HOW TO EFFECTIVELY DEAL WITH MINORITY SHAREHOLDERS: SOME PRACTICE POINTERS AND RECENT DEVELOPMENTS

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I. INTRODUCTION

Minority shareholders, or shareholders who own less than 50% of the outstanding voting interests of a company, are typically shareholders of companies backed by venture capital and are often a key source of venture capital funding, particularly in the early stages of venture capital transactions. Although venture capital funding has generally declined in the United States during 2016, with approximately $39 billion invested during the first three quarters of 2016 as compared to approximately $48 billion invested during the relative period in 2015,[1] the U.S. venture capital market is expected to rebound at the end of 2016 or in early 2017.[2] When seeking out minority shareholders to invest in VC-backed companies, majority shareholders should carefully consider a number of important protections and exit strategies commonly associated with minority investments.

II. HOW TO DEAL WITH MINORITY SHAREHOLDER INVESTMENTS

One of the best ways to deal with minority investments as a majority shareholder is to negotiate contractual protections at the outset of the relationship to minimize any future issues that may arise. Drag-along rights and powers of attorney are two common contractual protections that majority shareholders use to allow flexibility and control over future transactions that may involve minority shareholders.

A. Drag-Along Rights

Drag-along rights generally allow majority shareholders to sell their ownership interests to a third party and to force (or "drag") the minority shareholders to join in the sale and sell all or a percentage of their ownership interests to the third party for the same price and on substantially the same terms. By agreeing to a drag-along provision at the time of a minority shareholder's investment, majority shareholders avoid the need to effect a squeeze-out merger (described in more detail below) if they desire to sell the company at a later date.

Below is an example of a majority-shareholder-friendly drag-along provision:[3]

1. Drag-Along Right.

1.1 Definitions. A "**Sale of the Company**" shall mean either: (a) a transaction or series of related transactions in which a Person, or a group of related Persons, acquires from stockholders of the Company shares representing more than fifty percent (50%) of the outstanding voting power of the Company (a "**Stock Sale**"); or (b) a transaction that qualifies as a "**Deemed Liquidation Event**" as defined in the certificate of formation of the Company.

1.2 Actions to be Taken. In the event that (i) the holders of at least a majority of the shares of Common Stock then issued or issuable upon conversion of the shares of Series A Preferred Stock (the "**Selling Investors**") approve a Sale of the Company in writing, specifying that this Section 1 shall apply to such transaction, then each Stockholder and the Company hereby agree:

(a) if such transaction requires stockholder approval, with respect to all Shares that such Stockholder owns or over which such Stockholder otherwise exercises voting power, to vote (in person, by proxy or by action by written consent, as applicable) all Shares in favor of, and adopt, such Sale of the Company (together with any related amendment to the certificate of formation of the Company required in order to implement such Sale of the Company) and to vote in opposition to any and all other proposals that could reasonably be expected to delay or impair the ability of the Company to consummate such Sale of the Company;

(b) if such transaction is a Stock Sale, to sell the same proportion of shares of capital stock of the Company beneficially held by such Stockholder as is being sold by the Selling Investors to the Person to whom the Selling Investors propose to sell their Shares, and, except as permitted in Section 1(c) below, on the same terms and conditions as the Selling Investors;

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[1] PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report Q3 2016, Data: Thomson Reuters, 2, http://www.pwc.com/us/en/technology/assets/pwc-national-moneytree-q3-2016-summary-report.pdf.

[2] KMPG Enterprise and CB Insights, Venture Pulse Q3 Report (October 13, 2016), 38, https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/10/venture-pulse-q3-2016-report.pdf.

[3] This provision tracks the form of drag-along provision suggested in the MODEL VOTING AGREEMENT OF THE NATIONAL VENTURE CAPITAL ASSOCIATION (rev. March 2014), *available at* http://nvca.org/resources/model-legal-documents/.

(c) to execute and deliver all related documentation and take such other action in support of the Sale of the Company as shall reasonably be requested by the Company or the Selling Investors in order to carry out the terms and provision of this Section 1, including, without limitation, executing and delivering instruments of conveyance and transfer, and any purchase agreement, merger agreement, indemnity agreement, escrow agreement, consent, waiver, governmental filing, share certificates duly endorsed for transfer (free and clear of impermissible liens, claims and encumbrances), and any similar or related documents;

(d) not to deposit, and to cause their Affiliates not to deposit, except as provided in this Agreement, any Shares of the Company owned by such party or Affiliate in a voting trust or subject any Shares to any arrangement or agreement with respect to the voting of such Shares, unless specifically requested to do so by the acquiror in connection with the Sale of the Company;

(e) to refrain from exercising any dissenters' rights or rights of appraisal under applicable law at any time with respect to such Sale of the Company;

(f) if the consideration to be paid in exchange for the Shares pursuant to this Section 1 includes any securities and due receipt thereof by any Stockholder would require under applicable law (i) the registration or qualification of such securities or of any person as a broker or dealer or agent with respect to such securities; or (ii) the provision to any Stockholder of any information other than such information as a prudent issuer would generally furnish in an offering made solely to "accredited investors" as defined in Regulation D promulgated under the Securities Act, the Company may cause to be paid to any such Stockholder in lieu thereof, against surrender of the Shares which would have otherwise been sold by such Stockholder, an amount in cash equal to the fair value (as determined in good faith by the Company) of the securities which such Stockholder would otherwise receive as of the date of the issuance of such securities in exchange for the Shares; and

(g) in the event that the Selling Investors, in connection with such Sale of the Company, appoint a stockholder representative (the "**Stockholder Representative**") with respect to matters affecting the Stockholders under the applicable definitive transaction agreements following consummation of such Sale of the Company, (x) to consent to (i) the appointment of such Stockholder Representative, (ii) the establishment of any applicable escrow, expense or similar fund in connection with any indemnification or similar obligations, and (iii) the payment of such Stockholder's pro rata portion (from the applicable escrow or expense fund or otherwise) of any and all reasonable fees and expenses to such Stockholder Representative in connection with such Stockholder Representative's services and duties in connection with such Sale of the Company and its related service as the representative of the Stockholders, and (y) not to assert any claim or commence any suit against the Stockholder Representative or any other Stockholder with respect to any action or inaction taken or failed to be taken by the Stockholder Representative in connection with its service as the Stockholder Representative, absent fraud or willful misconduct.

