IBA Guide on Shareholders' Agreements

United States

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This article focuses on the General Corporation Law of the State of Delaware (DGCL), as well as broad principles of contract law and practice.

1. Are shareholders' agreements frequent in the United States?

Shareholders' agreements are very common for privately held US companies. In particular, these agreements are often included as part of the documentation for venture capital financing. The model legal documents prepared by the National Venture Capital Association, an industry standard in US venture capital financing, cover the terms typically addressed in a shareholders' agreement in the Investors' Rights Agreement; the Voting Agreement; and the Right of First Refusal and Co-Sale Agreement. Shareholders' agreements are fairly uncommon for publicly listed US companies; they are most commonly utilised by founders or large shareholders and put in place in connection with the initial public offering (IPO) or a significant business combination. This guide focuses primarily on shareholders' agreements for privately held US companies.

2. What formalities must shareholders' agreements comply with in the United States?

A shareholders' agreement is a type of private contract and therefore governed by the traditional rules of contract law. This agreement is not subject to any specific formalities by virtue of being a shareholders' agreement. However, as further discussed below, certificates for shares that are subject to a shareholders' agreement should note the existence of certain types of provisions if they are included in the agreement.

3. Can shareholders' agreements be brought to bear against third parties such as purchasers of shares or successors?

As a general principle of contract law, a shareholders' agreement is binding only on the

parties to the agreement. However, a shareholders' agreement typically provides that it is binding on the transferees of shareholders who are signatories to the agreement. Accordingly, a shareholders' agreement commonly provides that, as a condition to any issuance of new shares or registration in the corporation's share records of a transfer of shares, the corporation must require that: (1) each new shareholder or transferee executes a joinder to the shareholders' agreement; and (2) any share certificates contain a legend advising of the existence of the shareholders' agreement and of its binding effect on transferees.

Further, shareholders' agreements can contain provisions that have the practical effect of constraining or otherwise affecting the latitude that third parties have in dealings with the corporation or its shareholders (eg, rights of first offer, first refusal or co-sale rights).

4. Can a shareholders' agreement regulate non-company contents?

As a matter of practice, shareholders' agreements commonly regulate matters relating to the governance and management of the corporation, and the rights and obligations of shareholders vis-à-vis the corporation and the other shareholders.

5. Are there limits on the term of shareholders' agreements under the law of the United States?

There is no statutory limit on the permissible term of a shareholders' agreement. However, shareholders' agreements for privately held companies commonly provide for termination on the occurrence of certain events, such as a public offering, sale, merger or liquidation of the corporation. Shareholders' agreements for US listed companies commonly provide for termination on one or more specified parties owning less than a specified number or percentage of shares.

6. Are shareholders' agreements related to actions by directors valid in the United States?

As a general matter, the DGCL vests the power and responsibility for conducting a corporation's affairs in the corporation's board of directors (section 141(a) of the DGCL). However, it is possible to restrict the otherwise broad latitude of the board of directors to manage a corporation.

Some restrictions are afforded by the DGCL itself, which provides that certain corporate actions require shareholder approval. Restrictions that go beyond those provided by statute typically require that shareholders generally, or particular constituencies of shareholders, grant approval before various actions that the board may otherwise approve can be taken by the corporation (eg, increase the number of authorised shares of any class of stock of the corporation or declare any dividend on any shares of capital stock of the corporation, subject to customary exceptions). Such non-statutory restrictions may be included either in the corporation's certificate of incorporation (if individual classes

of shareholders have the benefit of such provisions as a component of the rights and privileges incident to those classes) or in a shareholders' agreement.

Directors also have fiduciary duties, including the duties of care and loyalty, that they must observe in managing the corporation. It is not possible to relieve a director from fiduciary duties through the shareholders' agreement.

