VENABLE LLP corporate alert

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Stockholder's Agreements: Controlling the Transfer of Stock

In addition to all of the day-to-day, operational decisions that go into running a business, the principal stockholders of a privately-held company must make many choices about what rights and obligations the company's stockholders will have with respect to each other as owners of the company and with respect to the company itself. These choices include how company-level decisions will be made, who will be elected to the company's board of directors, how to resolve any impasses if the decision-makers disagree, who can become a stockholder of the company, and what happens if one of the stockholders "wants out". Perhaps the most important of these types of decisions relates to what sort of restrictions apply to the ownership and transfer of the company's stock.

There are often compelling reasons for a privately-held company to limit or restrict the ownership and transferability of its stock, including incentivizing employees, concerns about the company's stock ending up in the hands of competitors or unknown third parties, and limitations imposed by the federal and state securities laws.

The most effective way for a privately-held company to limit or restrict ownership and the transferability of its shares is by contract, often in the form of a written stockholder's agreement. A stockholder's agreement is an agreement among stockholders of a company that governs the rights and obligations of those stockholders with respect to each other and with respect to the corporation. A stockholder's agreement can take many forms: it can be single, comprehensive agreement, or one in a series of stand-alone agreements; it can apply to all of the stockholders of a corporation or only select stockholders; it can address one stockholder-related issue (such as stock ownership and transfer restrictions) or a variety of issues, including registration rights, board membership, voting agreements and confidentiality obligations. Whatever form a stockholder's agreement takes, it is essential that the provisions of any stockholder's agreement, including the provisions relating to stock ownership and transfers, not conflict with the company's organizational documents or applicable law and that all stockholder-related agreements work together.

In most stockholder's agreements, stock ownership and transfer restrictions take the form of a general restriction on transfer, which is then subject to certain enumerated exceptions. In order for a stockholder to be able to transfer his or her shares, the transfer must meet the specific requirements of one of the exceptions. The principal exceptions to the general "no transfer rule" that appear in stockholder's agreements often fall into one of the following categories, which are discussed in more detail below: (1) permitted transfers; (2) rights of first offer and first refusal; (3) "tag along" and "drag along" rights; and (4) buy-sell arrangements. As discussed in more detail below, some of these exceptions create procedural requirements, while others simply identify categories of transferees that are acceptable. A stockholder's agreement may contain only one of these exceptions, or it may contain all or a combination of them.

Permitted Transfers

Many stockholder's agreements permit a stockholder to transfer his or her shares if the transfer qualifies as a "permitted transfer". For example, a stockholder's agreement might generally prohibit stock transfers except for transfers that are approved by the company's board of directors or by stockholders holding shares that represent no less than some minimum percentage of the outstanding company stock, or transfers effected after the stock is first offered to the company or other stockholders for purchase pursuant to a right of first offer provision or a right of first refusal provision, which are discussed in more detail below.

Many stockholder's agreements also permit transfers to specific individuals or entities. These types of exceptions to a general restriction on transfer are designed to allow a stockholder to transfer his or her shares to closely related persons, to his or her affiliates (i.e., entities he or she controls), to other existing stockholders, or to family-related trusts for estate-planning purposes.

Rights of First Offer and First Refusal

A "right of first offer" requires any stockholder proposing to sell shares of his or her stock to offer those shares to the company or other non-selling stockholders before offering them to a third party. If the company and the non-selling stockholders opt not to buy the stock, the selling stockholder is permitted, usually for a limited period of time, to sell the stock to a third party. The third-party sale cannot have terms more favorable to the third-party buyer than the terms offered to the company and the existing non-selling stockholders, including pricing terms.

A "right of first refusal" requires any selling stockholder, if he or she receives a *bona fide* third-party offer to purchase shares of his or her stock and wants to accept the offer, to offer to sell those shares to the company or the non-selling stockholders. The offer to the company and the non-selling stockholders must be made on terms similar to those offered by the third-party, including pricing terms. If the company and the non-selling stockholders opt not to buy the stock, the selling stockholder is permitted to sell the stock to the third party, typically for a limited period of time.

Tag-Along and Drag-Along

"Tag-along" rights (which are sometimes referred to as "co-sale" rights) permit a stockholder to sell a *pro rata* portion of his or her shares of stock if another stockholder is selling stock to the same purchaser. Tag-along rights are often used to ensure that if the company's majority stockholder sells his or her stake in the company, minority stockholders have the right to join the sale and sell their shares with the same terms as would apply to the majority stockholder.

In contrast, "drag-along" rights force a stockholder to sell his or her company stock if the majority stockholder(s) is selling stock. Drag-along rights protect the majority stockholder(s) by ensuring that if the majority stockholder(s) sells his or her shares to a third party, the minority stockholders are required to join and sell their shares in the majority stockholder's sale.

Buy-Sell Provisions

Many stockholder's agreements include provisions permitting or requiring the company, or sometimes the stockholders, to buy the stock of another stockholder if certain triggering events occur. Common triggering events include the death, incapacity or termination of employment of a stockholder who is an individual, or the bankruptcy or change of control of a stockholder that is an entity.

A "buy-sell" provision that requires the company or the other stockholders to buy the selling stockholders stock upon the occurrence of one of the specified events is sometimes called a "put right". A "buy-sell" provision that allows the company or other stockholders to require a selling stockholder to sell the shares of his or her stock to the company or the other stockholders on the occurrence of one of the specified events is sometimes called a "call right".

It is worth noting that establishing a purchase price for stock subject to a buy-sale arrangement is a critical element in the exercise of a put right or call right and should be carefully considered. Unlike a right of first refusal or similar provision, which is triggered by an independent third-party purchase offer and includes a built-in purchase price established by the third-party offer, a put right or call right is typically triggered by an event (*e.g.*, the death of the stockholder) that does not itself establish a purchase price. A stockholder's agreement will typically include a section that sets out the method for determining the price of the stock to be purchased in circumstances in which a stockholder is obligated (or has a right) to sell shares to the company or another stockholder and there is no third-party purchase offer establishing the price. For example, in these circumstances, the stockholder's agreement might provide that the purchase price will be set by the board of directors based on a good faith determination, or it might require a third-party appraisal.

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