If provided with a drag-along provision that is similar to the foregoing, minority shareholders may seek to include one or more of the following protections:

- A lock-up period (i.e., a period of time after the execution of the agreement during which the majority shareholders may not sell their ownership interests to third parties);
- A higher shareholder approval threshold to trigger the drag-along provision (e.g., approval by shareholders owning 75% of the ownership interests of the company vs. shareholders owning 51%);
- Limit the types of transactions that trigger the drag-along provision (e.g., a sale of equity interests vs. a merger or sale of all or substantially all assets);
- Require a bona fide third party buyer to trigger the drag-along provision (vs. an affiliate of a majority shareholder);
- Require the execution of a definitive agreement to trigger the drag-along provision (vs. a bona fide offer);
- A minimum purchase price (e.g., a price per share greater than 1.5 times the liquidation preference) or rate of return (e.g., an internal rate of return of at least 10%) to trigger the drag-along provision;
- A required form of consideration (e.g., cash or marketable securities); and

- Limitations to the representations, warranties and covenants they are required to make in the definitive acquisition agreement (e.g., "several" and not joint liability, limitation on liability to an amount not in excess of the cash the shareholders receive in the sale, no non-competition or non-solicitation covenants, no out-of-pocket expenses).

When exercising their rights under a drag-along provision, majority shareholders should be careful to strictly comply with the terms of the drag-along provision. In *Halpin et al. v. Riverstone National, Inc.*, C.A. No. 9796–VCG, 2015 WL 854724 (Del. Ch. Feb. 26, 2015), a company sought specific performance of a drag-along provision in the shareholders' agreement that required minority shareholders to tender and/or vote their shares in favor of certain change-of-control transactions proposed by the majority shareholders. The Delaware Court of Chancery held that the drag-along provision did not apply since the majority shareholders had not complied strictly with its terms when exercising their rights thereunder (i.e., they did not provide advance notice of the drag-along transaction or utilize a proxy to vote the minority shareholders' shares). [4] Following *Halpin*, majority shareholders should ensure that they strictly comply with all procedural and other requirements of a drag-along provision (including provision of timely notice and use of a proxy, if available) and that all such requirements are specific and clear when drafted.

Majority shareholders should also ensure that the drag-along provision does not conflict with any other provision in the relevant governing document relating to the types of transactions covered by the drag-along provision, such as provisions regarding consent/voting rights, general transfer restrictions, rights of first refusal and rights of first offer, by adding appropriate exceptions and/or making it clear that the drag-along provision supersedes any provision in the governing document to the contrary.

B. Irrevocable Power of Attorney

An irrevocable power of attorney or proxy signed by the minority shareholders at the time of their initial investment can be a very useful weapon in the event that a minority shareholder in connection with a future transaction refuses to comply with a drag-along provision, potentially allowing the majority shareholders to sell the company without obtaining the minority shareholder's signature. A power of attorney typically grants majority shareholders the ability to sign any documentation and transfer title to ownership interests on behalf of minority shareholders to implement the drag-along provision. As there can be enforceability issues around such power of attorneys and in order to enhance its enforceability, it is advisable to have the power of attorney executed as an instrument separate from the investor rights or similar agreement containing drag-along and other investor rights provisions. The separate power of attorney should include supporting provisions like opportunity to consult with own counsel, understands that the power of attorney is an integral and important part of the agreement, etc.

Similarly, in situations where follow-on financings are contemplated, such as early-stage investments, a power of attorney may be utilized to grant majority shareholders the power to vote all ownership interests and execute any documents on behalf of the minority shareholders in connection with any such financings. This type of power of attorney helps majority shareholders avoid the potential issue of minority shareholders delaying follow-on financings.

III. COMMON WAYS TO GET RID OF MINORITY SHAREHOLDERS

Once minority shareholders have obtained their ownership interests in a company, conflicts of interest, a rough economy or a new business direction, among other reasons, may lead majority shareholders to wish for the minority shareholders to surrender their ownership interests and terminate their relationship with the company. If drag-along rights in connection with a sale are not available, majority shareholders should consider the following methods for forcing out minority shareholders and the risks associated with such methods.

A. Dilution

One way for majority shareholders to force out minority shareholders is to dilute the minority shareholders' ownership interests. Majority shareholders may dilute minority shareholder's ownership interests by issuing new ownership interests in the company, making distributions, effecting stock splits or reverse stock splits, or carrying out a merger, consolidation, reclassification or other reorganization of the company. Since majority shareholders control the board, they typically have the power to cause the board to approve such issuances and transactions at a price that may be lower than the price paid by the existing minority shareholders. Dilution not only reduces the profits of the minority shareholders, but may also result in a loss of board seats, voting rights, information rights and any other ancillary rights of minority shareholders that may be tied to a certain percentage ownership in the company.

[4] *Halpin et al. v. Riverstone National, Inc.*, C.A. No. 9796–VCG, 2015 WL 854724, at *9 (Del. Ch. Feb. 26, 2015).

