

Protecting Key Internal Business Relationships

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Identifying Types of Internal Relationships

- Relationships between the Business Entity and its Shareholders/Members/Partners
- Relationships between the Business Entity and its Managers/Officers/Directors
- Relationships between the Business Entity and Outside Investors
- Relationships between the Business Entity and Employees
- Relationships with Affiliate/Related Parties

Shareholder/Member/Partner Relationships

- Critical to address various rights, responsibilities, obligations, expectations, etc., both (1) *among* the equity owners and (2) *between* owners and managers/officers/directors
- Vehicle for doing so is a well drafted Operating/Shareholder Agreement
 - “Pre-Martial Agreement” for Businesses
- Allows the owners to modify the default statutory rules to capture the “spirit of the deal” and create a framework through which the parties can operate and control the future disposition of the business
- Provides the owners with a degree of predictability and stability to otherwise unpredictable and unstable relationships

Operating/Stockholder Agreements

- The Agreement can help balance the competing objectives of the business entity itself and the individual owners
- From Business Entity Perspective → assure continuity of ownership through restrictions on transfers/encumbrances to outside parties
- From Owner Perspective → create a mechanism to allow owner to realize on their investment (death, disability, etc.)
- In absence of an Agreement, default NC laws may defeat/conflict with owners’ objectives
 - Under NC corporate law, owners can freely transfer interests so can’t insure continuity of ownership
 - On the flip side, NC law does not allow owners to force a buyout of their interest

Operating/Stockholder Agreements

- New North Carolina LLC Act Implications
 - Public policy objective is to give “maximum effect to the principle of freedom of contract and the enforceability of operating agreements”
 - Operating Agreement overrides the LLC Act default rules and allows owners to control respective rights/obligations and governance of business
 - New LLC Act allows Operating Agreements to be *written, oral or implied*
 - → Require a “written” operating agreement in the Articles of Organization to avoid misunderstandings and internal disputes
 - Amendments should be in writing as well

Operating/Stockholder Agreements

- Modify Default Rules under New LLC Act
- “Member-managed” is default rule → one vote each regardless of relative capital contributions
 - Minority members could outvote majority owner(s) and control decision-making
 - specify “manager-managed” in Articles to supplant default rule
- Distribution Rights based on relative “contribution amounts”
 - Equal to the FMV of capital, services, or “other direct or indirect benefits” contributed or promised to be contributed
 - New Act does not require agreement among members as to value of noncash contributions → danger of claimed increased economic rights through unilateral service or uncertainty as to nature and extent of services performed
 - O.A. should require member agreement to type of services, scope and duration of services, and FMV to attribute to services for establishing “contribution amounts”
- Transfer of Membership Interest → only entitled to “economic rights” associated with interest until “admitted”

Key Provisions in Operating Agreement

- **Business Purpose of the Company**
 - Default rule under NC law is that the entity may engage in any lawful business and has the requisite powers to conduct its business
 - Limiting the business purpose/activities of the entity may be important to protect the interests of passive members who are not managing the operations of the business
 - Can also be useful in protecting certain external relationships such as with lenders → SPE provisions
 - Specify what type of member consent is necessary to expand into new business areas

Key Provisions in Operating Agreement

- **Management Rights & Responsibilities**
 - Under default rules, the power to manage the entity rests with the managers and decisions made by majority vote
 - Specify manager-managed (even if all members will be appointed as managers)
 - Duties of Managers:
 - (i) Good Faith
 - (ii) with Due Care
 - (iii) subject to the operating agreement, in a manner he/she believes to be in the best interest of the LLC
 - May want to expand or limit the fiduciary duties of the managers to protect members

Key Provisions in Operating Agreement

- **Management Rights/Responsibilities**
 - Composition of Board of Managers and how are they appointed and/or replaced
 - Ability to Delegate Managerial Powers
 - Identify which actions can be taken by each manager and which actions require unanimous/majority consent
 - Compensation Terms
 - Indemnification rights
 - Reserve right to create incentive-based unit class (profits interests)

Key Provisions in Operating Agreement

- **Actions Requiring Member Approval**
 - Unless O.A. says otherwise, LLC Act requires unanimous member approval to:
 - Adopt or amend the Operating Agreement
 - Transfer assets of LLC
 - Admit new members
 - Dissolve
 - Convert to a different entity
 - What matters should members vote on and what approval is required?
 - Need for a super-majority or unanimous vote on certain issues?
 - Create voting vs. non-voting membership classes
 - How to address possibility of deadlock among members (Texas Showdown? Put/Call Rights?)

