STOUT

Contractual Terms in Shareholder/Operating Agreem

A Survey of Recent Judicial Interpre Enforcement

Through in-depth analyses of recent cases, we find that courts analyzing shareholder/operating agreements strive to determine and effectuate the parties' intent – but agreements aren't always safe harbors from liability for oppression.

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When business owners sign a shareholder or operating agreement, they are usually in the optimistic early stages of forming a new venture; thus, they may not always pay careful attention to every term in the agreement. But when a dispute arises, the language of the agreement becomes critical. For example, an operating agreement may alter the applicability of state statutory provisions, which are often subordinate

to operating agreements.[1] In the corporate context, some courts have held that breach of a shareholder agreement can serve as evidence of oppressive conduct by controlling shareholders or directors.[2]

We examine U.S. courts' recent treatment of contractual provisions commonly found in shareholder/operating agreements. These cases highlight the deference courts generally afford to parties to define the scope of their duties to one another.

Who Is Bound by the Agreements?

Shareholder and operating agreements are interpreted broadly and may apply even to nonsignatories and nonshareholders or members. This is common in the context of involuntary transfers, as sometimes happens in divorces. For example, in *Baumbouree v. Baumbouree*, 202 So. 3d 1077 (La. Ct. App. 2016), a shareholder agreement bound the nonsignatory wife to the valuation provisions that the ex-husband had signed during the marriage. Because the stock was in his name, he had the exclusive right to control it, and the ex-wife was bound to his agreement.[3] Likewise, in *Slutsky v. Slutsky*, 451 N.J. Super. 332 (N.J. Super. Ct. App. Div. 2017), a shareholder agreement signed only by the ex-husband was determinative in valuing the ex-husband's interest in a partnership.

In *Summer Haven Lake Assn. v. Vlach*, 25 Neb. App. 384 (Neb. Ct. App. 2017), the court held that the defendant intended to bind himself personally when he signed a shareholder agreement with blanks reserved for "shareholder" rather than on the signature line for the authorized officer of his corporate principal (who was the actual shareholder). Conversely, a Delaware Chancery Court held that an actual shareholder was not bound to a shareholder agreement when he acquired stock without knowledge of its transfer restrictions. *Henry v. Phixios Holdings, Inc.*, 2017 WL 2928034 (Del. Ch. July 10, 2017).

The shareholder agreement bound the plaintiff even though the court declared that she never became a shareholder in *Catamount Radiology, P.C. v. Bailey*, 2015 WL 3795028 (D. Vt. June 18, 2015). There, the plaintiff failed to fulfill her obligation to

purchase shares under the shareholder agreement, but nonetheless remained an employee of the corporation. The terms of the shareholder agreement applied to her employment regardless of her status as a shareholder. Thus, the plaintiff could pursue her claim for equal compensation under the shareholder agreement.

Forum-Selection and Arbitration Clauses

Forum-selection and arbitration clauses, which limit the available forum in which disputes may be resolved, are both common and commonly upheld. In some cases, these provisions have been held to apply to nonsignatories.

Arbitration and forum-selection clauses typically designate a forum for various types of claims "arising out of" or "relating to" the agreement. In Pinto Tech. Ventures LP v. Sheldon, 526 S.W.3d 428 (Tex. 2017), the court held that a forum-selection clause that covered claims "arising out of" the agreement applied to tort and contract claims. The court reasoned that the agreement and its terms were operative facts in the dispute, and that the agreement was the but-for cause of the shareholders' claims. Similarly, in Kadiyala v. Pupke, 2017 WL 2350454 (N.D. Ill. May 30, 2017), the forum-selection clause applied to the plaintiff's fraud claims even though the clause did not bind all the defendants because the claims involved the agreements and the disputes arose out of
them.[4]

