CHAPTER 1

# The International Joint Venture

## §1.01 WHAT IS AN INTERNATIONAL JOINT VENTURE?

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A textbook on international joint ventures, directed to lawyers, may raise academic doubts as to the subject-meaning under consideration.

The response, a definition, is found on page 12 where it is stated:

> An international joint venture is an association of entities, whether singular or collective, in a jurisdiction foreign to one of the parties, who have established a contractual relationship, including that derived from rights and obligations resulting from ownership of an interest in a collective entity, which association is intended to realize economic gain for the interested parties over a reasonable period of time, or an indefinite term, and wherein all parties are able to exercise some control or influence over the legal entity chosen.

It is with this description, surely imperfect, but at least moderately useful, that we begin our journey.

One afternoon your telephone rings and your client wants to schedule an appointment to confer with you about doing business in a foreign jurisdiction. At the conference, the question is asked: should the client establish a wholly owned subsidiary or form an alliance with a local entity in the foreign jurisdiction?

From your client's viewpoint, there is the understandable belief that the representation and control of the company in a foreign jurisdiction is best done through complete administrative dominion, which translates into a wholly owned subsidiary.

Frequently, this is the chosen method with multinationals having operations all over the world and particularly so, as experience is gained in various countries through years of trial and error. Nevertheless, there are strong compelling reasons for forming local alliances for all business entities, no matter the magnitude or previous knowledge of the client. This local alliance, the subject matter of this treatise, is the international joint venture. Of course, it is not the only alliance possible, but our exclusive focus in this textbook is the international joint venture.

Nevertheless, forming an association does not necessarily mean losing management control. These are different, although complex issues, as we shall see later. But such problems do not detract from the compelling reasons to forge a local affiliation.

There are many arguments in favor of forming an association with another, national group. While some of the rationales are valid for a wholly owned subsidiary, the accumulation of all reasons favors the use of a joint venture. The reasons may be summarized succinctly, characterizing the client as the "foreign investor":

## §1.02 FROM THE VIEWPOINT OF THE FOREIGN INVESTOR

### [A] Regional Trade Barriers

Globalization of commerce has meant international flows of capital and goods. Contrary to this development, has been the rise of agreements between countries that form amongst themselves trading blocks with common tariffs against goods or services coming from non-participating or non-member countries. This clearly puts exporters in the non-member countries at a serious disadvantage.

The only effective way for a company wishing to do business in these economic blocks is by forming a joint venture with a company in a member country. Since the creation of these integrated trade zones, many companies from the United States and Europe have set up joint ventures outside their own countries. Instead of exports the emphasis switches to producing the goods locally in collaboration with a national partner, which in turn permits exports within the trading zone.

The international joint venture is an effective option for circumventing trade barriers and gaining access to foreign markets on favorable conditions.

### [B] Capital Flexibility

Doing business abroad through a joint venture reduces the currency risks associated with a foreign investment. If an American company does business in the European Union, it can either export dollars to finance its commercial operations or it can form a company in the European Union, borrow substantial local funds, and need not concern itself if the local currency, the Euro, should devalue against the dollar.

On the other hand, should the Euro appreciate against the dollar since the inception of the original investment, dividends declared and remitted back to the United States shall represent a currency gain. It is a known fact that many companies earn more on currency gains then they do on the sale of the goods to the public in the home country.

Moreover, forming an international joint venture with a local partner achieves additional capital objectives. It reduces the amount of the foreign capital the foreign investor has to import. Less capital is locked into the joint venture, thus permitting the foreign investor to gain needed experience in doing business in another jurisdiction with different laws, commercial customs, and cultural ways. A joint venture also





creates an experimental phase or a capital escape valve dependent on the commercial progress or lack of it.

A subsidiary formed between a foreign investor and a national investor permits limiting the capital investment of the foreign investor, but does not necessarily preclude the foreign investor from having a legal right to increase its capital investment should there be solid commercial success. This can be done by the parties by agreeing that the capital of the subsidiary shall be augmented in accordance with additional equity participation rights granted to the foreign investor.

Where the investing corporation would like to have a wholly owned subsidiary but realistically judges it needs more familiarity with the local foreign market, the parties may negotiate a contractual provision, to illustrate some examples, whereby the capital of the local subsidiary is augmented in harmony with predetermined objectives or watersheds: gross sales, net profit, volume turn-over. This is an increasing equity joint venture. There exists, of course—the corollary—a decreasing joint venture.

In a decreasing joint venture, the foreign investor has a "put" to compel the local partner to buy out all or a part of the foreign investor's stake. This might be dependent on issues of nationalization, loss of government contracts, enactment of unfavorable investment laws, and change in share ownership of the national investor, to name but a few reasons.

Understanding these general legal ideas permits the corporate financial department to tailor its foreign investment very carefully, with the guidance of counsel.

### [C] Return on Capital, Interest Reductions and Tax Exemptions

The classic, corporate finance problem of securing a fair return on capital invested within a reasonable length of time is conveniently solved through the legal form of an international joint venture. Less capital invested by having a local partner with local marketing experience should permit years of trial and error to be bypassed and the corporate purpose to be realized quickly.

An attractive return on capital is also accelerated if the foreign government has a strong policy of favoring foreign investment. It permits the use of local funds with recourse to a local bank. The funds may be lent at a very favorable rate of interest. The host government may have an aggressive policy of attracting foreign capital. Interest payments may be waived for a specified period of time as well as there being given a tax holiday. If there are no problems with retained earnings under local accounting rules, capital needs can be quickly accumulated with no associated debt service cost. This affects favorably all the financial ratios.

