

**CORPORATE SHAREHOLDERS' AGREEMENTS
AND LLC OPERATING AGREEMENTS**

by

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Identifying the Owners and Their Percentage Ownership

Because owners usually share in the future value of the company— whether in the form of profits, stock holdings, membership units or other arrangements—decisions as to who will be an owner should be made according to the expected contribution of each individual to the enterprise. It is not an easy task to look into the future to determine who will share and in what proportion, in the value created by the company.

The owners usually are comprised not only of the founders, but also frequently key management personnel that are identified as being necessary for the success of the venture. Some people refer to them as the “five C’s” (CEO, CMO, COO, CTO and CFO). Although not required, it is common for the five C’s to receive some level of stock or membership rights in connection with their commitment and service to the start-up. There may also be owners who have made available the capital, contributed intellectual property and those who have provided sweat equity. Above all, is the person or persons who have developed the idea/concept for the business. Some or all of the roles of the five C’s can be filled by persons who have contributed capital, IP, sweat equity, etc.

A brief summary of these management roles is as follows:

The CEO/President is typically the founder within a startup, but not always. Sometimes the founder does not have the required skill set to be the visionary, set long term strategy and direction and achieve placement for the company in the competitive environs. Personality-wise, the CEO needs to be able to meet with key investors and strategic partners. Some organizations have both a CEO and President with the CEO continuing the outward presence and the President facing inward to manage the day-to-day operations.

The CMO (sometimes called CSO) of an organization is in charge of all marketing or sales driven activities of the business. This role drives new leads for the business whether B2B or B2C and getting customers to engage in repeat sales. Revenue will make or break a business so this role is sometimes called a Chief Revenue Officer, as without effective marketing or sales leadership, there will be no revenues.

The COO is in charge of operations of the company (can be duplicative of the President role) with the exception that the President manages all of the 5 C roles.

The CTO is in charge of all technology for the company. This technology could be the entire lifeblood of an "e-commerce company." Or more routine as in management of the back office systems and software that keep the business functioning. The more critical the role that IT plays in your company, the more important the CTO is to the organization.

The CFO is in charge of all financial activities - accounting, budgeting, cash management and reporting for the company – and supervision of office staff supporting those functions. The CFO also maintains the relationships with outside CPA firms and bankers. In a startup, the CFO is also the controller and treasurer of the business, managing all accounting and cash decisions themselves, until the business gets to the scale it can afford a bigger staff.

Owners can also be other key employees your client desires to incentivize to stay and perform or to reward for loyalty and service already given. Once you have identified the owners, you will

need to decide how much of a percentage interest they should receive and in what form that interest will be granted.

Due to the different types of contributions made by owners as well as their continuing value to the company, it is difficult to make determinations as to percentages – how to divide up the equity stake in the company.

Although there are different schools of thought, it is common to place a big premium on being the originator of the idea for the product or technology on which the company is based. Assuming two founders in a small entity, that would mean that a 50/50 split between the two co-founders might be along the lines of two-thirds/one-third if a premium is given to the original idea and for starting the initial development efforts and finding the original management team.

It would also follow that people who fund the business should get a premium, because cash funding founders are acting no different than a seed stage investor. If we start again with the 50/50 split, an adjustment would seem warranted for cash investment.

Key executives (five-C's) should get a premium stake over non-key executives (e.g. office manager or graphic designer).

If we accept that hierarchy, total ownership would be divided by employee tiers. So, in this case, something like the following:

Owner	Ownership %	Total for Tier	Total
Founder (idea)	20%		
Founder (development)	10%		
Founder (funding)	10%	40%	40%
CEO	5%		
CFO	5%		
CSO	5%		
CMO	5%		
CTO	5%	25%	65%

investment transaction. In addition to the bylaws and shareholders agreement or operating agreement, there are also employment term sheets or employment contracts with key persons which may also contain provisions relating to management authority or responsibilities. It is therefore incumbent on counsel to be sure that all relevant documents are checked and provisions included to be certain management of the company in its various capacities stays in the hands of those who have negotiated that right.

An LLC can be established as a member-managed entity or as a manager-managed entity. As a startup's decision making and power is often driven by ownership, it is more common that management is by the members to preserve each owner's say in certain matters as a percentage of vote. There certainly can be an operating manager appointed for the day-to-day operations (or a board of managers as discussed above) and the flexibility of LLC's permits titles, such as the Five C's, to be given to employees/owners. As owners of an LLC are not traditional employees, but most often partners who are given draws rather than W-2 wages, the equivalent of an employment term sheet or contract would be a guaranteed payment agreement, which may also spell out the obligations and rights of the particular partner as to management. The LLC operating agreement, however, is the most relevant document and traditionally sets out which person shall act as manager, successor manager and tax matters partner (to deal with all tax return and tax election issues).

Voting Provisions including Supermajority Voting Requirements

While management of a corporation or limited liability company can be included in various agreements as discussed above, a shareholders agreement or operating agreement will also set out the voting provisions both as to common and preferred shares or membership units (if voting preferred). Again, as it is not the intention of investors in the traditional sense to impact management, vote by investors is usually limited to those aspects that could impact its investment in a serious way rather than day-to-day determinations. In those instances where the investor vote is required, either it is required that the investor consent affirmatively to the action or that the action require a supermajority vote of $\frac{66}{100}$ or higher in order for it to pass. Note

that for any corporate entity with differing voting rights, only a C corporation can be used. S corporations cannot permit different rights to vote or preferred shares.