Key Provisions in Operating Agreement

- **Capital Contribution/Call Provisions**
 - Default rule allows contributions to take the form of cash, services, promissory notes, other benefits
 - Specify how noncash contributions will be valued
 - Articulate obligations to contribute additional capital and consequence of not contributing to a capital call
 - Dilutive effect
 - Deemed Member loans
 - Forfeiture or buy/sell trigger
 - Reserve rights to borrow funds or create new class of units to raise capital

Key Provisions in Operating Agreement

- **Capital Contribution/Call Provisions**
 - Preemptive Rights to contribute capital to avoid dilution
 - Maybe limit to certain classes of units
 - Exclude incentive-based units from preemption right
 - May want to include provision allowing for waiver of preemption rights if trying to attract capital/investors
- **Guaranteed Obligations**
 - Personal guarantees by one or more members → indemnification and contribution rights

Key Provisions in Operating Agreement

- **Distribution Provisions**
 - How are decisions regarding timing and amount of distributions made?
 - How to define “distributable cash”
 - Will there be preferred distributions?
 - Profits interest language
 - Prevent a creditor of a member from impacting distribution decisions

Key Provisions in Operating Agreement

- **Transfer Restrictions; Buy-Sell Provisions**
 - Agreement should clearly set forth transfer restrictions
 - Conversion to nonvoting interests
 - Permitted Transferee language
 - Estate planning
 - Transfer to other members
 - What events will trigger a buy-sell option or obligation?
 - Death
 - Disability
 - Termination of Employment
 - Bad Actor Provisions
 - Creditor/Divorce Issues

Key Provisions in Operating Agreement

- **Transfer Restrictions; Buy-Sell Provisions**
 - Build in Right of First Refusal in case of third party offer
 - Articulate circumstances in which sale/purchase is voluntary vs. mandatory
 - How will the purchase price be determined?
 - Control appraisal process
 - Payment Terms → don't overburden cash flow of business
 - Key Man Insurance

Relationships with Investors

- Make to sure to comply with state and federal securities laws when raising capital
- It is illegal to offer securities to the public unless:
 - (1) the offering is registered with the SEC and/or state regulators; OR
 - (2) The offering qualifies for an exemption

Relationships with Investors

- What if Rules are broken?
 - Numerous civil, and possibly criminal, penalties
 - (i) repayment of all consideration paid by the investors
 - (ii) Payment of interest on the investor proceeds
 - (iii) payment of investigation costs and attorneys fees
 - Joint and several liability for all partners, officers, directors, dealers or salesmen who materially aid in the offering (unless they can establish they had no knowledge of underlying facts)
- So, find a safe harbor and prevent disgruntled investors from exercising right of rescission

Relationships with Investors

- Rule 506(b) Offering under Regulation D
- Most Attractive/Used Exemption for Small Business
- Unlimited Offering Amount
- Up to 35 unaccredited investors
- Unlimited accredited investors
- No general solicitation/advertising
- File Form D with SEC within 15 days of first sale
- ****Best part: limited blue sky compliance due to federal preemption under NSMIA**

Relationships with Investors

- Disclosure Documents → Private Placement Memorandum (PPM)
- Provide full, fair and complete disclosure of all material information related to the issuer, its finances, business, operations and management
- Provide disclosures BEFORE offer is made → send to pre-qualified prospective investors
- In addition to fulfilling disclosure obligations, it helps to establish defense against potential accusations from disgruntled investors
- Avoid verbal and written representations outside of the PPM that could diminish the protective value of the PPM
- Ensure all sales, solicitations, and promotional materials are consistent with the terms of the PPM
- Be sure to update PPM with an material changes or to address any inconsistencies

Relationships with Investors

- Have them sign Subscription Agreements
 - Include broad representations and warranties regarding:
 - Accreditation
 - Financial Sophistication
 - Understanding of Offering
 - No Guarantee of Investment Success
 - Restricted Securities
 - Include Investor Suitability questionnaire
- Limit voting rights of investors in the Operating Agreement to avoid disruptions in ability to operate business
- Incorporate the right to buy out an investor at a future time

Relationships with Employees

- In some cases, it may be preferable to memorialize the relationship in a written employment agreement
- If so, articulate the scope of employment and services to be performed
- Describe the duties, expectations, responsibilities, and restrictions on authority to act
- Term of employment → at will or for a specified duration?
 - Avoid auto-renewals
 - Allow ability terminate immediately “for cause” and after a short notice period without cause

Relationships with Employees

- Use of Restrictive Covenants
 - Non-competition agreements
 - Non-disclosure of confidential information
 - Non-solicitation of customers
 - Non-solicitation of suppliers
 - Non-solicitation of employees
 - Non-interference with business
- Traditionally, all but non-disclosures are considered “restraints on trade” and closely scrutinized by NC courts, but now some courts are starting to scrutinize non-disclosures more like other covenants