B. Reverse Stock Splits

Majority shareholders may also pursue a reverse stock split to force out minority shareholders. To effect a reverse stock split, a company typically amends its charter to decrease the number of authorized shares and replaces a certain number of shares with one whole share of stock (for instance, in a 1-for-100 reverse stock split, 100 shares are split into one share of stock).[5] Although a reverse stock split does not impact the respective ownership percentages of a company's shareholders, it often results in the minority shareholders holding less than one whole share of stock. The company may then take advantage of statutory mechanisms that allow the company to cash out the minority shareholders at the fair value of their fractional shares.[6]

C. "Squeeze-Out" Mergers

A "squeeze out" merger is another common method that majority shareholders use to force minority shareholders to sell their ownership interests in a company. In a squeeze-out merger, the majority shareholders adopt a plan of merger, merging the company with and into a newly-formed or pre-existing entity and basically forcing minority shareholders to sell their ownership interests for cash as part of the merger.

1. Short-Form Merger

Many states, including Texas and Delaware, have adopted statutory mechanisms whereby a parent company may merge with and into a wholly-owned (or substantially owned) subsidiary, with the parent company continuing as the surviving company in the merger.[7] This form of merger, which is commonly referred to as a "short-form merger" or a parent-subsidiary merger, may occur without the approval of the shareholders of the subsidiary, requiring only the approval of the board of directors of the parent company. To carry out this type of merger, majority shareholders typically form a new entity to serve as the parent company with the majority shareholders as the only shareholders. The majority shareholders then merge the company with the minority shareholders with and into the new entity without obtaining the minority shareholders' consent, assuming that the majority shareholders meet the required ownership threshold under the applicable statute.

2. Long-Form Merger

Where majority shareholders do not own all or substantially all of the outstanding ownership interests in a company, or the company was not formed in a state that permits short-form mergers, majority shareholders may pursue a traditional "long-form" merger whereby the company merges with and into a newly-formed or pre-existing entity owned by the majority shareholders, with the company continuing as the surviving company in the merger. In addition to the approval of the board of directors of the company, this form of merger requires the approval of the shareholders of the company. Whether the approval of all or a portion of the minority shareholders is required in order for such shareholder approval to be obtained depends on the voting rights of the minority shareholders under the governing documents of the company. In cases where a certain percentage of minority shareholder approval is required, majority shareholders often chase the minority shareholders holding the largest percentage interests, the minority shareholders who are part of the management team and/or the minority shareholders that are affiliates in order to reach the required percentage.

3. Appraisal Rights

Generally, minority shareholders are entitled to dissent from a squeeze-out merger and seek appraisal of their shares if they comply with certain statutory procedures and do not vote in favor of the merger.[8] The appraisal process helps ensure that minority shareholders receive a fair cash value for any shares that they are forced to sell. In Texas, the right of a minority shareholder to dissent from a squeeze-out merger and obtain the fair value of its shares is the exclusive remedy for recovery with respect to the squeeze-out merger, except in the case of fraud.[9] In Delaware, appraisal is the exclusive remedy for recovery with respect to short-form squeeze-out mergers, except in the case of fraud or illegality.[10]

Majority shareholders may attempt to obtain a waiver of appraisal rights (also commonly known as dissenter's rights) from minority shareholders in connection with a squeeze-out merger. A common way to do so is to ensure that the definition of a "sale" of the company in the drag-along provision covers a squeeze-out merger and that the drag-along provision includes covenants requiring minority shareholders to vote in favor of the merger and take all actions to

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[5] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. §21.364(d) (2016); DEL. CODE ANN. tit. 8, §242 (2016).
[6] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. §21.163 (2016); DEL. CODE ANN. tit. 8, §155 (2016).
[7] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. §10.006 (2016); DEL. CODE ANN. tit. 8, §253(a) (2016).
[8] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. §§10.351, 10.354 (2016); DEL. CODE ANN. tit. 8, §262 (2016).
[9] *See* TEX. BUS. ORGS. CODE ANN. §10.368 (2016).
[10] *See Glassman v. Unocal Exploration Co.*, 777 A.2d 242, 248 (Del. 2002).

waive any dissenters' rights that they may have in connection with the merger.

Prior to seeking to obtain prospective contractual waivers of appraisal rights, majority shareholders should consider the enforceability of such waivers, which were recently called into question under Delaware law. In *Halpin*, the minority shareholders of the company demanded appraisal of their shares of common stock despite the drag-along provision in the stockholders' agreement that required them to tender and/or vote their shares in favor of the merger (and, by extension, waive their appraisal rights).[11] The minority stockholders argued, among other things, that a common stockholder cannot contractually waive appraisal rights in advance.[12] Since, as mentioned above, the court held that the drag-along provision did not apply, the court did not address this argument. [13] Therefore, the issue of whether common stockholders may prospectively contractually waive appraisal rights was left open.

However, the court in *Halpin* acknowledged that holders of preferred stock can contractually waive their appraisal rights since the rights of preferred stockholders are largely contractual.[14] Thus, following *Halpin*, majority shareholders should consider whether to issue preferred stock instead of common stock to minority shareholders if an advance waiver of appraisal rights is important to the majority shareholders. The rights of members of limited liability companies and limited partners of partnerships are also largely contractual and, under Texas and Delaware law, members and limited partners are not entitled to statutory appraisal rights.[15] As such, majority shareholders may avoid appraisal rights issues by structuring the company as a limited liability company or partnership or issuing preferred stock instead of common stock to minority shareholders.

D. Shareholder Oppression

While majority shareholders are typically permitted to dilute minority shareholders' ownership interests and statutorily "squeeze-out" minority shareholders, case law in most states prohibits majority shareholders from engaging in "oppressive" conduct when doing so. Where minority shareholders can establish oppressive conduct in these states, various equitable remedies, such as court-ordered buyouts at fair value or dissolution of the company, may be available in addition to monetary damages.