On 2024 August 2024, the DGCL was amended in order to address recent caselaw regarding the facial validity of certain shareholder agreements. In *West Palm Beach Firefighters Pension Fund et al v Moelis & Co*, the Delaware Court of Chancery held that broad consent rights granted to the corporation's founder and controlling shareholder pursuant to a shareholders' agreement, as well as certain rights regarding the composition of the corporation's board of directors and board committees, were facially invalid because they impeded the board's ability to manage the business of the corporation in accordance with Section 141(a) of the DGCL. The amendments provide that, whether set forth in a certificate of incorporation or not, a corporation has the power to enter into agreements with current or prospective stockholders that contain consent rights and the other provisions addressed in Moelis. For example, the amendments allow for covenants that restrict future corporate actions specified in the shareholders' agreement and provisions that require boards to obtain shareholder consent or approval before taking certain actions. Importantly, the proposed amendments do not alter the fiduciary duties of directors or existing standards of review with respect to a decision to enter into such agreements.

7. Does the law of the United States permit restrictions on the transfer of shares?

Restrictions on the transfer of shares are permitted, subject to certain requirements and limitations.

First, restrictions must be in writing, although not necessarily in a shareholders' agreement (section 202(a) of the DGCL). Second, transfer restrictions are effective and enforceable only against persons who have actual knowledge of them (section 202(a) or the DGCL). Accordingly, transfer restrictions must be noted conspicuously on the certificates for shares subject to such restrictions or otherwise notified to the holders of the shares in the case of shares that are not certificated. Finally, the DGCL sets out a number of authorised transfer restrictions that are presumptively permissible, including the obligation of shareholders to first offer the shares to the corporation or other holders; the obligation of the corporation or other holders to acquire the shares subject to such an agreement; and prohibition on the transfer to designated persons or classes of persons, so long as such a prohibition is not 'manifestly unreasonable' (section 202(c)–(d) of the DGCL). For restrictions not expressly identified by the DGCL, courts require that restrictions be reasonable in order to find them enforceable (see *Capital Grp Cos v Armour*, 2005 Del Ch LEXIS 38 (Del Ch Mar 15, 2005)).

Restrictions on the transfers of shares may be contained in the corporation's certificate of incorporation, by-laws or the shareholders' agreement. The shareholders' agreement is often preferred as the forum for transfer restrictions because it provides greater flexibility with respect to content and is likely to be the process by which such restrictions may be amended.

8. What mechanisms do the laws of the United States permit for regulating share transfers?

Common restrictions on transfers for privately held companies include the right of first offer or first refusal provisions and co-sale provisions, and drag-along and tag-along provisions, as well as forced transfers through call/put options and other mechanisms. In addition, either the share purchase agreement for an issuance or the shareholders' agreement entered into in conjunction with such issuance will typically contain an undertaking by the shareholders not to transfer the acquired shares other than in certain specified transfers and otherwise subject to procedural requirements aimed at ensuring that transfers are exempt from the registration requirements of applicable US securities laws.

9. In the United States, do by-laws tend to be tailor-drafted or do they tend to use standard formats?

By-laws tend to be standardised as they regulate mostly procedural matters and generally reflect statutory requirements. By contrast, the shareholders' agreement contains more detailed and tailored provisions that shareholders desire to put in place in order to restrict the latitude of the board to manage a corporation's affairs and to govern the rights and obligations of shareholders vis-à-vis the corporation itself and vis-à-vis each other.

10. What are the motives in the United States for executing shareholders' agreements?

The shareholders' agreement bridges the gap between the rules covered by by-laws and statutory provisions, and the rules that shareholders and the corporation otherwise desire to put in place. This gap can also be bridged through the certificate of incorporation, in particular as regards the provisions specifying the rights and preferences of the different classes of shares in the case of a corporation having more than one class of shares; however, the certificate of incorporation is a fairly standardised publicly available document and amending it can be more cumbersome than amending a shareholders' agreement. Therefore, provisions to bridge this gap are generally contained in the shareholders' agreement.

11. What contents tend to be included in shareholders' agreements in the United States?

Shareholders' agreements cover the rules governing the relationship of shareholders to the corporation and the relationship of shareholders with each other.

12. What determines the content included in shareholders' agreements in the United States?

The content of shareholders' agreements is primarily determined through negotiations among the corporation, its existing shareholders and new investors, as applicable. In the case of venture capital financing, the model legal documents prepared by the National Venture Capital Association generally provide the basis for the parties' agreement, with deviations reflecting the outcome of the parties' negotiations and current market practices.