Additionally, many governments offer tax exemptions for new industries ranging from no transfer tax on the purchase of land to reduced and at times complete exoneration of taxes for a specified period. The variation is substantial, but it is a strong and compelling reason for setting up operations in a foreign land. These fiscal benefits vary greatly from country to country and there are even situations where the foreign investor may request a specific fiscal benefit, for example, a moratorium on income taxes for a certain period.



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### [D] Economies of Goods and Services

It may happen that an American company and, perhaps an Italian company, form a joint venture in Italy with each group participating in the capital. These partners may be substantially "cash heavy" multinationals with no need for capital assistance from anyone. Yet they join forces through a common subsidiary. Why?

The American company may possess substantial know-how in the construction of a plant for manufacturing a specific plastic product and the Italian company may possess substantial knowledge for transforming the product, refining it, if such be the case, and seeing the intermediate production process through to its end.

Joint efforts result in a transformed product ready for sale. Each group contributes what it does best with the economies it has perfected. While the total is larger than the sum of its parts, the expenses are not.

There are many other examples. Joint ventures between a manufacturer and a distributor in a foreign country are quite common. The manufacturer may be responsible for the technical support, the importing of its own product, while the distributor is responsible for the sales and advertising. All of these activities in a jointly owned subsidiary are delegated to the partners possessing the particular skills in the relevant area.

At times a mammoth building construction or complex enterprise requires a temporary alliance of multiple skills, such as the erection of a dam. These skills may contractually be bound in the consortium contract wherein each party sets forth his rights and obligations.

Research and development, marketing, purchasing, and selling are all areas where cooperation is possible and complementary services are united. Many of these forms of collaboration have received special legislative attention from competition authorities so as to better define the rules affecting such activities.

Therefore, counsel advising clients engaging in joint ventures in countries or blocs which have competition legislation must be aware of their implications.

### [E] Commercial Errors Reduced

Starting up a wholly owned business in a foreign jurisdiction entails various uncertainties and even competent, skilled interlocutors do not eliminate entirely situations of misunderstanding. It is not simply possible for an outsider to come into another business culture and make the correct assessment of the economic climate. There are so many factors to be considered. There are questions of obtaining credit, foreign investment rules, civil and commercial law codes, the daily passage of laws whose existence is not even known to distant counsel because of language obstacles, union considerations, exchange rate fluctuations, zoning and safety orders, import and export decrees, taxation, restrictions on hiring foreign personnel, the list is lengthy. Having a local partner is a prudent method of becoming integrated into the local business and legal milieu and avoiding costly mistakes.



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### [F] Easy Withdrawal

A difficulty that arises in case of a wholly owned subsidiary is when a company wants to withdraw from it, an event provoked by a multitude of reasons ranging from poor commercial results to a desire to sell for capital gains due to an immensely profitable operation.

But a company cannot easily withdraw from a foreign jurisdiction without going through a formal dissolution process which in turns entails labor considerations such as collective firing. These are costly and complex legal procedures.

It is far simpler to avoid such procedures, which is possible when you have a partner who is willing to purchase your interest. Even in an insolvent situation, it may still be possible to make a distress sale to your partner.

On the other hand, should the interest being sold be a profitable one, a partner avoids the necessity for looking for a buyer. Consequently, having more than one partner in a subsidiary operating in an international joint venture thus facilitates withdrawal from the jurisdiction in question.

Selling a wholly owned subsidiary requires encountering a buyer with more significant financial recourses than required for a partial equity interest. Moreover, selling an entire equity interest to a third party usually means that a different management style enters with new key personnel. This is often seen as a threat by the existing labor force, even if none is intended. However, the sale of a block of shares in a joint venture implies a more moderate disruption as the local partner continues as a point of stable reference.

Having partners in an unsuccessful venture, or one which is bringing below-average returns, permits withdrawing as a matter of fact, if not legally. The disinterested partner simply allows the other partners to manage the company with a minimum of vigilance needed. If we are dealing with a legal form which insulates the owners from the debts of the entity, the absentee equity owners only have to ensure they are not guilty of negligent management obligations.

### [G] Organizational Flexibility

Monolithic corporate entities establishing a solely owned company in a foreign jurisdiction necessarily are subject to their own multiple bylaw restrictions, formal management guidelines, a need for shareholder general assemblies and most importantly from the view point of doing business abroad, management policies that are often contrary to local business practices. Wholly owned subsidiaries of multinationals are naturally a mirror reflection of the home-office organization. This can be disadvantageous.

Requiring a local manager to constantly report or request to home-office management, various local financial expenditures, personnel requirements, expansion plans, new product development and awaiting approval from the home office is time-consuming and not very efficient.

Communications between a distant subsidiary and the home office are difficult not because of technical communication problems, which today hardly exist, but rather because there is no common economic reference. The ultimate authority of a London Board of Directors simply cannot have first-hand knowledge of the day-to-day economic realities of a subsidiary in Ecuador. It is possible, but not probable.

On the other hand, ameliorating the situation by conferring a general power of attorney to a local manager and thereby making it possible to bind the entire group is not an attractive alternative to the London Board of Directors. Managing an active subsidiary with many employees in a foreign jurisdiction, but whose general director is a foreigner to the nationals may be interpreted as a vote of "no confidence" towards local citizens.

Moreover, we have no reason to believe a Londoner sent to Ecuador as general manager of a wholly owned subsidiary is going to have any more understanding of the local economic climate than our London Board of Directors. Of course, the London company could employ a national of Ecuador to be the subsidiary manager. However, this is not always a practical solution.

If we are not dealing with blue-chip multinationals with years of overseas experience, but rather modest capital companies engaging in its first international joint venture, there is an understandable reluctance to turn over a new venture to an "outsider" who is an employee with no prior responsibilities with the corporate organization. Between these two extremes, total reliance on the home office and complete independence of the subsidiary, there exists a compromise.

