PRIVATE ORDERING OF EXIT IN LIMITED LIABILITY COMPANIES: THEORY AND EVIDENCE FROM BUSINESS ORGANIZATION CONTRACTS

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This study compares the characteristics of real-world contracting to the theories of interest (share) transfer restrictions. The evidence from the hand-collected database of operating agreements of 289 non-listed limited liability companies formed in Delaware shows the positive effect of most of these contractual provisions on encouraging efficient investments in closely-held firms. First purchase rights, such as a right of first refusal and a right of first offer, and tag-along rights stipulate efficient investments by discouraging value-decreasing transfers of securities to third parties and reducing incentives for opportunistic renegotiation. Similar problems arising during the ordinary course of business are solved by different forms of put and call options, including their special buy/sell-out modifications—Russian roulette clauses. The findings assist in understanding circumstances where a particular interest transfer restriction is preferable. Along with informing the theory, the results can be used in the practice of drafting shareholders' agreements and joint venture agreements and in interpreting and enforcing these agreements.

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I. INTRODUCTION

In October 2014, a New York court put an end to a lengthy dispute between the founders of Arizona Beverages Co., maker of the popular AriZona Iced Tea, over the issue of parting their ways.[1] Two friends from Brooklyn, Don Vultaggio and John Ferolito, launched the successful business of producing ready-to-drink tea in 1992. Long friendship and business success, however, did not prevent the two founders from running into a conflict. Mr Ferolito, in an effort to avoid decision-making deadlocks, distanced himself from active management. Later, invoking a provision in the shareholders' agreement that banned share transfers to third parties, Mr Vultaggio blocked the attempts by Mr Ferolito to sell his 50% holding in the company. This led to numerous lawsuits, the first dating back to February 2008. After a failed effort to challenge transfer restrictions in a court, Mr Ferolito sought judicial dissolution of the corporation based on shareholder oppression grounds. Mr Vultaggio opted for buying out his partner on the corporation's behalf. But the huge gap between the parties on price—whereas the party looking for an exit valued the firm at up to $4 billion, the valuation of the party willing to buy out was less than $500m—prevented the possibility of a negotiated buy-out. At the last stage of the lengthy and costly court proceedings, the court had to reconcile the differing valuations.[2] The proceedings involved depositions of ten individuals, with some continuing over multiple days, testimonies of many witnesses, hundreds of thousands of pages of documents and financial data, and generated nearly $200m in estimated legal fees.[3]

Had the parties negotiated more detailed exit clauses, the outcome would have been different. Business partners encounter different problems both at the stage of structuring their relations and later during the functioning of the venture. Examples are the definition of each partner's contribution and of corresponding voting rights, self-dealing by one of the partners, opportunistic renegotiation of cooperation terms with the aim of extracting more benefits from the project, deadlocks in decision-making and the resulting paralysis of the firm. Transactional

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[1] *See* Ferolito v. AriZona Beverages USA LLC, *et al.*, 2014 WL 5834862 (N.Y. Supr. 2014).

[2] The narrative of the dispute is based on court documents and newspaper publications. *See* Ferolito v. Vultaggio, 78 A.D.3d 529 (N.Y. App. Div. 2010); Ferolito v. Vultaggio, 99 A.D.3d 19 (N.Y. App. Div. 2012); Ferolito v. Menashi, 918 F.Supp.2d 136 (E.D.N.Y. 2013); Ferolito v. AriZona Beverages USA LLC, *et al.*, 2014 WL 5834862 (N.Y. Supr. 2014); Mike Esterl, *The Heated Litigation Over Arizona Iced Tea*, WALL ST. J., Sep. 4, 2014; Mike Esterl, *Judge Values AriZona Iced Tea Maker Around $2 Billion*, WALL ST. J., Oct. 15, 2014.

[3] In a recent interview, one of the founders called the corporate conflict "a decade of waste and foolishness" and reckoned he had spent 70% of his time on litigation instead of running the business. Though the industry sales grew at an annual average rate of 6.5% in the five years through 2014, the firm's share during this period fell to 20.7% from 24.9%. Mike Esterl, *AriZona Iced Tea Pops Open a Can-Do Spirit*, WALL ST. J., Aug. 26, 2015.

lawyers have designed different contractual provisions dealing with these problems in cases where legislative solutions are deemed insufficient or inappropriate. In particular, under many circumstances these problems can be efficiently and effectively solved by regulation of interest or share transfers.[4] Contingent ownership provisions (explicit and implicit options)[5] encourage investments, limit agency, moral hazard, and hold-up problems, prevent escalations of conflicts, and provide business partners with swift and much less costlier means for exiting investments.[6] Ignoring the regulation of interest transfers or badly drafted exit clauses, as the case of AriZona Beverages Co. demonstrates, can cost time, money, and lost business opportunities. Paraphrasing Shakespeare, the fault is not in the stars, but in business organization contracts, that partners turn into adversaries.[7]