In *Mortenson Kim, Inc. v. Safar Kim, Inc.*, 2017 WL 5905555 (E.D. Wis. Nov. 30, 2017), the court granted a motion to compel arbitration even though the validity of the agreement containing the arbitration clause was at issue. The arbitration clause required arbitration of all claims "relating to" the agreement. Although only half of the claims directly involved the agreement, the remaining claims relied on the same facts as the arbitrable claims. But in *Kramlich v. Hale*, 901 N.W.2d 72 (N.D. 2017), even broad language requiring arbitration of disputes, claims, or controversies "arising out of or relating to" an operating agreement did not require arbitration of claims that involved both the LLC and a separate partnership. The clause was not

broad enough to extend to other agreements.[5]

In *Altobelli v. Hartmann*, 499 Mich. 284 (2016), a former principal of a law firm sued individual principals of the law firm. The Michigan Supreme Court held that the plaintiff's tort claims fell within the scope of an operating agreement provision that mandated arbitration for any dispute between the firm and the former principal, even though the firm was not a named party. Similarly, in *Bonanno v. VTB Holdings, Inc.*, 2016 WL 614412 (Del. Ch. Feb. 8, 2016), a defendant nonsignatory could rely on a forum-selection clause because the defendant's relationship was "sufficiently close" to the signatories of the agreement such that it was foreseeable that the defendant could sue under the agreement's provisions. In Loya v. Loya, 507 S.W.3d 871 (Tex. App. 2016), the plaintiff was bound by a forum-selection clause requiring dispute resolution in the Netherlands, where her ex-husband (who had transferred shares to his ex-wife) had signed an agreement explicitly binding parties regardless of death or divorce.

A nonsignatory plaintiff was bound by an arbitration clause in *Craddock v. LeClairRyan, P.C.*, 2016 WL 1464562 (E.D. Va. April 12, 2016), because her conduct constituted acceptance. Although the shareholder agreement suggested a specific method of acceptance, the court did not find that suggestion limiting. The plaintiff's actions suggested her intent to accept the shareholder agreement.[6]

In *Trujillo v. Gomez*, 2015 WL 1757870 (S.D. Ca. April 17, 2015), the court found an arbitration provision in a shareholder agreement enforceable against both plaintiffs, even though at the defendant's recommendation one plaintiff had not signed it. Gomez suggested that the plaintiffs (Trujillo, Sr., and Trujillo, Jr.) form a corporation to protect their business interests and offered to create one on the condition that he become a 50% shareholder. He offered the other 50% to the plaintiffs but advised that Trujillo, Jr., hold the shares and that Trujillo, Sr., hold none. The arbitration clause was enforceable against Trujillo, Sr. because he was bound as a third-party beneficiary – and the complaint acknowledged that Trujillo, Sr., accepted the agreement's benefits, and that all parties understood that his shares were held by

Trujillo, Jr.

In *Meister v. Stout*, 353 P.3d 916 (Colo. App. 2015), the court held that an operating agreement's arbitration clause covered one nonsignatory's claims against another nonsignatory under a theory of equitable estoppel. Plaintiffs DeLollis and Stout formed Venti, LLC, and signed its operating agreement. The plaintiffs and the defendant later signed a purchase agreement under which the defendant obtained an interest in Venti. Because the purchase agreement incorporated the operating agreement by reference, the court applied the arbitration clause to the defendant's claims against Venti because his claims presumed the existence of, relied on, or otherwise referred to the operating agreement.

Interpretation

Operating/shareholder agreements vary widely in quality and scope, and they sometimes omit key terms. Courts often avoid reliance on extrinsic evidence or findings of ambiguity. Instead, they seek to discern the parties' intent through reference to the agreement's existing language, when possible.