While not exactly a management issue per se, in order to prevent their ownership interest from being diluted by future issuances of shares, investors will typically require that they be given the right to participate in any subsequent offering of shares, options, warrants or other securities.

Restricting Transfers of Shares and Membership Units

A shareholder agreement or operating agreement should clearly set out any restrictions or obligations related to the equity units and will typically include a general prohibition on transferring equity, or any rights or obligations under the shareholder agreement or LLC operating agreement, except as specifically permitted in the agreement or as consented to by the equity owners (or a defined group of equity owners, e.g., holders of x percent of the preferred shares or units).

There normally is some flexibility built into the agreement so that shareholders or members can deal with their shares efficiently for tax planning purposes – known as “permitted transfers”. For example, where the shareholder/member is an individual (e.g., a founder), such equity owner should ensure that the shareholder/operating agreement permits him to transfer his ownership to an entity wholly-owned by him or his family members, a custodian, trustee (including RRSP, RIF, IRA or similar retirement or investment fund) or other fiduciary for the owner, and/or his family members, or any other person if such transfer is effected pursuant to the owner’s last will and testament, or, where there is no will, applicable laws dealing with the succession of property upon death.

In case of a permitted transfer, the shareholders agreement or operating agreement should state that any transfer is conditional upon the transferee agreeing to be bound by and becoming a party to the applicable agreement.

In addition to the general restrictions on transfer, in startup ventures where it is anticipated that professional investors may be sought, the shareholders or operating agreement should include a right for the entity to repurchase the equity owned by a founder on the death, disability or insolvency of the founder, or on the involvement of the founder in a division of net family property as a result of marital breakdown or in the event of such investment possibility (which investment may require control of 100% of issued shares). Such a repurchase right may instead be included in a separate founder share or equity repurchase agreement. This is discussed in more detail below as are rights of first refusal and other preemptive rights.

Confidentiality, Noncompete and “Assignment of Invention” Provisions

In a startup product or technology company, the product idea or technology under development is often the most valuable asset of the company. It is critical to have not only confidentiality agreements respecting the confidential nature of the company’s information, but, in many instances, noncompetition agreements with key employees and founders. The company must restrict those who have the capacity to impact the company’s success if their knowledge developed in connection with their service to the company or knowledge/product idea which they or others sold or transferred to the company for consideration, could be harmful if made public or used in competition with the company or transferred to a third party for use. In the technology and product development communities, Assignment of Invention agreements are required to the extent such key employees or founders have rights to same under law. These rights can be both brought to the company upon employment or can be acquired during employment as services are provided, so both instances must be covered. There are also Assignment of IP and Other Assets agreements entered into in which the owner of rights is assigning and contributing those rights to the company in exchange for compensation – which could be ownership equity in the company. In these Assignment agreements the assignor also makes representations as to ownership and rights to the property assigned and a schedule is attached describing the intellectual property or other property being assigned in connection with the agreement. It is also proper to have the spouse of the assignor sign these agreements to avoid any claim of marital property rights in the asset being assigned.

Other Common Provisions

Shareholders Agreements and Operating Agreements also contain other more standard provisions relating to the following:

- Valuation – it is critical that the method of valuing shares and membership interests be set forth. Valuation methods may change depending upon who the member or shareholder is that requires the valuation and the circumstances requiring the valuation to occur. Death, disability and withdrawal of an owner being the most common. In the startup venture arena, valuation for purposes of investor equity is of huge importance and impacts further investment potential once valuation is determined.
- Permitted Transferees – as discussed above, there are numerous persons or possibilities for sale, transfer, repurchase and assignment of shares and membership units, each with unique terms dependent upon the deal.
- Payment Terms – Once valued, if shares or membership interests are to be repurchased, the terms of repayment (number of payments, down payment, interest rate, security, voting during repayment, default rights) must all be put in place at the time the interests are reacquired by the company or a third party (if permitted as a transferee).
- Jurisdiction and Governing Law – important to be clear if the requirements of law of a particular jurisdiction are to be applied and a convenient forum used in the case of litigation.
- Amendment of the Operating Agreement or Shareholders Agreement – this provision should contain the percentage of vote required to amend the agreement and specification of any provisions which cannot be amended without consent of particular parties or supermajority vote should be clearly specified.

Grant of Power of Attorney – it is often useful to have all shareholders or members grant a power of attorney to the company to arrange for the transfers of all shares or membership interests as provided in the agreement and to have such power coupled with an interest.

Dissolution – consideration needs to be given to whether or not the owners of the entity should agree that the entity cannot be dissolved except by a certain percentage of vote and that otherwise, shareholders and members waive any right to seek dissolution.

Co-Terminus Provisions – it may be prudent to provide that termination of rights as a shareholder or member also terminate rights as an officer, director or manager as the case may be. Frequently, these provisions specify that the terms of any employment or similar agreement that are not dependent upon share or membership ownership are not affected by the sale or transfer.