In publicly-traded firms, liquid equity markets perform the role of contingent ownership structures allowing minority investors to exit and creating conditions for new controlling investors to appear.[8] In partnerships, notwithstanding restrictions on the transferability of investments,[9] the right of each partner to force the dissolution of the firm ensures an equivalent result.[10] The situation is different in non-listed limited liability firms where the members, because of locked investments, are in stronger dependence upon each other's actions.[11] This explains the importance of the regulation of equity transfers in

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[4]This study relies on data from the operating agreements of non-listed limited liability companies. Hence, more appropriate is the use of the terminology applied in the context of limited liability companies, such as "interest transfer" instead of "share transfer", "unit" instead of "stock", "operating agreement" or "limited liability company agreement" instead of "shareholders' agreement", and "member" instead of "stockholder".

[5]Put and call options are explicit options, while tag- and drag-along rights can be considered as implicit options where a party can put its interest to a third-party buyer or can call the interests of other parties, respectively. Gilles Chemla, Michael A. Habib, & Alexander Ljungqvist, *An Analysis of Shareholder Agreements*, 5 J. EUR. ECON. ASSOC. 93, 95 (2007).

[6]*See* Chemla et al., *supra* note 5, at 100–03; Georg Nöldeke & Klaus M. Schmidt, *Sequential Investments and Options to Own*, 29 RAND J. ECON. 633, 639–48 (1998).

[7]In *The Tragedy of Julius Caesar*, Gaius Cassius Longinus, a leading conspirator to assassinate Julius Caesar, attempts to convince Marcus Brutus that Caesar should be killed. Cassius suggests that the rise of the dictator is the result of their own actions and men can be masters of their fate: "The fault, dear Brutus, is not in our stars, / But in ourselves, that we are underlings." WILLIAM SHAKESPEARE, THE TRAGEDY OF JULIUS CAESAR, act I, sc. 2, 230 (1599), *available at* http://www.opensourceshakespeare.org/.

[8]*See infra* Part II.

[9]Unlimited liability of a general partner coupled with her right to bind the partnership creates a reasonable expectation for each partner to block the entry of new partners with governance rights because the actions of an arriving partner can endanger not only the other partners' investments but their personal wealth as well. *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 52 (2010); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 424–25 (2000). Although limited liability smoothens this concern, the active role of members in the governance of non-listed firms can still generate a legitimate motive to limit the transferability of investments.

[10]*See infra* Part II.

[11]*See infra* Part II.

ensuring successful cooperation in the setting of non-listed limited liability firms, particularly where the probability of private benefit extraction or hold-up is high.

And yet business partners often overlook governance structuring. They are likely to direct attention towards the realization of the business idea and limit the design of the governance structure by agreeing about the allocation of ownership and voting rights. Statutory default rules are relied upon for filling the gaps. Meanwhile, these rules can be inadequate or insufficient. The pool of available contractual instruments is much larger. Initial allocation of ownership and voting rights, in its turn, is a one-time event. Theoretical models demonstrate that unconditional ownership structures alone are not able to limit control inefficiencies and induce efficient investments neither for the case of simultaneous investments,[12] nor for the case of sequential investments.[13] The dynamic nature of relations between business parties requires mechanisms that can assist ownership re-allocation in response to changing conflicts. Interest transfer clauses create contingent ownership structures that can be altered at the initiative of partners along with evolving conflicts of interests.[14] In addition, by offering ways out of decision-making deadlocks, contingent ownership structures allow parties to choose optimal initial ownership structures for every project.

The primary focus of this article is the use of various transfer clauses by investors in firms that are closely held. All rights covered in this study are purely contractual in the sense that they are not provided by statutes and thus apply only if so agreed by the members of firms. These are private choices. Nevertheless, transfer restrictions are relatively standardized and have been tested many times. Their widespread use is a strong suggestion that transfer restrictions are both joint-efficient for the contracting parties and effective for achieving the pursued aims.

Transfer restrictions were the subject of theoretical models.[15] Testing the predictions of these models has always been a problem because special rules on interest transfers are typically used in closely-held business entities where the agreements of the investors are, as a rule, confidential. For a long period, the best scholars could do was to test the

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[12]Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POLIT. ECON. 691, 701–04 (1986) (if one of the parties controls the project, it will tend to overinvest, while the non-controlling party will underinvest; if none of the two parties controls, each will invest more than it would have invested under the control of the other party, but these investments will still be less than optimal; therefore, the project will be controlled by a party whose investments are more important and if both are making important investment, the control is expected to be joint).