Relationships with Employees

- Enforceability of Restrictive Covenants:
 - (i) must be in writing;
 - (ii) part of the employment contract/relationship;
 - (iii) based on valuable consideration;
 - (iv) reasonably necessary to protect a legitimate business interest of the employer;
 - (v) reasonable in scope as to time, geographic territory, and scope of activities
- *new employment constitutes valuable consideration but not existing employment → so put the restrictive covenant in the offer letter so terms are clearly stated before employment begins
- Existing employment → bonus or salary increase, promotion in responsibilities, change in employment terms and conditions

Relationships with Employees

- Geographic limitation reasonableness
 - Employer must be able to demonstrate the restricted territory is not broader than reasonably necessary to protect the employer's recognized business interests
 - Identify location of customers and why the restrictions are necessary to protect those relationships
 - Courts look at (i) area or scope of restriction; (ii) area assigned to employee; (iii) area where business was operated; (iv) nature of the business; (v) nature of the employee's duty and his knowledge of the operations

Relationships with Employees

- Reasonableness as to Time
 - Scope of Activity Reasonableness
 - Should not unreasonably prevent employee from undertaking work unrelated to the scope of services he/she provided for the business
- Reduce risk of claims for “tortious interference” by having new employee represent he/she is not subject to restrictive covenant (include indemnification obligation)

Relationships with Employees

Employee Work Product

Have the Employee agree that all of his/her work product created during employment (and all rights therein) belong to Employer and that Employee assigns all of the same to Employer.

Non-Disclosures.

All employees should be required to sign non-disclosure agreements as to company trade secrets and confidential information. Do this at the start of employment or may need to give new consideration.

Relationships with Employees

- Document Employment Policies with Handbook
 - Can assist with unemployment claims
 - Have employees sign acknowledgment of receipt of handbook
 - Document any warnings given to employees
 - Provide reasons for termination

Protecting Clients in their External Business Relationships



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External Business Relationships

- **Customers/Clients**
- **Manufacturers/Suppliers/Vendors**
- **Licensing Relationships**
- **Distributors/Resellers**
- **Sales representatives**
- **Independent Contractors**
- **Subcontractors**
- **Business partners”/joint venturers/joint developers**
- **Potential acquirers/acquirees**

External Business Relationships

- **How to Protect Client Interests in relationships?**
- **Thoughtfully-prepared contracts.**
- **Guiding Principle for contract terms -- what furthers the client’s interests.**
 - **Protecting the Client from Day One ... do they need a Non-Disclosure Agreement before starting negotiations with the other party?**

Issues/Considerations Applicable to Most Business Contracts

- **Price and Payment terms**
 - How much, for how long?
 - Any price increases/fluctuations?
 - Timing and method of payment.
- **Duration/Term of Contract**
 - Set term
 - Initial Term with Renewal upon notice
 - Initial Term with Automatic renewal subject to notice not to renew
 - No set term (subject to termination)

Issues/Considerations Applicable to Most Business Contracts

- **Termination**
 - Termination By Mutual Agreement
 - Termination upon Notice
 - Termination for Breach
 - Any right to cure?
 - Termination for Insolvency
 - Effect of Termination
 - Survival of any obligations?
- **Indemnification**
 - Scope of Indemnification
 - Indemnification Procedures
 - Insurance

Issues/Considerations Applicable to Most Business Contracts

- Representations and Warranties
- Limitation of Liability
- Limitation of Damages
- Remedies
 - Injunctive relief
 - Damages
 - Liquidated Damages

Issues/Considerations Applicable to Most Business Contracts

General Provisions

- | | |
|---|--|
| <ul style="list-style-type: none">○ Entire Agreement○ Amendments to Contract○ Assignment○ No Partnership/joint venture○ Third-Party Beneficiaries?○ Notices○ Survival○ Severability○ Waiver | <ul style="list-style-type: none">○ Governing Law○ Venue for lawsuits○ Dispute Resolution○ Waiver of Jury Trial○ Attorneys' Fees○ Construction of Contract○ Force Majeure○ Publicity○ Counterparts/electronic signatures |
|---|--|

Purchase Orders/Invoices

- Offer/Acceptance
- Prices/Taxes
- Payment Terms
- Seller's Property
- Drawings and Data
- Changes
- Stop Orders
- Delivery
- Transportation/Packaging
- Inspection and Rejection
- Quality Assurance
- Warranty
- Termination and Cancellation

- Intellectual Property Indemnity
- General Indemnification
- Insurance
- Confidentiality
- Compliance with Laws
- Export Issues
- Notice
- Force Majeure
- Supply Chain Security
- Environmental Health and Safety
- Applicable Law
- Assignment
- Severability

Manufacturing/Supply Agreements

- Scope of Agreement
- Sale of Products (process)
- Supplier's Adherence to Standards
- Availability of Products
- Delivery
 - Quality
 - Inspection
 - Acceptance And Rejection
 - Recalls
- Exclusivity (on either side)?
- Territory
- Forecasts
- Orders
- Pricing
- Payment
 - Invoices
 - Payment Terms
 - Taxes