A well-chosen national partner for a local subsidiary is an ideal choice, the necessary hybrid method, the perfect interlocutor between the foreign investor and the national economy. Having a foreign partner with capital invested dilutes the fears normally associated with outsider management, someone strange to the team, because in this case the outsider has capital invested and this should mean a commitment to a common goal.

As we shall see, having a national partner does not mean relinquishing control over a substantial equity investment. Management control can easily be established through various legal documents.

Moreover, a local subsidiary, with a local partner and management responsibilities well defined by the local corporate structure confers multiple advantages. The risk of negligent management is limited to the local corporate assets. The general director may be an employee of the foreign partner, in our case the English company, but his lack of local commercial customs is complemented by the foreign partner and other national managers. Accordingly, establishing a subsidiary with a local entity permits not only reducing unexpected liability exposure but also tailoring the corporate structure and the bureaucratic form in accordance with local necessities, which can range from a two-employee office to a staff of three hundred people.

Whereas the foreign corporate investor may have a base of thousands of shareholders, this does not prevent the foreign investor from forming a local, national limited liability company in another jurisdiction with a foreign partner, along simpler management lines, yet with the necessary controls, checks, and balances.





The limited liability company so formed can have a modest capital and a simple corporate structure, perhaps one general manager which represents the subsidiary before third parties, although this authority is delegated authority emanating from the board of directors of the subsidiary.

The highly intricate corporate structure of a typical multinational can thus be shed for a simple, linear chain of command in another jurisdiction. As an additional bonus, this is probably more in accordance with the way the national companies do business and more familiar to national banks and other important third parties with whom the subsidiary must deal with on a daily basis. Local government official and banks normally look to one individual to deal with and do not appreciate being informed that their request is being considered by a distant board of directors.

### [H] Natural Resources

A great deal of joint-venture activity takes place between companies from industrialized countries and companies from the so-called emerging countries. Such a joint venture permits access to local agricultural resources at a reasonable cost plus margin price structure. A very common motive is the foreign group needs the raw materials of the host country. The manufacturer of furniture needs trees; the processor of tea needs plantations; the wholesale florist needs fields of flowers; the producer of cars needs labor.

The cosmetic industry uses sardine oil as a vital ingredient. Forming a joint venture with a local sardine supplier in a Mediterranean country ensures a much needed raw material and, more importantly, secures it on quality terms. From the catch to the extraction, our cosmetic manufacturer can be certain that the final product will be in the state of quality it requires.

An airline company with government capital may form a subsidiary with a catering company to ensure the quality and price of food served on its routes. The resources in this example may have access to a reasonably priced agricultural economy and labor market, but the sales price to the airline company is cost plus a specified margin. The prepared food is served on world-wide routes with quality and price ensured.

Between natural resources and human resources there is a fine line and probably only in the most basic of industries can the division be made with any economic sense.

### [I] Human Talent

No country has a monopoly on talent. Software developers from India, electronic engineers from Mexico, mold designers from Portugal, skilled personnel are needed in international economic endeavors and the surest way to utilize their expertise is to work with them through a local subsidiary. The international auditing firms, which must draw upon countless skills and highly developed professional qualifications, have found that only by admitting local partners, by setting up joint ventures with national professionals, has it been possible to sustain steady, qualified growth.



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CHAPTER 9

# The Shareholders' Agreement

## §9.01 INTRODUCTION

The shareholders' agreement has become the legal tool to establish regulations between the owners of a company, regulations more easily enforced when we are dealing with a closed corporation or private limited liability company.

The shareholders' agreement permits owners of a company to vary considerably the natural consequences of the share corporation form of the joint venture vehicle chosen. The shareholders' agreement allows minority owners to prevent abusive action by the majority. The shareholders' agreement fosters a fair distribution of power, whether through ownership or management, by requiring the majority to seek the consent of the minority on a variety of topics.

Properly used, the shareholders' agreement is the bill of rights of the owner of equity, no matter what the legal form. This is because, in spite of its name, it can be used with any legal form. The shareholders' agreement is not unique or exclusively used with the closed share corporation or private limited liability company.

Because of their public nature, the use of a shareholders' agreement in joint ventures involving public companies is both restricted and has less application. With a share base of thousands, there have to be rules which nourish market flexibility and transparency, legal conduct which stimulates reliance on public information, primarily the articles of incorporation.

Much of the practice orientating small and medium companies forming international joint ventures is dealing with a different legal environment where the owner base is reduced numerically. In these cases the joint venture vehicle may be a share corporation, but with the minimum amount of shareholders which can vary from jurisdiction to jurisdiction.

Other times, the preferred joint venture vehicle may be the private limited liability company which can have as little as two equity owners. The shareholders'

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agreement function in the small share corporation and the private limited liability company plays a significantly more active role than it does in the public corporation.

The existence of the shareholders agreement in a closed corporation shall be known to all the owners. The owners, unlike a public corporation, shall probably have an active participation in the management. If all do not participate, they nevertheless want to keep a vigilance, to have the right to know what is happening and without a lot of cumbersome obstacles being erected.

Consequently, a substantial part of the ensuring analysis is intended for application to medium capital joint ventures, what would be generally classified in the USA as a closely held corporation or in Europe as a private limited liability company.

As our understanding becomes more complete we shall see that the shareholders' agreement has a primordial position in all operational aspects of the international joint venture. It is the equivalent of bylaws in corporation law but it is more than just a set of rules on what authorizations are needed for a particular item and how the approval shall be obtained.