1. Texas Shareholder Oppression Law

Texas case law has historically acknowledged the shareholder oppression doctrine. *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied), was the leading case on shareholder oppression in Texas up until 2014. In *Davis*, a minority shareholder of a Texas corporation alleged that the majority shareholder engaged in oppressive conduct toward the minority shareholder by refusing to recognize his ownership in the corporation and denying him certain rights associated with such ownership.[16] The court considered the definition of "oppressive conduct" under Texas law and in other jurisdictions, citing (i) a New York court's definition of oppressive conduct as conduct that "substantially defeats the expectations that objectively viewed were both reasonable under the circumstances and were central to the minority shareholder's decision to join the venture" (commonly known as the "reasonable expectations" test) and (ii) an Oregon court's definitions of oppressive conduct as "'burdensome, harsh and wrongful conduct,' 'a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members,' or 'a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely'"[17] (commonly known as the "fair dealing" test). Applying these definitions to the facts of the case, the court held that the majority shareholders had engaged in oppressive conduct and that a court-ordered buy-out was an appropriate equitable remedy.[18] Following *Davis*, Texas courts continued to apply the "fair dealing" and "reasonable expectations" tests to shareholder oppression cases up until 2014.[19]

On June 20, 2014, in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), the Texas Supreme Court issued a landmark opinion limiting the rights of minority shareholders to recover for shareholder oppression. In

[11] *Halpin et al. v. Riverstone National, Inc.*, C.A. No. 9796–VCG, 2015 WL 854724, at *4 (Del. Ch. Feb. 26, 2015).
[12] *Id.* at *5.
[13] *Id.* at *8.
[14] *Id.* at *1.
[15] *See* TEX. BUS. ORGS. CODE ANN. §10.351 (2016); DEL. CODE ANN. tit. 6, §§15-120, 18-210 (2016).

[16] *Davis v. Sheerin*, 754 S.W.2d 375, 377-378 (Tex. App.—Houston [1st Dist.] 1988, writ denied).
[17] *Id*. at 381-82.
[18] *Id*. at 383.
[19] *See, e.g., Kohannim v. Katoli*, 440 S.W.3d 798 (Tex.App.–El Paso 2013, pet. denied); *Boehringer v. Konkel*, 404 S.W.3d 18 (Tex.App.–Houston [1st Dist.] 2013, no pet.); *Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex.App.-Tyler 2006, pet. denied); *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 699-701 (Tex.App.-Fort Worth 2006, pet. denied); *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188, 196 (Tex.App.-Texarkana 2003, no pet.); *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex.App.-Houston [1st Dist.] 1999, pet. denied).

Ritchie, a minority shareholder of a Texas closely-held corporation alleged that the majority shareholders engaged in oppressive conduct by refusing to buy her shares or meet with prospective purchasers of her shares.[20] After considering the meaning of "oppressive" under the Texas receivership statue and Texas case law, the court rejected the application of the "fair dealing" and "reasonable expectations" tests and concluded that the more stringent business judgement rule is the proper standard for shareholder oppression cases.[21] Applying the business judgement rule to the facts of the case, the court held that the majority shareholders' conduct did not constitute "oppressive" conduct.[22] The court also held that the Texas receivership statute did not authorize a court-ordered buyout as an equitable remedy, since a rehabilitative receiver was the only authorized statutory remedy for shareholder oppression.[23] Finally, the court declined to "recognize or create a Texas common law cause of action for 'minority oppression.'"[24] As a result of *Ritchie*, the ability of minority shareholders of Texas corporations to recover for oppressive actions by majority shareholders diminished significantly.

2. Delaware Shareholder Oppression Law

There is a split of authority in Delaware regarding the shareholder oppression doctrine. Delaware does not have a shareholder oppression statute, leaving shareholder oppression entirely to case law. In *Litle v. Waters*, No. 12155, 1992 WL 25758 (Del. Ch. Feb. 11, 1992), the Delaware Court of Chancery considered a claim of shareholder oppression where the minority stockholder alleged that a director's failure to declare dividends constituted a "gross and oppressive abuse of discretion." Since few Delaware cases had addressed oppressive conduct, the court cited a New York court's definition of oppressive conduct as "a violation of the 'reasonable expectations' of the minority" and "burdensome, harsh and wrongful conduct."[25] Applying this definition to the facts of the case, the court held that the minority stockholder's allegations were sufficient to state a claim for shareholder oppression.[26]

A year later in *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993), the Delaware Supreme Court considered claims of breaches of fiduciary duty where minority stockholders alleged that the majority stockholders (i) attempted to force the minority stockholders to sell their shares at a discount by embarking on a scheme to pay negligible dividends, (ii) breached their fiduciary duties by authorizing excessive compensation for themselves and other employees of the company, and (iii) breached their fiduciary duties by pursuing a discriminatory liquidity policy that favored employee stockholders over non-employee stockholders. The court considered whether there should be special, judicially-created rules to "protect" minority stockholders of closely-held corporations, but determined that such rules would be inappropriate, noting that minority stockholders have the opportunity to bargain contractually for protection.[27] Instead, the court held that "the entire fairness test…is the proper judicial approach," shifting the burden to the majority stockholders to establish the entire fairness of their dealings with the minority stockholders.[28] While *Nixon* is often the primary support for the argument that Delaware does not recognize the shareholder oppression doctrine, the court did not expressly consider or reject shareholder oppression claims. Therefore, the question of whether minority stockholders can bring a claim for shareholder oppression in Delaware remains unsettled.

E. Breach of Fiduciary Duty

Even if minority shareholders do not have a cause of action for shareholder oppression, they may still pursue a common law cause of action against majority shareholders for breach of fiduciary duty under Texas and Delaware law.

