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A Corporate Lawyer's Perspective
On Equity Compensation and Other Issues in Closely Held Entities

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A CORPORATE ATTORNEY'S PERSPECTIVE ON EQUITY COMPENSATION AND OTHER EMPLOYMENT ISSUES IN CLOSELY HELD ENTITIES

For the entity, particularly a closely held one, the granting of equity raises numerous issues. It can exponentially complicate the capital structure and governance and expose the entity to new potential liabilities. Unless the entity is going to go public or be sold in the short term, it may not make sense for the entity to provide equity to executives.

1) Impact of Granting Equity to an Employee of a Closely Held Entity – Entity's Perspective

In closely held entities, ownership and management frequently overlap and decisions are made with little formality. By granting equity, a new outside owner is introduced.

a) Impact on culture – will require greater adherence to corporate formalities

i) Regular meetings

ii) Corporate records

iii) Accurate financial records

iv) Tracking of company vs. personal expenses

v) Examples

b) Entity has new potential exposure to executive:

i) Majority shareholders owe fiduciary duties to minority shareholders

(1) Controlling or dominant shareholder may not use his or her position to take an action that favors the controlling shareholder over the minority shareholders unless there is a legitimate business purpose (for the corporation).

For an entity that historically was owned and operated by one person or family, this can be a big change that exposes the controlling shareholders to new potential liabilities if they do not adjust their historical operating methods.

"A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the

corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside." Pepper v. Litton 308 US 295 (1939)

(2) This issue often arises in transactions in which the controlling shareholders use their control of the board or their control of shareholder voting to give themselves benefits not shared with other shareholders (i.e., freeze-outs of minority shareholders, sales of control, share repurchases by closely-held corporations that disadvantage the minority, liquidations or redemptions that unfairly benefit controlling shareholders).

(3) Examples

(4) See materials: Mackay, J., New Jersey Corporations and Other Business Entities (3rd ed. 2005) – Section 7.07 "Fiduciary Duties of Controlling Shareholders – General".

ii) Shareholder Claims of Oppression (N.J.S.A. 14A:12-7).

In an action brought under this statute, the court may appoint a custodian, appoint a provisional director, order a sale of the corporation's stock or dissolve the corporation if:

(1) Shareholders are so divided they have failed to elect successor directors for two consecutive annual meetings;

(2) The directors are unable to effect one or more substantial matters; or

(3) If the corporation has 25 or fewer shareholders, those in control acted fraudulently or illegally, mismanaged the corporation, abused their authority or have acted unfairly or oppressively toward one or more minority shareholders.

(4) Examples

c) Transferability of Equity:

Under common law, shares or membership interests are freely transferable. Without an agreement, the executive could sell his or her equity stake to a stranger, a customer or a competitor.

2) Protections Entities Should Have Before Granting Equity.

a) Securities laws: need an exemption under securities laws to issue securities–Rule § 701. Raises disclosure issues.

b) Shareholder Agreement/Operating Agreement Protections

i) Restrictions on transfer – Entity does not want executive transferring equity to third parties

ii) Buyback Right – in shareholder agreement, special charter or bylaw – can protect the company/majority shareholders and/or the employee/minority shareholder

A) If employee dies, becomes disabled or ceases to be employed by the entity, entity or other equity holders can/must buy back the equity.

B) If there is dissention or deadlock, the majority equity holders can buy the minority's interest.

iii) Drag along rights – Right that enables a majority shareholder or the board to force a minority shareholder to join in the sale of a company. Usually, in a closely held company, the majority owner doing the dragging must give the minority shareholder the same price, terms, and conditions as any other seller to avoid claims for breach of fiduciary duty or oppression. Often buyers will only purchase 100% of an entity (not just a controlling interest), so drag-along rights enable the controlling shareholder to force the minority shareholder to sell. This prevents the minority shareholder from trying to "hold up" the majority by refusing to sell his or her shares to a buyer.

iv) Clear understanding of how entity will be managed

v) Clear understanding of information rights and confidentiality restrictions

3) Executive's Perspective: Receiving Equity in Closely Held Entity

i) How will executive cash-out?

(1) No market for securities.

(a) Is there an upcoming IPO or sale transaction?
(b) Contract for a buyout formula.
(c) Lack of market for ownership interest makes it difficult to leave a bad relationship.

(2) Close corporations rarely pay dividends.

(3) What happens to equity upon death, disability or termination of employment?

(4) Will the entity or other shareholders have the cash to buyout executive upon an exit?

ii) How will executive obtain sufficient information to monitor entity performance? Does the executive want a seat on the board?

iii) Tag along rights: If a majority shareholder sells his stake, the minority shareholder has the right to join the transaction and sell his minority stake in the entity on the same terms.

iv) Is executive subject to capital calls? Will executive's equity be diluted if executive does not meet a capital call? Preemptive rights?

v) Is entity an S corporation or a LLC that will cause executive to owe taxes on entity income even if it is not distributed? Should distributions be required in order to enable executive to pay taxes?

vi) What decisions require a vote of equity owners? Should executive be able to veto any decisions? Should a super-majority vote be required?

vii) Dispute resolution provisions – is confidentiality important?

viii) Shareholder Rights – corporations

(1) Vote – may be changed or eliminated by appropriate provisions in charter or by contract.

(2) Distributions – Whether to pay distributions is determined by the board. Often close corporations pay bonuses to employees instead of dividends to avoid double taxation or to avoid sharing profits

with nonparticipating minority shareholders. Reluctance to pay dividends or make distributions to shareholders can be challenged. This could be grounds for an oppression claim.

(3) Preemptive rights/Anti-dilution – Without a specific provision in the certificate of incorporation, shareholders of NJ corporations formed after January 1, 1969 do not have preemptive rights.

(4) Information rights – Shareholders have a statutory right to obtain basic financial information and some general information about the corporation (a copy of the certificate of incorporation, bylaws, right to inspect the corporate books and records). Unless shareholder negotiates additional rights to information by contract, right to information is relatively limited.

(a) Absolute statutory right to obtain basic financial information.

NJ does not require corporations to provide their shareholders with financial information on an annual basis. However, a NJ corporation must mail balance sheets and profit and loss statements for the preceding fiscal year to any shareholder requesting them – BCA 14A:5-28(2).

(b) Unqualified common law right to obtain copies of the charter and bylaws.

(c) Qualified statutory right to review shareholder records – shareholder voting lists, shareholder records and minutes of shareholder meetings.

4) Preferable Forms of Equity Grants

a) Non voting stock – executive receives equity but voting control remains with the voting shareholders.

b) Restricted stock – stock issued to executive contains certain restrictions (such as vesting over time or vesting upon the achievement of certain goals) that subject it to forfeiture.

c) Junior Stock – a class of stock that has less rights than, is "junior" to, other stock (i.e., behind other stock upon liquidation, diminished voting rights, smaller dividend, etc.). Often the stock converts to common stock upon an IPO or sale of the entity.