It can, and should, purport to regulate on a multitude of subjects which cannot be conveniently put into the articles of incorporation. Company articles speak in generalities and not in particulars, such as the annual budget, what are the capital expenditure limitations, ceilings on salaries, what is the business plan for the next five years. These are not matters for the general public, or for revelation to competitors which would be the case since company articles are filed and available to third parties.

Likewise, we may legitimately inquire why not just make a reference to the shareholders' agreement in the articles of the company or, if we are dealing with a share corporation, simply endorse on the certificate a reference to the existing agreement. In this way, the public and purchasers are put on notice.

Many US jurisdictions, by case law or legislative act, have expressly permitted these techniques provided the company in question fulfills the requirements of a closed corporation. The definition of a closed corporation varies from State-to-State and there is needed strict compliance with the law.

In Europe, it is rare to find legislation concerning closed corporations. There is legislation affecting private limited liability companies, which approximate very closely the US closed corporation, and there is the general corporation law. In those jurisdictions, if there is legislation permitting shareholders' agreements, it is going to be general and perhaps only regulate in detail a specific requirement, such as in Brazil where the shareholders' agreement to be valid must be filed with the corporation. Deposit requirements are not generally demanded in Europe.

Consequently, with such a varied approach to the material, the frequent practice in international joint ventures is not to make references to the shareholders' agreement in the articles, for this would only provoke third parties to make inquiries and put a brake on commercial activity; if there are no deposit requirements, the existence of the agreement is unknown, a private matter for the owners; and regarding endorsements on shares, this appears to meet with reluctance by most proprietors of small family corporations. Although it is not a threat to marketability, it is seen as such and insistence on endorsing shares with the reference can become a serious impediment to finalizing the joint venture.





For all these reasons, logical or not, the shareholders' agreement continues to have widespread use, it can be very beneficial to a proper functioning of the joint venture, but it continues to be treated as a "private contract," a confidential matter between the owners. In summary, the companies with a limited number of partners, and this is the usual joint ventures, tend not to reveal their business and relationships with their partners.

Before examining in detail the practical aspects of a shareholders' agreement, it is helpful to indicate other nomenclature so as to clear confusion in terminology.

## §9.02 THE PUBLIC CORPORATION, THE PRIVATE COMPANY OR CLOSELY HELD CORPORATION, AND THE SHAREHOLDERS' AGREEMENT

This dissertation is primarily directed towards the practitioners who counsel close corporations although the theory of the shareholders' agreement is the same for a publicly listed company as it is for a private corporation, except that the nature of a public corporation imposes too many limitations on the shareholders' agreement to make it a sensible relevant document in such a setting.

It has been noted that US public companies seldom contain blocks of shareholders who have recourse to the shareholders' agreement and the question is raised: why? No specific rules prohibit their use (Venturozzo, 2013).

It cannot be definitely stated this is the fact, without recourse to statistical studies not part of this exposition but valid assumptions can be made why it would not make sense for publicly listed companies to be composed of blocks of shareholders operating through shareholders' agreements, or voting trusts, or other forms of enhancement of shareholder control.

One argument advanced against the use of shareholders' agreements in publicly listed companies is the diffuse nature of the ownership of shares. With millions of shareholders, constituting a significant block of owners for mounting a united vote would require an enormous effort on the part of any one shareholder. It is thus not cost efficient. If an investor is disenchanted with management, the less costly route is to sell.

The second hypothesis is that in many publicly listed companies, the existences of significant blocks are held by institutional investors who do not want to be fettered in advance. These institutional investors, often large pension funds, wish to be free to disinvest, vote as their interests require, in short, to be entirely free from any future obligations.

Another hypothesis has to do with legal remedies. In the US in contrast to civil law jurisdictions, the protection of minority shareholders is highly developed. Therefore, the economic cost of anyone shareholder seeking out other shareholders is too high when the law affords considerable recourse for alleged wrongs to anyone shareholder, particularly when we consider the availability of class actions.

A different reason can be sought, where they exist, in the "poison pill" provisions of the articles of incorporation of public companies where a "triggering event" such as the acquisition of shares above a threshold amount, e.g., 12%, "triggers" the right for



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other present shareholders to purchase additional shares at a reduced rate, thus poisoning the appetite for a third-party acquisition.

Such a provision is equivalent to a typical clause in a shareholders' agreement to protect minority owners in a close corporation and hence in the public company, the need for a private shareholders' agreement regulating this possibility is not necessary.

And, of course, a shareholders' agreement could be construed to enumerate the necessary conditions for the application of a poison pill clause. Such a legal consequence is hardly in the mind of the usual share investor but it surely is for the lawyers of the large institutional investors whose investment runs into hundreds of millions of units who realize it is not necessary.

Finally, under US federal legislation various acts would construe the existence of shareholders' agreements as constituting groups which requires disclosure as to purpose of acquisitions and, more painfully, prohibition for a period of time on purchase and sale of shares in an attempt to curtail presumed insider trading.

Counsel for the institutional investor shall not want such possible restrictions affecting the client

None of the above assumed theories are applicable to the close corporation which accounts for most of the economic activity, at least in number, of common and civil jurisdictions and hence their diffuse, dominant role in the activity of the closely held corporation.

## §9.03 REASONS FOR A SHAREHOLDERS' AGREEMENT VERSUS ARTICLES OF CORPORATION

With the complexity of present day joint venture agreements, many of the items contained in a shareholders' agreement may be either partially duplicated in the former or find reference therein. In addition to the clauses of the joint venture agreement, one may inquire: why are there no other provisions of the shareholders' agreement contained in the articles?