[13]*See* Nöldeke & Schmidt, *supra* note 6, at 640–41.

[14]*See* Chemla et al., *supra* note 5, at 100–03; Nöldeke & Schmidt, *supra* note 6, at 639–48.

[15]*See infra* Part IV.

theoretical implications in simulated laboratory experiments.[16] This study is the first attempt to fill this gap by looking to the contracting practices of real businesses in dealing with interest transfers. The study analyzed governance structures in 289 non-listed limited liability companies (LLCs) filed with the United States Securities and Exchange Commission (SEC). The sample companies were thus not start-ups or small corner shops; rather they were independent large firms or joint ventures formed by large corporations.

The findings support some theoretical predictions, show the weaknesses of others, provide insights that have never been considered before, and explain some puzzling questions. Since the founders of the studied companies usually had access to the services of highly-qualified professional consultants, their contractual choices offer valuable lessons for understanding the governance structures of non-listed firms in general and the use of transfer clauses in particular. By analyzing the operating agreements, the study identified best drafting practices and circumstances where particular transfer restrictions are preferable.

First purchase rights are preferred in firms where the identity of members matters for investing and equity transfers to third parties can affect the balance of power within the firm. The number of members is a key determinant of choosing a specific variation of these rights. Tag-along and drag-along rights, which are linked to third-party transfers, mitigate conflicts in change-of-control transactions. Particularly, a tag-along right is employed where non-controlling members lack sufficient voting rights to block such changes and are not protected by fiduciary duties of the controlling members. Theoretical predictions that put and call options applicable during the everyday functioning of a business, by dealing with agency, moral hazard, and hold-up problems, encourage investments are largely supported by the data. Depending on the underlying conflicts and ownership structure, the partners choose specific types of options. A minority put option is effective for minority protection in cases where investors do not have strong voting and other rights to protect their interests. A minority call option is appropriate for dealing with majority self-dealing and hold-up strategies in companies where minority cannot veto large transactions but has strong financial position and expertise to manage the business independently. Call options are used for overcoming (minority) veto and other hold-up problems. Unlike minority put and call options, the activation of a majority call option is conditional upon special circumstances, such as a decision-making deadlock over large transactions, failure to invest, breach of the agreement, other. Special buy/sell-out options (Russian

[16] *See, e.g.*, Brit Grosskopf & Alvin E. Roth, *If You are Offered the Right of First Refusal, Should You Accept? An Investigation of Contract Design*, 65 GAMES & ECON. BEHAV. 176 (2009); Claudia M. Landeo & Kathryn E. Spier, *Shotguns and Deadlocks*, 31 YALE J. ON REG. 143 (2014).

roulette clauses) are appropriate for solving deadlocks and other conflicts in companies where both (groups of) members have equal voting rights, access to financial resources, and each could continue the business without the other.

A brief description of the research design follows.[17] The first step was to use existing theoretical literature for explaining joint-efficiency implications of various transfer restrictions. In the case of some restrictions, theoretical explanations are contradictory. In these situations, an attempt was made to develop the theory further by relying on models that come closer to the real practice of using transfer clauses. At the next stage, practical data were used to test the theoretical predictions. For this purpose, the sample agreements were coded for the type of transfer restrictions, various aspects of their design, other member rights, and firm-level data (ownership structure, industry).

The article is divided into eight parts. Following the brief discussion of corporate governance problems in non-listed firms and the description of interest transfers in Parts II and III, respectively, the remainder of the article focuses on the theory and practice of contingent ownership structures. Part IV develops theoretical arguments for using interest transfers. Descriptive data and research design are presented in Part V. Part VI reports the results of the statistical analysis and offers explanations. Part VII uses information from the sample agreements to illustrate common techniques of drafting interest transfer clauses. Finally, Part VIII concludes.

II. Corporate Governance in Non-Listed Limited Liability Firms

A typical governance framework of firms includes three elements—voice, liability, and exit. Investor voting is one of the distinctive features of the law of business organizations.[18] Corporation statutes grant shareholders the right to nominate and elect board members,[19] vote on amendments to corporate charters and bylaws, on fundamental changes,[20] and make their own proposals for shareholder meetings.[21] The Dodd-Frank Act has added to this list a universal, yet advisory, say-on-pay vote for top executives' compensation of listed companies with at least $75m public equity float since the beginning of 2011.[22] In addition to formal voting, investors can also express their concern by engaging in private

[17]For details *see infra* Part V.