1. Texas Fiduciary Duties

While majority shareholders generally do not owe minority shareholders formal fiduciary duties under Texas law, informal fiduciary duties may arise where a moral, social, domestic or purely personal relationship of trust and confidence exists between shareholders.[29] To mitigate this risk, majority shareholders may enter into a shareholders' agreement with minority shareholders to limit or waive any fiduciary duties that may arise if such limitation or waiver would be permissible in the partnership context and is not contrary to public policy.[30]

2. Delaware Fiduciary Duties

Under Delaware law, a stockholder owes a fiduciary duty to other stockholders only if the stockholder owns a majority interest in or exercises

[20] *Ritchie v. Rupe*, 443 S.W.3d 856, 861-62.
[21] *Id.* at 863-72.
[22] *Id.* at 871.
[23] *Id.* at 872.
[24] *Id.* at 878.
[25] *Litle v. Waters*, No. 12155, 1992 WL 25758, at *7-9 (Del. Ch. Feb. 11, 1992) (citing *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1018-19 (N.Y. Sup. 1984).
[26] *Id.* at *9 (Del. Ch. Feb. 11, 1992).
[27] *Nixon v. Blackwell*, 626 A.2d 1366, 1379 (Del. 1993).
[28] *Id.* at 1381.
[29] *See Ritchie v. Rupe*, 443 S.W.3d 856, 874.
[30] *See* TEX. BUS. ORGS. CODE ANN. §21.101(a)(11) (2016).

control over the business affairs of the corporation.[31] In a claim of breach of fiduciary duty, the majority or controlling stockholder standing on both sides of a transaction, such as in a squeeze-out merger, bears the burden of proving its entire fairness.[32] However, majority stockholders may shift the burden of proof to the minority stockholders by having an independent special committee or an informed majority of the minority stockholders approve the transaction.[33] Majority stockholders may also obtain a fairness opinion or engage an independent financial advisor to further support the fairness of a transaction.[34]

IV. HOW TO PROTECT YOURSELF AS A MINORITY SHAREHOLDER

Since minority shareholders in private companies typically have limited or no ability to influence the business and affairs of a company and cannot easily sell their shares, minority shareholders are at risk of being taken advantage of by majority shareholders. As such, minority shareholders typically request certain protections when negotiating their investment in a company, including, without limitation, the protections described below.

A. Board Seat

Board seats permit minority shareholders to have some influence over the business and affairs of a company. While minority shareholders typically will not be able to exercise any control over the board, board seats enable them to vote on important company decisions and stay abreast of developments. To make board seats even more valuable, minority shareholders may negotiate for super majority voting or veto rights relating to key matters that may materially and adversely affect minority shareholders, such as a sale of the company or issuance of new ownership interests, to be unanimous. They may also request regular board meetings (e.g., monthly or quarterly) to ensure that they are kept informed on company matters.

The number of board seats allocated to a minority shareholder typically corresponds with the minority shareholder's percentage interest in the company, particularly in early-stage investments. Majority shareholders often require that a board seat held by a minority shareholder fall away if the minority shareholder's ownership interest decreases below a specified percentage (usually between 10-25%, depending on negotiation leverage). A minority shareholder's board seat may also be tied to an employment agreement with the company and fall away upon termination of employment.

If minority shareholders are not successful in negotiating board seats, they may request board observer rights enabling them to attend and participate in all board meetings in a nonvoting capacity. Board observer rights, like board seats, are typically tied to the minority shareholder's percentage interest in the company and/or employment with the company. Minority shareholders with board observer rights should be required to keep information provided at or in connection with board meetings confidential pursuant to confidentiality agreements or other binding agreements since minority shareholders do not have fiduciary duties like directors.

B. Tag-Along Rights

Tag-along rights (also commonly known as "co-sale rights") generally allow minority shareholders to join in on the sale of a majority shareholder's ownership interests in the company to a third party on a pro rata basis at the same price and on substantially the same terms as the majority shareholder. In addition to helping protect the value of a minority shareholder's investment, tag-along rights allow minority shareholders to take advantage of a majority shareholder's bargaining power with a third-party buyer and potentially sell their ownership interests in the company for a higher price than they may be able to negotiate on their own. Since majority shareholders are often institutional investors that intend to sell their ownership interests in the company after they realize a return on their investment, there is a fairly high likelihood that tag-along rights will come into play.

Majority shareholders generally do not find tag-along rights objectionable, as such provisions are standard and many buyers prefer to buy the entire business. However, majority shareholders typically include certain customary exceptions, such as sales to permitted transferees, pursuant to a board-approved transaction, to employees pursuant to an employee bonus or incentive plan or in a public or private offering. Majority shareholders may also try to limit tag-along rights to certain key minority shareholders instead of granting such rights to all shareholders.

Below is a sample of a typical tag-along/co-sale provision:[35]

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[31] *Ivanhoe Partners v. Newmont Min. Corp.*, 535 A.2d 1334, 1344 (Del. 1987).

[32] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

[33] *See Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985); *Kahn v. Lynch Communication Systems*, 638 A. 2d 1110, 1117 (Del. 1994).

[34] *See In re Cysive, Inc. Shareholders Litigation*, 836 A. 2d 531, 545 and 554-558 (Del. Ch. 2003).

[35] This provision is based on the form of co-sale provision suggested in the MODEL RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT OF THE NATIONAL VENTURE CAPITAL

1. Right of Co-Sale.

   (a) Exercise of Right. If any shares of Capital Stock owned by a Key Holder, or issued to a Key Holder after the date hereof (including, without limitation, in connection with any stock split, stock dividend, recapitalization, reorganization, or the like), but not including any shares of Preferred Stock or of Common Stock that are issued or issuable upon conversion of Preferred Stock ("**Transfer Stock**"), are to be sold to a Prospective Transferee, each respective Investor may elect to exercise its right, but not obligation, to participate on a pro rata basis in the assignment, sale, offer to sell, pledge, mortgage, hypothecation, encumbrance, disposition of or any other like transfer or encumbering of the Transfer Stock (or any interest therein) proposed by the Key Holder (the "**Proposed Key Holder Transfer**") as set forth in Subsection 1(b) below and, subject to Subsection 1(d), on the same terms and conditions specified in the written notice from a Key Holder setting forth the terms and conditions of a Proposed Key Holder Transfer (the "**Proposed Transfer Notice**"). Each Investor who desires to exercise its Right of Co-Sale (each, a "**Participating Investor**") must give the selling Key Holder written notice to that effect within fifteen (15) days after the deadline for delivery of the Proposed Transfer Notice described above, and upon giving such notice such Participating Investor shall be deemed to have effectively exercised the Right of Co-Sale.