To some extent they could be inserted in the articles but there will always be countless provisions which cannot occupy the articles as they concern issues and minutiae which quite simply would "clutter" up the articles and render them more like a guide book for managing a company.

Consider some of the following areas which, if the joint venture is to be successful, should be agreed upon between the parties, and the awkwardness of putting them into corporate articles becomes obvious:

- Management of the company
- Business plans
- Loans by partners to the joint venture
- Guarantees by partners on loans to the joint venture company
- Use of capital funds and expenditures
- Restriction on competition between partners
- Method of keeping accounts





- Labor policies
- Salary guidelines.

Perhaps some of these items could be contained within the joint venture agreement but by its nature and its perception by others the joint venture agreement precedes the formation of the joint venture. On the other hand, the shareholders' agreement will be referred to constantly during the life of the joint venture and is no less important than the joint venture agreement but it has a different object.

It regulates present, future and detailed daily events between shareholders or future shareholders of a joint venture. This is the general philosophy of a shareholders' agreement. It is a contract by which shareholders agree to behave (i.e., vote) in a predetermined fashion and there is no limit to its scope.

Even if all the elements of a shareholders' agreement could be contained in a very detailed joint venture agreement, it is wise to have a separate agreement since the two documents do not serve the same purpose.

Whereas the joint venture agreement may indicate the reasons for the establishment of a joint venture, reciting the conditions of the joint venture (capital, the classification of shares and the composition of the articles of association), the shareholders' agreement is between shareholders or future shareholders and regulates conduct between owners of social parts, i.e., shares or other forms of ownership in a collective society.

The shareholders' agreement is generally used in predetermining issues such as management decisions (expenditure, annual budget, research and development projects, decisions on capital increases, mergers), the composition of the board of directors or management, dividend policies and exceptions to general company statutory provisions.

It is a document where shareholders may attempt to secure conduct which cannot easily be put into the company articles. For example, the articles of association of the joint venture company may contain a right of preference on the transfer of nominative shares but the shareholders may through a shareholders' agreement accept to waive it if the transfer is from one shareholder to an affiliate of this shareholder.

The agreement may contain detailed provisions as to how the word 'affiliate' shall be defined. The definition may be sufficiently complex that the shareholders believe, particularly in a corporation with few shareholders, that putting elaborate language into the articles of a 'family' corporation is awkward.

The matter can be dealt with on a contractual basis. It eliminates the need to strive for language that a notary or conservator will accept, language so precise that third parties have no doubt about its meaning. Words such as 'affiliate', 'controlled company' and 'subsidiary' are not always unambiguous.

A key negotiating condition which could not be put into the company articles may be stated in a shareholders' agreement. Shareholder A may promise shareholder B that out of a board of directors composed of three directors, shareholder A will always vote for one person nominated by shareholder B. Such an objective would better be handled by creating classes of shares with special voting rights rather than revealing private agreements between two entities which, if put into the articles, raises



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complex questions should there be a breach. A confidential shareholders' agreement between shareholder A and shareholder B does not establish the general characteristics of the company but rather how some or all shareholders will behave.

The shareholders' agreement is useful for ensuring that minority owners have certain rights not in proportion to their ownership of capital. More than any other legal document, the shareholders' agreement is a contract which can grant special rights to a minority group, ensure that the minority are not dominated by the majority, and secure for the minority a voice in the day-to-day operation of the company.

In simple language, and for use by practicing commercial lawyers, we want a document which requires one of the partners to vote or not in a certain way (usually it is to vote). The object of this vote is to secure one of the normal functions of any owner, the right to participate in management, to receive dividends or to prevent increases of capital, for example when the minority interest to be protected is a modest fraction of the capital or falls short of having equal status with another owner.

A final observation on the utility of a shareholders' agreement is it is confidential. Any rights inserted in the articles of incorporation are of public notice. Consequently, counsel shall have to decide to what extent confidentiality or public notice is of more benefit.

## §9.04 SIMILAR EXPRESSIONS FOR "SHAREHOLDERS' AGREEMENT"

Frequent, substitute expressions for "shareholders' agreement" are "collateral agreement", "convention of voting rights", "defence of minority", "shareholder pacts", "shareholder conventions", "side agreement", "stock restriction agreement", "syndicate of defence", "syndicate of votes", "syndicate of boycott", "voting agreement", "voting right shareholders agreements", "voting defence", and "pact of consultation."

In shareholders' agreements where voluntary or obligatory options exist to purchase the shares of an owner, the expressions to describe such situations frequently invoke the phrases "buy-and-sell agreement" or "sale and purchase agreement" or "survivor-purchase agreement" and if the optionee is the corporation, the description may be "stock purchase agreement" or "stock retirement agreement". These phrases describe a specific situation and are not as inclusive as the more generalized term "shareholders' agreement". Nevertheless, in legal literature the document is occasionally referred to as a "shareholders' agreement"

Whatever the designation given to a particular document, the shareholders' agreement will be recognized by its intentions of conditioning the right of vote of the signatories which are always shareholders, but of course can include signatories who are not shareholders such as a lender, investor, or promoter of the company and of course the company itself, although the latter may raise questions of the validity of the shareholders' agreement.

This doubt is raised because limitations to the corporate power granted by legislation are not looked favorably upon by the courts and this theme of rights of the company which cannot be abrogated must be a constant alarm. The hallmarks of the shareholders' agreement is its attempt of control of votes; its normally long duration; its





wide-ranging impact on a number of corporate topics; its private nature, all underpinned by the theory of contract whose principles permit a substantial amount of creativity based on consent.

## §9.05 A DETAILED LIST OF SHAREHOLDER CONTROL

The shareholders' agreement falls within the area of law known as "shareholder control" and while it is a major component of this sector with the most creative potential, it is not the only method accessible to shareholders.