[18]FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 63 (1991).

[19]*See* Michael J. Goldberg, *Democracy in the Private Sector: The Rights of Shareholders and Union Members,* 17 U. PA. J. BUS. L. 393, 407–08 (2015).

[20]*Id.*, at 413.

[21]*Id.*

[22]*See* Randall S. Thomas & Christoph Van der Elst, *Say on Pay around the World*, 92 WASH. U.L. REV. 653, 660–61 (2015).

negotiations with managers.[23] This practice is widespread among active institutional investors—they often use behind-the-scenes discussions with officers and directors to influence behavior.[24]

Where voice, due to the negligible size of equity holding, is not effective, investors can turn to liability laws. In addition to regulatory and contractual constraints that prescribe the behavior of managers and shareholders, corporate law traditionally imposes on managers fiduciary duties of care and loyalty[25] and on controlling stockholders,[26] at a minimum, the duty of loyalty.[27] The threat of ex post liability for failure to act in the interests of the corporation and its stockholders gives managers and controlling shareholders an incentive to act so.[28] The liability instrument is further strengthened by the right of shareholders to bring derivative suits on behalf of the corporation for injury done to the corporation.[29] Minority investors can also resort to statutory and judicial remedies of minority oppression.[30] Such remedies may include an

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[23] *See* Bart Bootsma, *An Electric Approach to Loyalty-Promoting Instruments in Corporate Law: Revisiting Hirschman's Model of Exit, Voice, and Loyalty*, 2013 ERASMUS L. REV. 111, 117 (2013).

[24] *See* Joseph A. McCahery, Zacharias Sautner, & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FINANCE [15] (forthcoming in 2016).

[25] The duty of care requires that managers act on an informed basis and with care; in Delaware corporations, the applicable standard of care is gross negligence. Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985). The duty of loyalty requires directors and officers to act in the best interests of the corporation and its stockholders rather than further their private interests. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). Courts traditionally describe these duties as owed to the corporation and its stockholders. This formulation "captures the foundational relationship in which directors owe duties to the corporation for the ultimate benefit of the entity's residual claimants." *In re* Trados Inc. Shareholder Litigation, 73 A.3d 17, 36–37 (Del. Ch. 2013).

[26] The owner of more than 50% of voting shares, whether directly or indirectly, is a controlling stockholder. A minority stockholder who exercises actual control over the corporation's business affairs qualifies as a controller as well. *See, e.g.*, *In re* Crimson Exploration Inc. Stockholder Litigation, 2014 WL 5449419, at *10 (Del. Ch. 2014).

[27] *See, e.g.*, Kahn v. Lynch Communication Systems, 638 A.2d 1110, 1115 (Del. 1994). Delaware courts operate with the term "fiduciary duties of controlling shareholders" without specifying the exact type of the duty. Nevertheless, unless a controller engaged in a conflicted transaction, entire fairness review cannot be triggered. *In re* Crimson Exploration Inc. Stockholder Litigation, 2014 WL 5449419, at *12–14 (Del. Ch. 2014).

[28] *See* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U.L. REV. 1039, 1043 (2011).

[29] *See* STEPHEN M. BAINBRIDGE, CORPORATE LAW 187 (2nd ed. 2009) (the most important function of derivative suits is providing means by which breaches of fiduciary duty are remedied). Derivative actions have been criticized for giving minority shareholders and their attorneys perverse incentives to sue—because of small investments in the firm, the complaining shareholder has very little incentive to consider the effect of the action on the firm and other shareholders. *See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271–73 (1986).

[30] *See* Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"*, 30 CORNELL INT'L L.J. 381, 387 (1997).

extreme option of a judicial dissolution of a firm or less radical options, such as oppression and appraisal rights, which preserve the firm as a going concern but allow minority members to exit at a fair market value of their holdings.[31]

The third possible investor action is exit. Investors can sell their equity in the market and terminate their exposure with the firm. This option is the easiest for minority investors but may be costly if a larger investor or many small investors are selling, for such sales can depress the stock price.[32] It is because of this effect that exit can have positive effect on corporate governance. A threat of a takeover, which becomes more likely when the firm's value is low, disciplines managers.[33] Even in the absence of such a threat, exit of a large number of minority investors, by putting equity prices under a downward pressure, can discipline insiders. Thus, the threat of exit is a form of investor activism that can be used behind the scenes to affect managerial decisions.[34]

The governance of listed firms revolves around the triad of the described corporate governance elements. The situation, however, is different in non-listed firms. The absence of a readily-available market in which equity can be traded has important implications.[35] Limited exit increases the reliance of the firm's members on the two other elements—namely, voice and liability.[36] One way to strengthen voice is to trade off diversification of investments with increased exposure to one firm. If members of non-listed firms are small, which is often the case, then lack of diversification arises even in the absence of such a trade-off.[37] This further reinforces the reliance on voice and liability. As a result, locked

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[31] *See* PAUL P. DE VRIES, EXIT RIGHTS OF MINORITY SHAREHOLDERS IN A PRIVATE LIMITED COMPANY 8–11 (2010); Miller, *supra* note 30, at 388.