   (b) Shares Includable. Each Participating Investor may include in the Proposed Key Holder Transfer all or any part of such Participating Investor's Capital Stock equal to the product obtained by multiplying (i) the aggregate number of shares of Transfer Stock subject to the Proposed Key Holder Transfer by (ii) a fraction, the numerator of which is the number of shares of Capital Stock owned by such Participating Investor immediately before consummation of the Proposed Key Holder Transfer and the denominator of which is the total number of shares of Capital Stock owned, in the aggregate, by all Participating Investors immediately prior to the consummation of the Proposed Key Holder Transfer, plus the number of shares of Transfer Stock held by the selling Key Holder.

   (c) Purchase and Sale Agreement. The Participating Investors and the selling Key Holder agree that the terms and conditions of any Proposed Key Holder Transfer in accordance with this Section 1 will be memorialized in, and governed by, a written purchase and sale agreement with the Prospective Transferee (the "**Purchase and Sale Agreement**") with customary terms and provisions for such a transaction, and the Participating Investors and the selling Key Holder further covenant and agree to enter into such Purchase and Sale Agreement as a condition precedent to any sale or other transfer in accordance with this Section 1.

   (d) Allocation of Consideration.

      (i) Subject to Section 1(d)(ii), the aggregate consideration payable to the Participating Investors and the selling Key Holder shall be allocated based on the number of shares of Capital Stock sold to the Prospective Transferee by each Participating Investor and the selling Key Holder as provided in Section 1(b), provided that if a Participating Investor wishes to sell Preferred Stock, the price set forth in the Proposed Transfer Notice shall be appropriately adjusted based on the conversion ratio of the Preferred Stock into Common Stock.

      (ii) In the event that the Proposed Key Holder Transfer constitutes a transaction or series of related transactions in which a person, or a group of related persons, acquires from stockholders of the Company shares representing more than fifty percent (50%) of the outstanding voting power of the Company (a "**Change of Control**"), the terms of the Purchase and Sale Agreement shall provide that the aggregate consideration from such transfer shall be allocated to the Participating Investors and the selling Key Holder in accordance with the Restated Certificate as if (A) such transfer were a Deemed Liquidation Event (as defined in the Restated Certificate), and (B) the Capital Stock sold in accordance with the Purchase and Sale Agreement were the only Capital Stock outstanding.

ASSOCIATION (rev. August 2013), *available at* http://nvca.org/resources/model-legal-documents/.

(e) Purchase by Selling Key Holder; Deliveries. Notwithstanding Section 1(c) above, if any Prospective Transferee or Transferees refuse(s) to purchase securities subject to the Right of Co-Sale from any Participating Investor or Investors or upon the failure to negotiate in good faith a Purchase and Sale Agreement reasonably satisfactory to the Participating Investors, no Key Holder may sell any Transfer Stock to such Prospective Transferee or Transferees unless and until, simultaneously with such sale, such Key Holder purchases all securities subject to the Right of Co-Sale from such Participating Investor or Investors on the same terms and conditions (including the proposed purchase price) as set forth in the Proposed Transfer Notice and as provided in Section 1 (d)(i); provided, however, if such sale constitutes a Change of Control, the portion of the aggregate consideration paid by the selling Key Holder to such Participating Investor or Investors shall be made in accordance with the first sentence of Section 1(d)(ii). In connection with such purchase by the selling Key Holder, such Participating Investor or Investors shall deliver to the selling Key Holder any stock certificate or certificates, properly endorsed for transfer, representing the Capital Stock being purchased by the selling Key Holder (or request that the Company effect such transfer in the name of the selling Key Holder). Any such shares transferred to the selling Key Holder will be transferred to the Prospective Transferee against payment therefor in consummation of the sale of the Transfer Stock pursuant to the terms and conditions specified in the Proposed Transfer Notice, and the selling Key Holder shall concurrently therewith remit or direct payment to each such Participating Investor the portion of the aggregate consideration to which each such Participating Investor is entitled by reason of its participation in such sale as provided in this Section 1(e).

(f) Additional Compliance. If any Proposed Key Holder Transfer is not consummated within forty-five (45) days after receipt of the Proposed Transfer Notice by the Company, the Key Holder proposing the Proposed Key Holder Transfer may not sell any Transfer Stock unless it first complies in full with each provision of this Section 1. The exercise or election not to exercise any right by any Investor hereunder shall not adversely affect its right to participate in any other sales of Transfer Stock subject to this Section 1.

C. Right of First Refusal

To the extent that majority shareholders are entitled to sell or transfer all or a portion of their ownership interest to a third party, minority shareholders may request a right of first refusal to purchase such ownership interests at the same price and on substantially the same terms as offered by the third party in a bona fide third party offer, subject to customary exceptions. The company itself typically has the first opportunity to exercise a right of first refusal, followed by the minority shareholders if the company does not exercise this right. If there are multiple minority shareholders and a minority shareholder exercises its right of first refusal, the minority shareholder may only purchase its pro rata share of the offered ownership interests. If any minority shareholder elects not to exercise its right of first refusal, the other majority shareholders usually have the right to purchase the ownership interests that such minority shareholder elected not to purchase on a pro rata basis. The majority shareholders may typically sell any ownership interests subject to rights of first refusal that are not purchased by the company or by the minority shareholders within a specified period of time (e.g., 60 days) to the third party.