This chapter explores the various forms of shareholder control ordinarily exercised by a separate document and while the various forms have their specific role, it is the shareholders' agreement which contains the most varied and effective form as shall be demonstrated.

Nevertheless, each investment by a client is sui generis and counsel must be prepared not to prejudge what form of shareholder control is the most adequate but assemble all the objectives of the client before making a decision.

Shareholder control can certainly be seen as an aspect of shareholder activism. However, our concern is not with shareholder democracy or engagement, but rather and specifically with ensuring within the close corporation that the rights of all shareholders, at times in conflict with management, at other times the minority interests in conflict with the majority shares, are protected and given sensible remedies.

Shareholder defence on the part of the minority or individual shareholder is hardly possible in the megalithic public corporation, except where its source is statutory. Shareholder control in the publicly quoted companies is a dim reality which does not affect the day to day life of either management or the shareholder, the latter normally visualizing their ownership as an investment and satisfied with a dividend stream or eventual capital gains.

There are techniques for shareholder control in the public corporation but this involves many of the alternative methods, such as classes of shares, voting trusts, pooling agreements, which in turn render the public corporation encumbered with legal complexities when a public listing is sought. Shareholder control in public corporations must seek other avenues which are not explored in this treatise.

Generally, all shareholder techniques find their most efficient use in the close corporation. However, there is no doubt that at times one or more of the following techniques may be used, with or without the execution of a shareholders' agreement and a brief review highlighting the principal characteristics of such alternatives is warranted.

Consequently, we shall consider the various alternatives to a shareholders' agreement, granting most of them only achieve limited objectives but this will afford counsel a general, panoramic view.

An initial, basic list relating to shareholder control is:



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***Right to Information***
Most jurisdictions confer upon shareholders the right to demand access to various items of information, provided same is held in confidence, but often there is imposed a minimum equity interest. To protect the minority shareholder these rights should be detailed and the percentage requirement either eliminated or diminished considerably.
***Termination of Joint Venture***
The parties can agree to a multiple of reasons which cause the joint venture to come to an end. There are the voluntary reasons, the expressed desire of the parties to end the joint venture through dissolution and liquidation of the assets. Such a provision would appear in the articles of the company.
***Voting on the Board of Directors***
The proper place to establish voting procedures, what majority is needed on what issue, are the articles of incorporation.



CHAPTER 19

# Drafting Suggestions: Expanding Adversary Rights for the Minority Shareholder

"[M]inority shareholders in close corporations can find themselves at majority shareholders' mercies, squeezed out of their jobs and companies, and cut off from all financial benefits from their investments."

Judd F. Sneirson, *Soft Paternalism for Close Corporations: Helping Shareholders Help Themselves*, 2008 Wis. L. Rev. 899 (2008)

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## §19.01 ACCESS TO CORPORATE DOCUMENTS

The purpose of the following clause is to make clear what most American corporate law statutes already grant but it is always prudent to draft language to ensure these rights. What the client sees, the client believes.

The clause permits the shareholder to have needed access to corporate documents which in the case of management bent on forcing out a shareholder is always a disturbing right to confront. Further, the general language, if coupled with appropriate veto rights, is enough to block many actions by a hostile board of directors through injunctive relief as the offended party is forewarned.

**Form no.**
**Shareholders' Agreement**
**Clauses of General Rights**
**To All Shareholders**
**Close Corporation**

"Shareholders shall be entitled to consult with and advice management of the Company on significant business issues, including management's proposed annual operating plans, and management will meet with Shareholder regularly during each year at the Company's facilities at mutually agreeable times for such consultation and advice and to review progress in achieving said plans.

Shareholders may examine the books and records of the Company and inspect its facilities and may request information at reasonable times and intervals concerning the general status of the Company's financial condition and operations, including, without intending to impose limits, all relevant accounting material, financial projections, and contracts with third parties. Prior to any management decision which may substantially affect the value of a shareholder's equity, the board of directors shall remit to the relevant shareholder, the reason for such action, affording the shareholder the right to set forth her/his objections.

The Company shall, concurrently with delivery to the Board of Directors, give a representative of each Shareholder copies of all notices, minutes, consents and other material that the Company provides to its directors, except that the representative may be excluded from access to any material or meeting or portion thereof if the Board of Directors determines in good faith, upon advice of counsel, that such exclusion is reasonably necessary to preserve the attorney-client privilege; to protect highly confidential proprietary information; or for other similar reasons. Upon reasonable notice and at a scheduled meeting of the Board or such other time, if any, as the Board may determine in its sole discretion, such representative may address the Board with respect to Shareholder's concerns regarding significant business issues facing the Company.

Shareholder agrees that any confidential information provided to or learned by it in connection with its rights under this letter shall be subject to the confidentiality provisions set forth in that certain Shareholders' Rights Agreement of even date herewith by and among the Company, the Shareholder and other investors."

## §19.02 DISPUTE RESOLUTION

While the following form may appear not sufficiently binding if we are dealing with a board of directors intent on squeezing-out a shareholder, nevertheless, the more the board of directors is obligated to listen to a shareholder in a non-judicial atmosphere and proceed with internal procedures, the more likely a settlement will take place.