In *Mintz v. Pazer*, 152 A.D.3d 761 (N.Y. App. Div. 2017), the court used a shareholder agreement to determine a valuation date for shares, though the agreement did not provide one. The agreement suggested that the parties intended valuation to reflect the fair market value of the shares at the time of sale. Because the parties had already exchanged appraisals, the court held that the valuation date should be contemporaneous with that exchange. Likewise, in In re: Discontinuance and Disposition of P.K. Smith Motors, Inc., 188 So. 3d 324 (La. Ct. App. 2016), the court enforced a shareholder agreement where the buy-sell provision stated, "The purchase price for each share of stock purchased pursuant to this Agreement shall be $___." Despite the lack of a price term, the court held that the overall agreement was clear and unambiguous, and the provision containing the blank price was a transfer restriction intended to keep shares within the family.

The court in *Bales v. Babcock Power, Inc.*, 476 Mass. 565 (Mass. 2017) held that the defendant employer's termination of plaintiff (for an affair with a coworker) was actionable. The defendant argued that the affair constituted a "willful and material breach" of the agreement. The defendant gave the plaintiff no opportunity to correct the breach, even though the agreement required this. According to the defendant, the plaintiff's behavior was "uncorrectable" and thus the correction would have been futile. The court found this interpretation "implausible" instead, the court held that the correction provision included an opportunity to correct adverse effects caused by an irreversible breach.

Authority and Breach

Operating/shareholder agreement provisions that provide shareholders, members, and managers or officers with general authority to take certain actions are not always safe harbors from liability when used to oppress other owners in specific contexts. For example, in *Celauro v. 4C Foods Corp.*, 2016 N.Y. Misc. LEXIS 3711, 2016 N.Y. Slip. Op. 31917(U) (Sup. Ct. Kings Co. Oct. 12, 2016), the defendants amended a shareholder agreement to enable them to repurchase the plaintiff's shares at a lower value. The amendment prevented transfer of plaintiff's shares, had no apparent business purpose, had no benefit to the shareholders, and was timed to coincide with the shareholder's imminent death. The court held that such an amendment, though innocuous and legal on its face, could breach the implied covenant of good faith and fair dealing and breach fiduciary duties.

In *State v. Bruun*, 405 P. 3d 905 (Utah 2017), broad powers granted to the defendants by the operating agreement did not unambiguously authorize the defendants to use LLC capital for the expenditures that led to their theft charges. The authority was qualified by specific restraints, rendering it reasonable to find that the defendants' acts were unauthorized. However, in *Andersen v. Succession of Bergeron*, 217 So. 3d 1248 (La. Ct. App. 2017), the court was asked to interpret an operating agreement that granted managing member RLB unilateral authority "to act for the company in any banking transaction, sale, mortgage, lease, or other transaction involving assets

or property owned by the company." It also provided that any transaction by a manager involving company property required a majority vote of membership. Finding that RLB had authority to transfer property without other members' consent, the court held that the majority vote provision applied only to acts of managers other than RLB because other interpretations would render the first provision meaningless.

Elsewhere, the defendants alone were not authorized to designate a special litigation committee in *LNYC Loft, LLC v. Hudson Opportunity Fund I, LLC*, 154 A.D.3d 10 (N.Y. App. Div. 2017). Such action constituted a "major decision" under the operating agreement, requiring the plaintiff's consent.

In *Conrad Black Capital Corp. v. Horizon Publs, Inc.*, 2015 IL. (1st) 132116-U (Ill. App. Ct. Dec. 23, 2015), the plaintiff's claim for breach failed even though the court found that the defendants did not comply with the shareholder agreement. The agreement provided that once a shareholder gives notice of his intent to sell shares, the shareholders must meet to determine whether the corporation will exercise its right of first refusal. Because the defendants indefinitely postponed the shareholder meeting, they breached the agreement. The plaintiff sought specific performance in the form of a buyout, claiming that the defendant corporation failed to exercise its right of first refusal. However, the court determined that the shareholder meeting was a condition precedent to the right of first refusal, and the plaintiff was only entitled to compel a meeting, not a buyout.