13. What are the most common types of clauses in shareholders' agreements in the United States?

Common types of clauses include:

1. board size and composition, and related voting agreements;
2. share transfer regulations and restrictions, including, particularly in the case of privately held companies, right of first offer or first refusal provisions, and co-sale provisions, drag-along and tag-along provisions;
3. pre-emptive rights;
4. lock-up provisions;
5. voting agreements, including with respect to increasing the number of authorised shares of stock;
6. information and observer rights;
7. confidentiality provisions; and
8. registration rights provisions (if not addressed in a separate agreement).

14. What mechanisms does the law of the United States permit to ensure the participation of minorities on the board of directors and its control?

Minority participation in a corporation's board of directors can be effected through voting provisions relating to board composition. Pursuant to these provisions, shareholders agree to a desired composition of the board (with key shareholder constituencies having the right to designate one or more members of the board) and further agree that they will cast their votes in director elections so as to achieve the agreed board composition. In addition, section 214 of the DGCL allows shareholders to invoke cumulative voting for the election of directors if provided pursuant to the corporation's certificate of incorporation. Cumulative voting allows shareholders to cast all their votes in favour of a single candidate (or any two or more candidates), which may sometimes allow a minority constituency to succeed in having one or more desired candidates elected.

15. Is it possible in the United States to ensure minority shareholder control by means of a shareholders' agreement?

As described above, it is technically possible to provide for minority shareholder control of a corporation through voting provisions governing board composition, which are typically found in a shareholders' agreement.

16. What are the usual valuation mechanisms in connection with rights of first refusal or share transfer regulations?

For the purpose of the right of first refusal and other share transfer regulations, shareholders' agreements typically value the corporation's shares by reference to the terms of the contemplated third-party transaction triggering the application of such a right or regulations. More generally, the value of a corporation's shares may also be set as the shares' 'fair market value'. Prior to an initial public offering, 'fair market value' may be determined: (1) in good faith by the board of directors; (2) on the basis of a formula, commonly a multiple of earnings before interest, tax, depreciation and amortisation (EBITDA); or (3) by an independent third-party appraiser.

17. Is it admissible for a shareholders' agreement clause to refer dispute resolution to courts other than those of the United States and/or under a law other than that of the United States?

Delaware allows the selection of a dispute resolution forum other than the one in the jurisdiction in which the corporation is organised. Specifically, Delaware views the selection of a foreign forum as '*prima facie* valid' unless 'unreasonable under the circumstances' (see *Aveta, Inc v Colon*, 942 A.2d 603, 608 n 7 (Del Ch 2008)).

A shareholders' agreement may also be governed by a law other than the law of the forum. In Delaware, courts generally honour contractually designated choice of law provisions, so long as the jurisdiction selected 'bears some material relationship to the transaction' (see *Pharmatene, Inc v Siga Techs, Inc*, No 2627-VCP, 2008 WL 151855, at *7 (Del Ch Jan 16, 2008). However, if the law chosen is that of a foreign jurisdiction, Delaware will not enforce such a law 'in a manner repugnant to the public policy of Delaware' (see *JS Alberici Constr Co v Mid-West Conveyor Co*, 750 A.2d 518, 520 (Del 2000)).

However, under the so-called 'internal affairs doctrine', even when shareholders have chosen the laws of another jurisdiction to govern their agreement, courts may still apply the laws of the state of incorporation with regard to matters that are 'peculiar to the relationship among or between the corporation and its current officers, directors and shareholders' (see *In Delaware, In Re Topps Co S'holders Litig*, 924 A2d 951, 958 (Del Ch 2007)).

18. Is it admissible for a shareholders' agreement to include an arbitration clause with its seat outside the United States and/or under a law other than that of the United States?

The Federal Arbitration Act permits the selection of a US or foreign arbitration institution to arbitrate the parties' disputes under its own rules. It also allows the choice of a seat outside the state where the corporation was incorporated, or even outside the US. The choice of the law of another state or foreign law to be applied by an arbitration tribunal is based on the principles outlined above.