[32] *See* Bootsma, *supra* note 23, at 116.

[33] *See* David Scharfstein, *The Disciplinary Role of Takeovers*, 55 REV. ECON. STUD. 185, 190–92 (1988).

[34] *See* Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2445, 2457–58 (2009); Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481, 2493–95 (2009); Alex Edmans & Gustavo Manso, *Governance through Trading and Intervention: A Theory of Multiple Blockholders*, 24 REV. FIN. STUD. 2395, 2406–08 (2011); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?* 23 CARDOZO L. REV. 1419, 1437–38 (2002). Recent empirical evidence supports this argument. *See* McCahery et al., *supra* note 24, at [22–24].

[35] *See generally* JOSEPH A. MCCAHERY & ERIK P.M. VERMEULEN, CORPORATE GOVERNANCE OF NON-LISTED COMPANIES 8 (2008) (explaining that investors in non-listed companies, as opposed to publicly held companies, have fewer market mechanisms to restrict opportunistic behavior); BAINBRIDGE, *supra* note 29, at 442 (emphasizing the absence of a market out mechanism as a critical difference between the public and close corporation).

[36] *Cf.* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 34–36 (1970) ("the role of voice would increase as the opportunities for exit decline, up to the point where, with exit wholly unavailable, voice must carry the entire burden of alerting management to its failings"). *See also* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 284 (1986) (lack of diversification induces investors in close corporations to take care).

[37] *See* Easterbrook & Fischel, *supra* note 36, at 274.

investments in non-listed firms strengthen the dependence of the firm's members upon each other's actions. Individual personalities of the members and trust between them become important.

Legislators have reacted to this reality in two ways. First, they offer rules that smoothen exit in non-listed firms and thus bring investors in these firms closer to the position of stockholders of listed firms. In particular, in partnership law, each partner has a right to dissolve the partnership.[38] This solution, however, when applied universally, increases the uncertainty risk and hold-up problems, for every partner can threaten to dissolve the partnership.[39] The second solution is the reverse of the first—further weakening of exit with the aim of preventing disruptions of the balance of power within the firm by arrival of third parties. In particular, default statutory rules in partnerships and limited liability companies allow partner (member) substitution only by the consent of all other partners (members).[40] Similar to the first case, a universal solution applied to all non-listed firms increases the hold-up problem because every partner can strategically veto interest transfers by others (recall the example from the introduction). Moreover, paradoxical as it may seem, reduced exit can weaken voice. Earlier we saw that limited exit increases the reliance of the members of non-listed firms on voice.[41] But it is also true that a threat to exit is a form of voice.[42] Hence, if exit is not possible, voice may be handicapped in the same way where exit is too easy.[43] In other words, exit and voice work best in a balanced combination.

Accordingly, statutory default rules can be inadequate or insufficient.[44] The pool of available contractual instruments, which can be tailored to the specific circumstances of investing in each firm, is much larger. Whereas strengthening exit can be achieved by employing various forms of put and call options, including tag-along and drag-along rights, first purchase rights can preserve the established balance of power within the firm without excessively scaling down exit.[45]

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[38]*See, e.g.*, RIBSTEIN, *supra* note 9, at 53. Indeed, from the firm's and its members' perspective, the outcome of exiting a partnership by dissolving it is very different from selling corporate stock in the secondary market. But from the viewpoint of the exiting investor, both options result in the liquidation of the investments.

[39]*See* Deborah A. DeMott, *Transatlantic Perspectives on Partnership Law: Risk and Instability*, 26 J. CORP. L. 879, 888 (2001).

[40]*See* RIBSTEIN, *supra* note 9, at 51 (for partnerships), 182 (for LLCs). In the absence of the consent of the firm's members, the assignee typically receives economic rights, but not the right to participate in decision-making.

[41]*See supra* note 36 and the accompanying text.

[42]*See supra* note 33–34 and the accompanying text.