Control and Membership

Courts tend to strictly construe provisions in shareholder or operating agreements that restrict control by the owners. Relying in part on the shareholder agreement, the court in *Sciabacucchi v. Liberty Broadband Corp.*, 2017 WL 2352152 (Del. Ch. May 31, 2017) concluded that Liberty was not in control of Charter even though Liberty held itself out to the Securities and Exchange Commission as controlling. The shareholder agreement prohibited Liberty from acquiring more than 35% of Charter's stock, from

designating more than four out of 10 directors, and from soliciting proxies or consents; it also required majority or disinterested approval for many transactions.

The plaintiff in *Kilpatrick v. White Hall on MS River, LLC*, 207 So. 3d 1241 (Miss. 2016) was found not to be a member of the LLC because he failed to fully pay his contribution required under the operating agreement, even though he was designated as a member on exhibits to the agreement and on entity tax returns. In *McDonough v. McDonough*, 169 N.H. 537 (N.H. 2016), an operating agreement provided that the LLC "shall continue in full force and effect for a term of twenty (20) years, unless sooner terminated or continued pursuant to the further terms of this Agreement." The court held that the second clause, when read with the LLC Act, permitted a majority of its members to revoke the dissolution provision – the agreement permitted unanimous amendments, and the Act permitted members to revoke dissolution by a majority vote.

Unintended Consequences

Unintended consequences can arise when operating and shareholder agreements are not amended as the entity's operations or goals change. Still, courts will sometimes apply the agreement to effectuate the parties' intent and apply it to the new factual context. For example, an amendment expressly acknowledging a two-year period was held to be a permanent amendment to an operating agreement in *Daniel v. Ripoli*, 2016 IL App (1st) 122607-U (Ill. App. Ct. Nov. 16, 2016), because it had no beginning or end date. Conversely, a strict reading was applied in *Veterans Contracting Group, Inc. v. United States*, 2017 WL 6505208 (Fed. Cl. Dec. 20, 2017). There, the court looked to a shareholder agreement to determine whether the plaintiff met certain ownership and control standards. Because the agreement required redemption of shares under certain circumstances (e.g., death or bankruptcy), the plaintiff did not "unconditionally" own his shares, and was therefore ineligible for the program at issue.

Judicial Approaches to Disputes

Generally, courts seek to interpret shareholder and operating agreements to effectuate the parties' intent and not to infringe on parties' freedom to contract. Courts will typically work to find the agreements binding, even where terms are missing and sometimes when closely affected parties are not signatories to the agreement.

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1. *See* e.g., Mich. Comp. L. 450.4401 (Michigan LLCs are generally subject to restrictions, or enlargement of management rights and duties, contained in operating agreements); N.Y. Ltd. Liab. Co. Law 402 (member voting in New York LLCs is subject to operating agreement modifications).
2. *See* e.g., *Madugula v. Taub*, 496 Mich. 685 (2014).
3. *See also Bulloch v. Bulloch*, 214 So. 3d 930 (La. Ct. App. 2017) (agreement dictating valuation of shares made by ex-husband prior to divorce controlled valuation of shares in divorce proceeding).
4. *See also Horn v. Kirey*, 2017 WL 6453330 (E.D.N.Y. Dec. 14, 2017) (forum-selection clause covered the plaintiff's tort claims where New York was the

designated forum "over any and all controversies arising directly or indirectly from this Agreement." The plaintiff's defamation claims stemmed from the agreement because they caused alleged breaches of the agreement).

5. *Cf. William Beaumont Hosp v. W. Bloomfield Mob*, 2016 WL 4008637 (unpublished, Mich. Ct. App. July 26, 2016) (where all claims were covered by arbitration language in different agreements, arbitration was appropriate even though not all claims were covered by the same arbitration clause).
6. *Cf. Larkho v. Nisar*, 2017 IL App (5th) 160141-U (Ill. App. Ct. March 27, 2017) (the plaintiff who never signed operating agreement was not bound by its arbitration clause; it was insufficient that the plaintiff allegedly reviewed agreement before investing in LLC).

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