One advantage of a right of first refusal for minority shareholders is that it provides them with the chance to increase their ownership interests in the company and potentially avoid dilution. Majority shareholders may resist rights of first refusal since any exercise of such rights by minority shareholders causes delays in stock sales. Rights of first refusal could also cause institutional investors to reconsider investing in a company. To mitigate the risk of delays and interference with third-party sales, majority shareholders may require minority shareholders to purchase all (and not just a portion) of the offered ownership interests subject to a right of first refusal. They may also request to exclude certain types of transfers from the scope of the right-of-first refusal provision, such as sales of small amounts of ownership interests and transfers for estate planning and tax purposes.

Below is a sample of a typical right-of-first-refusal provision:[36]

[36] This provision tracks the form of right-of-first-refusal provision suggested in the MODEL RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT OF THE NATIONAL VENTURE CAPITAL ASSOCIATION (rev. August 2013), *available at* http://nvca.org/resources/model-legal-documents/.

1. Right of First Refusal.

   (a) Grant. Each Key Holder hereby unconditionally and irrevocably grants to the Company the right, but not an obligation, of the Company, or its permitted transferees or assigns, to purchase some or all of the shares of Capital Stock owned by the Key Holder, or issued to the Key Holder after the date hereof (including, without limitation, in connection with any stock split, stock dividend, recapitalization, reorganization, or the like), but not including any shares of Preferred Stock or of Common Stock that are issued or issuable upon conversion of Preferred Stock (the "**Transfer Stock**") with respect to a Proposed Key Holder Transfer, on the terms and conditions specified in the Proposed Transfer Notice (a "**Right of First Refusal**") to purchase all or any portion of Transfer Stock that such Key Holder may propose to transfer in any assignment, sale, offer to sell, pledge, mortgage, hypothecation, encumbrance, disposition of or any other like transfer or encumbering of any Transfer Stock (or any interest therein) proposed by any of the Key Holders (a "**Proposed Key Holder Transfer**"), at the same price and on the same terms and conditions as those offered to the person to whom the Key Holder proposes to make a Proposed Key Holder Transfer (the "**Prospective Transferee**").

   (b) Notice. Each Key Holder proposing to make a Proposed Key Holder Transfer must deliver a written notice setting forth the terms and conditions of a Proposed Key Holder Transfer (a "**Proposed Transfer Notice**") to the Company and each Investor not later than forty-five (45) days prior to the consummation of such Proposed Key Holder Transfer. Such Proposed Transfer Notice shall contain the material terms and conditions (including price and form of consideration) of the Proposed Key Holder Transfer, the identity of the Prospective Transferee and the intended date of the Proposed Key Holder Transfer. To exercise its Right of First Refusal under this Section 1, the Company must deliver a Company Notice to the selling Key Holder within fifteen (15) days after delivery of the Proposed Transfer Notice.

   (c) Grant of Secondary Refusal Right to Investors. Each Key Holder hereby unconditionally and irrevocably grants to the Investors the right, but not an obligation, of each Investor to purchase up to its pro rata portion (based upon the total number of shares of Capital Stock then held by all Investors) of any Transfer Stock not purchased pursuant to the Right of First Refusal, on the terms and conditions specified in the Proposed Transfer Notice (a "**Secondary Refusal Right**") to purchase all or any portion of the Transfer Stock not purchased by the Company pursuant to the Right of First Refusal, as provided in this Subsection 1(c). If the Company does not intend to exercise its Right of First Refusal with respect to all Transfer Stock subject to a Proposed Key Holder Transfer, the Company must deliver a written notice from the Company notifying the Investors and the selling Key Holder that the Company does not intend to exercise its Right of First Refusal as to all shares of Transfer Stock with respect to any Proposed Key Holder Transfer (a "**Secondary Notice**") to the selling Key Holder and to each Investor to that effect no later than fifteen (15) days after the selling Key Holder delivers the Proposed Transfer Notice to the Company. To exercise its Secondary Refusal Right, an Investor must deliver an Investor Notice to the selling Key Holder and the Company within ten (10) days after the Company's deadline for its delivery of the Secondary Notice as provided in the preceding sentence.

   (d) Undersubscription of Transfer Stock. If options to purchase have been exercised by the Company and the Investors with respect to some but not all of the Transfer Stock by the end of the ten (10) day period specified in the last sentence of Subsection 1(c) (the "**Investor Notice Period**"), then the Company shall, immediately after the expiration of the Investor Notice Period, send written notice (the "**Company Undersubscription Notice**") to those Investors who fully exercised their Secondary Refusal Right within the Investor Notice Period (the "**Exercising Investors**"). Each Exercising Investor shall, subject to the provisions of this Subsection 1(d), have an additional option to purchase all or any part of the balance of any such remaining unsubscribed shares of Transfer Stock on the terms and conditions set forth in the Proposed Transfer Notice. To exercise such option, an Exercising Investor must deliver an Undersubscription Notice to the selling

> Key Holder and the Company within ten (10) days after the expiration of the Investor Notice Period. In the event there are two (2) or more such Exercising Investors that choose to exercise the last-mentioned option for a total number of remaining shares in excess of the number available, the remaining shares available for purchase under this Subsection 1(d) shall be allocated to such Exercising Investors pro rata based on the number of shares of Transfer Stock such Exercising Investors have elected to purchase pursuant to the Secondary Refusal Right (without giving effect to any shares of Transfer Stock that any such Exercising Investor has elected to purchase pursuant to the Company Undersubscription Notice). If the options to purchase the remaining shares are exercised in full by the Exercising Investors, the Company shall immediately notify all of the Exercising Investors and the selling Key Holder of that fact.