[43]*See* HIRSCHMAN, *supra* note 36, at 55, 82–83.

[44]*See*, *e.g.*, *Benjamin Means, A Voice-Based Framework for Evaluating Claims of Minority Shareholder Oppression in the Close Corporation*, 97 GEO. L.J. 1207, 1252 (2009) (no solution is right for every corporation).

[45]Particularly, the right of a minority investor to put its share at a specified price can discipline the controlling shareholder; first purchase rights discourage interest transfers to third

Theoretical models of contingent ownership rights in shareholders' agreements show the importance of these provisions in providing shareholders with certainty with regard to their expectations and in stipulating ex ante efficient investments. In a simple model of sequential relationship-specific investments by two partners, Nöldeke and Schmidt show that options to buy shares at a fixed price prevent opportunistic renegotiations and induce both parties to invest efficiently.[46] In the absence of contingent rights, parties have incentives to engage in renegotiations in order to prevent opportunistic behavior by one of them. For instance, after initial investment, the intention of one of the parties to transfer its interest to a third-party buyer in a value-decreasing control transaction requires alterations of the ownership structure of the firm in order to prevent the transfer. By constraining renegotiation directed at exploiting a vulnerable contractual party, contractually agreed contingent ownership structures ensure the parties' shares of the firm's payoff in initial proportions and, therefore, allow optimal ex ante investments in the firm.[47]

This study is the first attempt to fill the gap in the scholarly literature and explore the practice of using transfer restrictions. It does so by analyzing operating agreements of large non-listed limited liability companies formed in Delaware. To be sure, the Delaware Limited Liability Company Act restricts interest transfers to third parties by a default rule. In the absence of a modifying agreement of the LLC's members, the assignee of an interest receives only the right to participate in sharing the profits and losses of the company and has no right to participate in the management of the company's business and affairs.[48] Full member substitution requires the consent of all members.[49] By contrast, stockholders in corporations are free to transfer their shares to third parties unless shares are subject to transfer restrictions.[50] Hence, in the LLC context—at least in the case of first purchase rights and tag- and drag-along rights—it is more appropriate to talk about "relaxations" of interest transfers, rather than restrictions.[51] Interest transfer rules thus enhance exit for otherwise locked LLC members.

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parties and provide the right-holders with a weak veto right if the transfer is proposed. For more details *see infra* Parts IV and VI.

[46] *See* Nöldeke & Schmidt, *supra* note 6, at 639–48.

[47] *See* Chemla et al., *supra* note 5, at 100–03.

[48] DEL. CODE ANN. tit. 6, § 18–702(a), § 18–702(b)(2) (2015). This default rule follows naturally from another default rule of the statute—the authority of each member to bind the limited liability company. *Id.*, § 18–402.

[49] *Id.*, § 18–702(a).

[50] *See, e.g.*, Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 278–79 (1967).

[51] First purchase rights, tag-along rights, and drag-along rights are activated where one of the existing members proposes to transfer its equity holding to a third party. By contrast, put and call options typically mandate intra-firm transfers—among the existing members or between the firm and its members—for reasons not related to third-party transfers (there are,

The inverted default rules of corporate and LLC statutes can affect the incentives of their users to contract for special transfer rules and, if they decide to do so, put them in different negotiating positions.[52] The following characteristics of the sample on which this study is based, although ameliorate these differences, do not cancel them. First, with very few exceptions, the majority of the sample LLCs had a centralized managements structure and were not organized as partnerships.[53] Corporate-like centralized management reduces the need to restrict the investors' ability to alienate their interests.[54] Second, although in the majority of the sample, the statutory transfer restriction rule was not waived, it was often substituted with other transfer clauses and could be applied only if the members failed to comply with the contractually agreed alternatives.[55] The subordination of the statutory restriction to contractual transfer provisions allows comparing the sample LLCs with corporations where shareholders have contracted for similar transfer clauses. Nevertheless, this does not mean that corporate shareholders are equally likely to choose the same transfer restrictions under identical circumstances. Therefore, whereas the effects of transfer restrictions for the contracting parties can be the same both in the LLC and corporate settings, their incentives to contract and thus the practices of contracting may differ.

III. BRIEF OVERVIEW OF INTEREST TRANSFER CLAUSES

Transfer restrictions regulating exit in non-listed limited liability firms can be classified into two main groups. The first group includes provisions that are usually activated when a current investor intends to transfer its interest to a non-member. The aim of first purchase, tag-along, and drag-along rights is to balance conflicting interests of the involved parties in such transfers. Change-of-control transactions in particular and third-party equity transfers in general, however, are extraordinary events in the life of closely-held business organizations. In the course of ordinary business, investors face many other instances abundant with conflicting interests. Put and call options, which form the second group, deal with these cases.

