision the redeemable investors are powerless to prevent the accumulation or reinvestment by the subsidiaries of their profits. Finally, given the uncertainty of redemption rights, it is advisable that if the close firm fails to redeem the stock on time, the relevant investor receives: (i) spring rights to control the board; and (ii) the drag-along rights to force the sale of the entire close firm.

Conclusion

Detailed exit rights provisions are critical in close firms.

---

[233] *Ibid.*
[234] *Ibid.*

Having a predictable exit horizon is important for the private equity funds to calculate its IRR and economic viability of investment. The *ex ante* choice is between a scheduled IPO or a private sale. There is no “silver-bullet” exit mechanics and the ultimate choice is determined in practice by a mixture of legal, practical and economic consideration and, above all, by the options available in the market.

Exit provisions serve not only the purpose of cashing out the investment. They also serve the purpose of being “civilised” divorce mechanics for the investors in close firms, which fall apart. Many options are available to ensure such “civilised” divorce. Surprisingly, the best scenario will also lie in the area of an private sale or IPO, because any of such exits will preserve the company as a going concern and ensure an objective, non-manipulative method of exiting the close firm.

7. CONCLUSION

"Corporate law [..] is best understood as a set of standard terms that lowers the costs of contracting."[235] US modern corporate law has been primarily developed with a view to serve the needs of public firms and is not adequate to regulate the needs of investors in close firms. The 1902 remark of Justice Holmes that "[s]tock [...] creates a personal relationship analogous otherwise than technically to partnership [and, therefore,] there seems to be no greater objection to retaining the right of choosing one's associates in a [close] corporation than in a partnership"[236] still seems to be more relevant to describe the relationship between the investors of a close firm, than the modern corporate doctrine. Structuring corporate governance in a close firm requires a bespoke approach and detailed contracting. For such firms, to paraphrase the seminal article of Yoshihiro Francis Fukuyama, the end of law has arrived.

Drafting a proper corporate governance structure for a close firm is both an art and science. It is an art, because there is no structure which will ideally fit two different close firms, let alone can be applied across the board. However, it also a science, because there are certain commonalities in these relationships, understanding which will facilitate the process of contracting.

We started by analysing the conflicts which arise in close firms and the reasons why the default provisions of corporate law cannot adequately regulate such conflicts. We identified three major areas where such conflicts arise (being (i) management structure; (ii) stock transferability; and (iii) exit scenarios) and concluded that the traditional pillars of corporate law require substantial modifications to meet the commercial needs of investors in close firms. We identified two critical reasons, which caused the failure of such

[235] Easterbrook, Fishel, *supra* note 7, at 283.

institutions in close firms. First reason is the close relationship between ownership and control in close firms. Second reason is the absence of liquid capital markets in the equity of close firms.

These two reasons necessitate the contractual adjustment of each of the pillars of corporate governance. The degree of such adjustment will depend on whether such close firm is a strategic partnership or a private equity close firm.

The important distinction of a strategic joint venture is that all inventors in such a close firm will typically participate equally in the business and the financing of the firm. Accordingly, the key issue in structuring such relationship is to set out the detailed operation provisions, which will ensure coherent participation of the investors in the day-to-day operative management of close firms. Parties will usually rely on the periodic revenues generated by strategic ventures to recoup their investment.

This relationship can be contracted with the conflicts which arise in private equity close firms, where the financing partner will not usually get involved into the operation management of the firm, but will prefer to have a clear exit scenario, which will generate major revenues from the investment. This overall objective will determine the brunt of the corporate governance regulation in private equity close firms, which will be shifted from the extensive regulation of the operative management of the firm to the preservation of equity value. Therefore, extensive provisions related to the adjustment of equity and regulation of exit rights become critical in private equity close firms.

Corporate governance in public firms is akin to buying a suit in the mall: it is good, but average, because the model shall fit all. Corporate governance in close firms requires a bespoke approach and a skilful tailor. This takes time, efforts and monies, but ultimately

---

[236] Barrett v. King, 181 Mass. 476, 478, 63 N.E. 934, 935 (1902) cited from Cataldo, at 230.

permits to create unique relationship meeting the commercial needs of the particular parties. It is the end of general corporate regulation indeed!