D. Pre-Emptive Rights

Pre-emptive rights (also commonly known as rights of first offer) entitle minority shareholders to purchase their pro rata share or more of future equity issuances (including securities convertible or exchangeable or exercisable for ordinary shares, such as options or warrants) by the company, subject to customary exceptions. In cases where the business is conducted through subsidiaries of the company, minority shareholders may request that pre-emptive rights extend to new equity issuances by the subsidiaries. Any ownership interests subject to pre-emptive rights that are not purchased by the minority shareholder typically may be issued within a specified period of time (e.g., 90 days) to another person on and subject to substantially the same terms and conditions and at the same price as those offered to the minority shareholders. Pre-emptive rights may be limited to certain key minority shareholders or available to all shareholders.

Common exceptions to pre-emptive rights include, without limitation, the following:

- Issuances of ownership interests to managers and employees who receive such ownership interests through an employee bonus or incentive plan (which may be capped at a specified percentage of the outstanding ownership interests of the company (e.g., 10%));
- Issuances of ownership interests to lenders or other financial institutions in connection with loan or leasing transactions;
- Shares issued in connection with an IPO; and
- Issuances of ownership interests in connection with an acquisition, merger, stock exchange or asset acquisition.

It is also becoming more common for companies to limit pre-emptive rights by including a "pay-to-play" provision that requires minority shareholders to purchase their pro rata share in a subsequent financing round or lose their right to participate in all future financing rounds.

Pre-emptive rights allow minority shareholders to maintain their ownership percentage and protect themselves from dilution when new ownership interests are issued. However, a minority shareholder may only take advantage of a pre-emptive right if it has sufficient funds to do so when the opportunity arises. Therefore, other protections against dilution, such as a veto right on future issuances, may be desirable.

Most states, including Texas and Delaware, provide for statutory pre-emptive rights, but such rights are usually only valid if provided for in the company's charter and/or may be waived even if the buyer pays the minority shareholder for the waiver.[37] Therefore, minority shareholders should not rely on statutory pre-emptive rights.

Below is a sample of a typical pre-emptive rights/right of first offer provision:[38]

> 1. Right of First Offer. Subject to the terms and conditions of this Section 1 and applicable securities laws, if the Company proposes to offer or sell any equity securities of the Company, whether or not currently authorized, as well as rights, options, or warrants to purchase such equity securities, or securities of any type whatsoever that are, or may become, convertible or exchangeable into or exercisable for such equity securities, which are to be issued by the Company primarily for capital raising purposes (collectively, "**New Securities**"), the Company shall first offer such New Securities to each Major Investor. A Major Investor shall be entitled to apportion the right of first offer hereby granted to it in such proportions as it deems appropriate, among (i) itself and (ii) its Affiliates.

[37] *See* TEX. BUS. ORGS. CODE ANN. §§21.203-21.205 (2016); DEL. CODE ANN. tit. 8, §102(b)(3) (2016).

[38] This provision tracks the form of right-of-first-offer provision suggested in the MODEL RIGHT OF INVESTORS' RIGHTS AGREEMENT OF THE NATIONAL VENTURE CAPITAL ASSOCIATION (rev. August 2013), *available at* http://nvca.org/resources/model-legal-documents/.

(a) The Company shall give notice (the "**Offer Notice**") to each Major Investor, stating (i) its bona fide intention to offer such New Securities, (ii) the number of such New Securities to be offered, and (iii) the price and terms, if any, upon which it proposes to offer such New Securities.

(b) By notification to the Company within twenty (20) days after the Offer Notice is given, each Major Investor may elect to purchase or otherwise acquire, at the price and on the terms specified in the Offer Notice, up to that portion of such New Securities which equals the proportion that the Common Stock then held by such Major Investor (including all shares of Common Stock then issuable (directly or indirectly) upon conversion and/or exercise, as applicable, of the Preferred Stock and any other Derivative Securities then held by such Major Investor) bears to the total Common Stock of the Company then outstanding (assuming full conversion and/or exercise, as applicable, of all Preferred Stock and other Derivative Securities). At the expiration of such twenty (20) day period, the Company shall promptly notify each Major Investor that elects to purchase or acquire all the shares available to it (each, a "**Fully Exercising Investor**") of any other Major Investor's failure to do likewise. During the ten (10) day period commencing after the Company has given such notice, each Fully Exercising Investor may, by giving notice to the Company, elect to purchase or acquire, in addition to the number of shares specified above, up to that portion of the New Securities for which Major Investors were entitled to subscribe but that were not subscribed for by the Major Investors which is equal to the proportion that the Common Stock issued and held, or issuable (directly or indirectly) upon conversion and/or exercise, as applicable, of Preferred Stock and any other Derivative Securities then held, by such Fully Exercising Investor bears to the Common Stock issued and held, or issuable (directly or indirectly) upon conversion and/or exercise, as applicable, of the Preferred Stock and any other Derivative Securities then held, by all Fully Exercising Investors who wish to purchase such unsubscribed shares. The closing of any sale pursuant to this Section 1(b) shall occur within the later of ninety (90) days of the date that the Offer Notice is given and the date of initial sale of New Securities pursuant to Section 1(c).

(c) If all New Securities referred to in the Offer Notice are not elected to be purchased or acquired as provided in Section 1(b), the Company may, during the ninety (90) day period following the expiration of the periods provided in Section 1(b), offer and sell the remaining unsubscribed portion of such New Securities to any Person or Persons at a price not less than, and upon terms no more favorable to the offeree than, those specified in the Offer Notice. If the Company does not enter into an agreement for the sale of the New Securities within such period, or if such agreement is not consummated within thirty (30) days of the execution thereof, the right provided hereunder shall be deemed to be revived and such New Securities shall not be offered unless first reoffered to the Major Investors' in accordance with this Section 1.

V. CONCLUSION

Minority shareholders are important investors in venture capital transactions. By proactively negotiating contractual protections and exit strategies at the commencement of the VC-relationship, majority shareholders and minority shareholders can work together to create a profitable business while ensuring that their respective interests remain protected.