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indeed, situations where options can be activated in cases of change-of-control transactions: when a third party establishes control over one of the firm's members).

[52]For example, an investor opposing possible entry of outside third parties to the capital of the firm may find it easier to promote a first purchase right in an LLC, where members are by default subject to transfer restrictions, than in a close corporation, where share transfers are not restricted. The default governance structure is one of the factors affecting the election of an appropriate organizational form to start a business project.

[53]*See infra* Part V.

[54]*Cf.* Easterbrook & Fischel, *supra* note 36, at 273 (arguing that where principal investors also manage, restricted share transfers can ensure that investor-managers are compatible).

[55]*See infra* Parts V and VII.E.

A. First Purchase Rights

Preemptive rights of purchasing securities in non-affiliated equity transfers (first purchase rights) allow right-holders to control or impede changes in the ownership structure of the enterprise by giving them a priority (first right) to buy securities sold by other members ahead of third parties. There are two main variations of these rights subject to the moment when the right is activated.[56]

A right of first refusal is triggered when an owner of securities has received a bona fide offer from an unaffiliated third-party buyer which it is willing to accept or, subject to such right, has agreed to sell securities to an unaffiliated third-party buyer.[57] According to a right of first refusal, the owner of securities is entitled to sell to a third party only if the right-holder passes by either refusing to buy the securities at the price and upon the terms offered by (agreed with) the third-party buyer or failing to react timely.

Under a right of first offer, the owner of securities that has an intention to sell but has not formalized any transaction with a third party shall inform about its intention to sell to the right-holder. The offer price is either (1) the price at which the owner wishes to sell and is thus offered by the owner, or (2) the owner's only obligation is merely to notify about its intention to sell and it is the right-holder who is invited to offer the price. In either case, the offer defines the minimum price of the transfer.[58] If the right-holder does not timely accept the offer or the owner rejects to sell to the right-holder according to the terms of the right-holder's offer, as applicable, the owner is entitled to sell to a third party at a price which is at least equal to the offer price.[59]

Both a right of first refusal and a right of first offer give the seller limited time to transfer its securities to a third party. After this period, a first purchase right is re-activated.

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[56]*See* RCM LS II, LLC v. Lincoln Circle Associates, LLC, 2014 WL 3706618, at *7 (Del. Ch. 2014).

[57]Good faith requirement in a right of first refusal aims to prevent abusive collaboration between the seller and an outside buyer which can result in an unjustified high offer price forcing the right-holder to exercise its right at this price or passing on the right and being deprived of it (if the transfer encumbrance is tied to the seller and is not reinstated by the buyer). This problem was discussed by the New York State Supreme Court in *Story v. Wood*, 166 A.D.2d 124, 128, 569 N.Y.S.2d 487, 489 (N.Y. App. Div. 1991) (a good faith offer is "a genuine outside offer rather than one contrived in concert with the seller solely for the purpose of extracting a more favorable purchase price from the holder.").

[58]If the right-holder must offer the sale price but it fails to do so, then, in the absence of a minimum price constraint, the owner can market its interest at any price.

[59]Most studies of rights of first offer focus only on one type of this right where the offer price is defined by the seller. *See* Grosskopf & Roth, *supra* note 16, at 176; Xinyu Hua, *The Right of First Offer*, 30 INT. J. IND. ORGAN. 389, 389 (2012); Marcel Kahan, Shmuel Leshem, & Rangarajan K. Sundaram, *First-Purchase Rights: Rights of First Refusal and Rights of First Offer*, 14 AM. L. & ECON. REV. 331, 332 (2012).

B. Tag-Along and Drag-Along Rights

A tag-along right is contracted primarily for addressing conflicts between investor groups in large security sales. In a typical situation of applying a tag-along right, the selling owner of securities is in a possession of a controlling equity block and the co-selling investors hold minority positions. It is the obligation of the former to inform the right-holders about their right to exercise their co-sale rights. The two main effects of a tag-along right are (1) serving as a put option on the securities of the remaining holders in cases of large member changes and, as such, providing them with an opportunity to exit the firm and (2) effectively forcing the main seller to share a control premium with the remaining investors.[60]

There are two main variations of this right with different effects on the seller and outside buyers. According to one form, an outside buyer, after acquiring a large position in the equity capital of a target company, has to extend its offer to the remaining equity-holders on the same terms (full tag-along right). The second variation does not oblige an outside buyer to make an offer for all outstanding equity securities. Rather, if there are any right-holders willing to participate in a third-party transfer, then the main seller is required to reduce its share in a transfer and provide right-holders an opportunity to co-sell their securities on a pro rata basis (proportional tag-along right). As a result, the seller, instead of fully cashing out its investment, may become a minority investor along with others.