**Form No.**
**Referral to**
**Board of Directors**

**"Dispute Resolution and Mediation/Arbitration**

**Option A.** The shareholders and company ('parties') commit to use their best efforts to resolve any disagreements or disputes internally and, only if such internal dispute resolution should not succeed, to proceed to arbitration by **[insert reference to arbitration entity]** in accordance with the Rules of Arbitration of **[insert reference to arbitration entity]**. Therefore, in the event of any dispute arising out of or relating to this Agreement, or its breach, termination or invalidity, all parties shall adhere to the following procedure in making any claim against any other party, **[or as an alternative clause]**

**Option B.** Should any party have a complaint against the company or the management of the company, or as a shareholder believe its rights are not being recognized and such





shareholder believes it is the subject of oppression, unfair management practices, fraud, illegal acts, squeeze-out tactics by the company, management of same, or any shareholder, then:

(1) Any disagreement or dispute shall first be referred to the next session of the board of directors ('board') or its equivalent for resolution, but not later than thirty (30) days after receipt of notice of complaint by shareholder to all parties.

(2) The complaining party shall immediately after notifying all parties of the basis for the dispute prepare and provide all parties and the board with a written, detailed summary of the basis for the dispute, together with all facts, documents, and other information supporting the dispute. The complaining shareholder may request from any party documents in the possession of that party.

(3) Should the dispute not be resolved by an unanimous decision of the board on that next session, or at the maximum within ninety (90) working days, the complaining party and the other parties, including the board, shall meet at a mutually agreed upon times and places in a good faith effort to compromise and settle the dispute.

(4) If a dispute resolution should not be possible between the parties in the dispute, any such dispute shall immediately be submitted to mediation in accordance with the following paragraphs.
Mediation and Arbitration.
All controversies, claims, disputes and matters in question shall be decided by mediation and/or arbitration in accordance with these paragraphs.

(5) The party who seeks resolution of a controversy, claim, dispute or other matter in question shall notify the other parties in writing of the existence and subject matter hereof, and shall designate in such notices the names of three prospective mediators, each of whom shall be registered with the **[insert reference to mediation entity]**.
The recipient party shall select from such list one individual to act as a mediator in the dispute set forth by the notifying party. The parties agree to meet with said mediator within two weeks after the recipient party has received notice of the dispute and agree to utilize their best efforts and all expediency to resolve the matters in dispute. The mediation shall not continue longer than thirty (30) hearing days without the written approval of all parties. No party shall be bound by any recommendation of the mediator; however, any agreement reached during mediation shall be final and conclusive and considered a binding contract entitled to enforcement by a court of law provided it is signed by all interested parties.

(6) If the dispute is not resolved by such mediation, it shall be decided by mandatory arbitration in accordance with **[insert reference to arbitration entity]** and their commercial arbitration rules. Any party may apply to **[insert reference to arbitration entity]** following failure of mediation/conciliation. The award entered or decision made by the arbitrator(s) shall be final and judgment may be entered upon it in accordance with applicable law in any court having jurisdiction thereof by application to the competent court.
The expenses of mediation and/or arbitration shall be shared equally by all parties.

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(7) Further, it is contemplated by the signatories to this Agreement, and the parties, including the company, to so instruct the arbitrators that based upon their findings and recommendations, an arbitrator/administrator shall be designated to implement the findings and recommendations immediately.
(8) The parties agree and consent to submit the nomination of an arbitrator/administrator to the relevant court for confirmation judicially of the nomination.
(9) The arbitrators are hereby directed to apply the rules of equity and to apply the remedies deemed appropriate without regards to the strict rule of law so as to achieve an equitable result for all parties.
(10) From the decision of the arbitrators there shall be no appeal to a court of law as to any decision on its merits.
(11) Should the dispute not be resolved amicably by an agreement signed by all parties, or, thereafter, should the findings and recommendations not be implemented, then any party, including the company, shall have the right to petition a court for dissolution of the company.

Buy-out provisions.
At any time, the parties/shareholders not seeking dissolution may avoid such a court decreed sentence by buying-out the other shareholder seeking dissolution based upon the valuation method set forth in clause..."

## §19.03 RESTRICTING POWER OF ARBITRATOR

If it is desirable to put some restrictions on the arbitrators' powers, the following is a suggested clause.

**Form No.**
**Specific Limitation**
**on Arbitration**

"The arbitrators may not award non-monetary or injunctive relief of any sort. The arbitrators shall have no power to award punitive damages or any other indirect damages, and the parties expressly waive their right to obtain such damages in arbitration or in any other forum. In no event, even if any other portion of these provisions is held to be invalid or unenforceable, shall the arbitrators have power to make an award or impose a remedy that could not be made or imposed by a court deciding the matter in the same jurisdiction.
The arbitrator shall determine the allocation of the costs and expenses of the arbitration, including the arbitrator's fee and the parties' attorneys' fees and expenses, based upon the extent to which each party prevailed in the arbitration.
No discovery will be permitted in connection with the arbitration unless expressly authorized by the arbitration panel upon a showing of substantial need by the party seeking discovery.
All aspects of the arbitration shall be treated as confidential. Neither the parties nor the arbitrators may disclose the existence, content or results of the arbitration, except as necessary to comply with legal or regulatory requirements. Before making any such





disclosure, a party shall give written notice to all other parties and shall afford such parties a reasonable opportunity to protect their interests.
The arbitrators shall render a written decision stating specifically the reasons of the fact and law on which the decision is based.
The result of the arbitration will be binding on the parties, and judgment on the arbitrators' award may be entered in any court having jurisdiction. Any party may contest the Arbitrators' decision and seek to have the award vacated, modified or corrected in a court of competent jurisdiction based only on the grounds (i) where the arbitrators' findings of fact are not supported by substantial evidence; or (ii) the decision was based on fraud or similar legal grounds."

## §19.04 MATERIAL NOT SUBJECT TO ARBITRATION

Not all materials can be subject to arbitration. The following clause takes this problem into account.