- Grant of Trademark License/Terms of Use
- Term and termination
- Any rights post-termination?
- Representations and Warranties
 - Warranty
 - Disclaimer
- Indemnification
- Intellectual Property
- Confidentiality
- Compliance with Laws
- Regulatory Matters
- Import and Export Requirements
- General Terms

Master Service Agreements

- Scope of Services
 - Statements of Work (SOW)
 - Assigned Management and Personnel
 - Subcontractors
 - License (e.g., Software)
 - Facilities
 - Service Levels
 - Additional Services
 - Fees and Expenses
 - Payment
 - Business Continuity and Disaster Recovery
 - Acceptance of Services
 - Customer Obligations
 - Changes to Services
 - Term
 - Representations and Warranties
 - Proprietary Rights/Ownership of work product and IP
- Risk of Loss
 - Confidentiality
 - Non-Solicitation (customers, employees, subcontractors)
 - Publicity
 - Use of Name
 - Compliance with Laws
 - Insurance
 - Data Protection
 - Cooperation
 - Export Control
 - Regulatory Matters
 - Books And Records
 - Audits
 - Termination
 - Effect of Termination
 - Indemnification
 - Limitation Of Liability
 - General Terms

License Agreements

- Grant of Rights
 - Rights as to what?
 - Rights to do what?
 - Where? (territory)
 - Exclusive/Nonexclusive
 - No other rights
 - Reserved rights
 - Sublicensing
 - Diligence
 - Licensee's Efforts
 - Payments
 - Fees
 - Royalties
 - Minimum Royalties
 - Earned Royalty
 - Milestone Payments
 - Payment Terms
- Records And Audits
 - Records
 - Auditing
 - Reports
 - Royalty Reports
 - Progress Report and Commercialization Plan
 - Prior Signing Agreement Licensee Has
 - Licensee Solely Responsible Determining Tax
 - IP Prosecution And Maintenance
 - Quality Control/Use of IP
 - Warranties/Disclaimer Of Warranties
 - Mutual Representations and Warranties
 - Licensor Representations and Warranties
 - Licensee Representations and Warranties

License Agreements (cont.)

- Confidentiality
 - Limitations on Use and disclosure
 - Confidential Information Defined
 - Confidentiality of Terms
 - Publicity
 - Markings
 - Use of Licensor Name
 - Licensee's Use of Rights to the Benefit of Licensor
 - No Challenge of IP Rights by Licensee
 - Export Compliance
 - Insurance
- Term And Termination
 - Term
 - Termination by Licensee
 - Termination by Licensor
 - Minimum Sales Requirements
 - Other Conditions of Termination
 - Cure Period
 - Infringement And Litigation
 - Notice
 - Licensee Prosecution of Infringement
 - Licensor Rights to Prosecution
 - Cooperation
 - Recovery of Damages
 - Indemnification
 - Indemnification
 - Procedure
 - General Provisions

Distribution/Reseller Agreements

- Scope
 - Definitions
 - Appointment of Distributor/Reseller
 - Orders
 - Territory
 - Exclusivity
 - Delivery And Shipment
 - Price (resale price maintenance – MSRP; MAP)
 - Payment
 - Reseller Responsibilities
 - Company Responsibilities
 - License
 - Term
- Representations and Warranties
 - Ownership of Intellectual Property
 - Right to use Trademarks
 - Compliance with Laws
 - Export Control
 - Confidentiality
 - Non-competition/Non-solicitation
 - Public Announcements
 - Audit Rights
 - Termination
 - Indemnification
 - Intellectual Property Indemnification
 - Limitation Of Liability
 - General Provisions

Sales Representative/Independent Contractor/Subcontractor Agreements

- Nature and Scope of Appointment
- Sales Price of Products
- Compensation
- Expenses
- Payments
- Responsibilities of Representative
- Responsibilities of Company
- Territory
- Exclusivity (either way)
- Term
- No Conflicts
- IP/Work Product Ownership
- Compliance with Laws
- No Authority to Bind
- Relationship of the Parties
- No employment relationship
- Use of Trademarks
- Confidentiality
- Non-competition/Non-solicitation/Non-disparagement
- Termination
- Effect of Termination
- Any Trailing Commissions?
- Indemnification
- General Provisions

Joint Development Agreements

- Involved Parties
- Term
- Schedule
- Purpose
- Confidentiality
- Scope
- Intellectual Property
 - Existing IP
 - Resulting IP
- Ownership/Use of IP
- Exclusivity
- Regulatory Concerns
- Fees/Costs/Expenses
- Resources
- No Guarantee of Success
- Termination

Parting Thoughts



- **The best time to protect client interests in business relationships generally is at the outset.**
- **Thoughtfully-prepared contracts can save clients much money, time, headaches, and maybe even the business.**