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**Form No.**
**Arbitration Clause**
**Excluding Statutory Material**

"GOVERNING LAW, LANGUAGE AND SETTLEMENT OF DISPUTES
**Governing law**
This Agreement shall be governed by and construed in accordance with the laws of **[insert jurisdiction]**.
**Language**
This Agreement, all communications to each Shareholder hereunder, all information, plans, specifications, instructions and services provided hereunder, and the proceedings of the Shareholders shall be executed, given and conducted in the English language. Any translation of this Agreement will be made available to each Shareholder at the expense of the Company.
**Arbitration**
Except for proceedings which by their nature involve notice and participation of creditors, pledgees, security interest holders, trustee in bankruptcy, insolvency and administration of insolvent assets, corporate reorganizations, as examples and without intention of being a limiting phrase, the procedure for resolution of disputes under this Agreement shall be as follows:

(a) Any dispute or claim between the Shareholders arising out of or in connection with this Agreement or the breach, invalidity or termination hereof shall be settled if possible in the first instance amicably. If amicable settlement cannot be reached, the matter under dispute shall be resolved by arbitration. This arbitration clause shall be deemed to be an agreement independent of the other terms of the Agreement.
(b) The arbitration shall be conducted in **[insert forum]** by a three-member board of arbitrators in accordance with the Arbitration Rules of **[insert arbitration institute]**. Each party shall select one arbitrator and the two arbitrators so chosen will

select the third arbitrator, who shall be chairman of the board of arbitrators unless the rules of said institute provide for a different selection method in which event the rules of said institute shall govern.

(c) The decision of the board of arbitrators, which shall be determined by a majority vote, shall be final and the Shareholders agree and acknowledge that any award rendered by such board may be executed in any court of competent jurisdiction. In its deliberations, the board of arbitrators shall apply the provisions of this Agreement **[Ed. Note, referring to the shareholders' agreement]**.

(d) The official language of the arbitration shall be in English.

(e) The award of the arbitrators will be final with respect to all controversies. Each party shall bear its own costs in the arbitration, including the fees and expenses of the arbitrator selected by it. The arbitrators shall decide which party shall pay the fees and expenses of the third arbitrator.

(f) The award of the arbitrators shall be enforceable by any court having jurisdiction over the Party or Parties against which the award has been rendered, or where assets of the Party or Parties against which the award has been rendered can be located.

(g) Each of the Parties agrees to pay the amount of any arbitration award and of any costs and expenses of arbitration which the arbitrators determine that it is required to pay within sixty (60) calendar days after receipt of notice of the arbitrators' final award."

For counsel who wishes to utilize an arbitration clause, a more complete draft of such a clause is suggested below.

## §19.05 DISSOLUTION RIGHTS

A powerful dissolution right for minority shareholders is the clause set forth below.

**Form No.**
**Clause Granting**
**Dissolution Rights**
**to Dissident Shareholder**

"Any party shall also have the right to request dissolution if:

a. The duration of the Company expires;
b. The accumulated losses of the Company exceed its registered capital of and the Company is unable to continue its operations;
c. The occurrence and failure to resolve a deadlock at the Board of Directors'
d. The Company fails to achieve its expected purposes and there is no hope of development for the Company;
e. A shareholder believes it has been subject to fraud, oppressive behavior, illegalities, prejudicial acts, squeeze-out tactics, or similar behavior, by either the company or other shareholders and mediation/arbitration has not resulted in a settlement signed by all parties/shareholders'





The above clauses are very general which puts a powerful weapon into the hands of a minority shareholder and which clauses coupled with buy-out provisions are useful to force a settlement prior to dissolution. The clauses above may go beyond the limit to which all parties will accede. Counsel can modify the clauses accordingly

This ability to invoke 'dissolution at will' can be also modified by making a list of issues which the parties consider at the formation of the company as justifying a request for dissolution.

An alternative to such a list is to have a limited life to the company and such term is set forth in the articles of incorporation. This is not an ordinary solution and unlikely clients will accept a limited term company. But it is a theoretical alternative.

Finally, some commentators such as another alternative the selection and appointment of a tie-breaking director in those cases where the board of directors is deadlocked due to either split votes evenly or the lack of a super-majority needed.

The use of a tie-breaking director appears to only delay the problem for ultimately the person selected may never be selected, since no one can agree whom to nominate, or if selected, the dissension does not disappear and more time is lost in dilatory tactics.

## §19.06 SPECIFIC BUY SELL CLAUSES FOLLOWING ARBITRATION

Often the minority shareholder faces the problem of valuation of shares.

**Form No.**
**Shareholders' Buy-Sell**
**Agreement Partial Clauses**
**Relating to Purchase**

"THIS SHAREHOLDERS' BUY-SELL AGREEMENT (this 'Agreement') is entered into and effective as of the ...day of..., 20.., by and among...

RECITALS

The Shareholders and the Company believe it is in their and the Company's best interests to provide for the purchase of shares of any shareholder whose rights have not been implemented as decreed by an arbitrator as well as for other specified causes indicated in the clauses hereinafter set forth.

NOW, THEREFORE, the parties agree as follows:

EVENTS CREATING AN OPTION IN COMPANY/SHAREHOLDERS TO PURCHASE SHARES.

Each of the following events or conditions shall constitute a purchase option ('call') conferring upon Company/shareholders the right to purchase the shares of the shareholder invoking, voluntarily or involuntarily, the aforesaid events or conditions, except for subparagraph (e) whereby Company/shareholders shall be under an obligation to purchase, conferring therefore upon the selling shareholder a sale option ('put'):

(a) the filing of a petition in bankruptcy by or against the Shareholder (unless the petition is dismissed within sixty (60) days) or otherwise held in abeyance by a court of law;



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