By contrast, a drag-along right allows its holder—the main selling owner of securities—to force other investors to sell along with the right-holder on the same terms in a control transfer to a third party.

C. Put Options, Call Options, and Buy/Sell-Out Arrangements

A put option allows its holder to sell the holder's interest to the other investors in the firm (or to the firm) at the will of the holder or upon the occurrence of contingencies specified in the agreement. A call option, on the contrary, is the right of the holder to buy the interests of other investors.

Put and call contractual arrangements, due to information asymmetries and bounded rationality of the contracting parties, are difficult to devise at the outset. First, contractual parties have to define the type of the option (put or call), the identity of the holder (majority or minority), and a state when the option can be activated. It is clear that information asymmetries with regard to the nature of ex post problems

[60] A tag-along clause may exclude minority co-selling right-holders from sharing the control premium with the main seller. None of the sample agreements, however, had a provision fixing a discounted price for the right-holders.

and ex post bargaining power distribution will prevent parties from optimal contracting. Even in the light of assuming full rationality of partners, private arrangements will generally remain incomplete because the parties can program future problems but, given transaction and enforcement costs, hardly can fully describe them.

The second drafting problem is the definition of a fair price for exercising the option. Information asymmetries between the parties at the stage of exercising option rights may affect their respective valuations. Theoretical models of optimal options rely either on ex ante fixed prices[61] or third-party valuation of the option price at the exercising date.[62] While in practice efficient fixed prices are almost impossible to define at the outset and it is highly possible that these prices will fail to reflect the reality over extended time periods, third party valuations are subject to potential biases and are costly.[63]

An alternative is to entitle the party who wishes to exercise an option to define the fair price under the condition that the opposing party can refuse the offer and use the same price to buy or sell the securities. The threat of selling at a low price or buying at a high price gives the triggering party an incentive to offer a fair price. However, such a buy/sell-out mechanism is effective only if the parties hold equal voting rights—so that control premiums and minority discounts can be disregarded—and have equal access to financing.

This valuation technique is in the basis of a so-called "Russian roulette" buy/sell-out option. Instead of relying on a formula, an independent appraiser, or a fixed price, the securities are valued based on the price offered by the first mover. The first moving party is unable at the trigger date to anticipate the decision of the partner either to put its interest or to call the interest of the triggering party at the offer price. Thus, the clause is a double-edged sword for its users—the offering partner can be forced either to buy or to sell the securities. As a result,

[61] *See, e.g.*, Nöldeke & Schmidt, *supra* note 6, at 637.

[62] *See, e.g.*, Chemla et al., *supra* note 5, at 98.

[63] Two widely used valuation techniques for defining the price of a put or call option are a price formula defined in the agreement or a third-party valuation. In the latter case, there are multiple variations. These variations can be combined to curb costs by moving gradually from less costly to costlier versions of third-party valuation. In particular, at the first stage the option value has to be agreed by the parties. If they are not able to agree, each shall present its own valuation and if the two valuations are not different more than a certain percentage (e.g., 5% or 10%), the average of the two is the option price. Otherwise, each has to appoint an appraiser for preparing valuations independently from each other. Again, if the two valuations do not differ significantly, the average is considered the price for the purposes of exercising the option. If they do differ, then the two appraisers appoint a third appraiser. The final price is defined by the latter or is the average of the third appraiser's valuation and the closest valuation offered by one of the two original appraisers. If the parties agree to be bound by an agreed valuation methodology, courts will refrain from second-guessing the determination of a value as long as it is a product of a good faith, independent judgment. *See* Peco Logistics, LLC v. Walnut Inv. Partners, L.P., 2015 WL 9488249, at *9, *10 (Del. Ch. 2015). Alternatively, the parties can opt for a certain level of judicial review for an appraisal process.

the parties have strong incentives to offer a price closer to the fair value of the securities.[64]

The following example illustrates the flaws of the mechanism. The shareholders of VSMPO-Avisma, the world's largest producer of titanium products, contracted for a Russian roulette mechanism. According to the agreement, if one of the parties activated the clause by offering its share for sale at a certain price, it was entitled to purchase the shares of the remaining parties at the offer price, unless the offerees decided to purchase the initiating party's share. In 2005, the outside minority investor, who enjoyed better financial position, put forward a low bid, erroneously expecting that the controlling managers would not be able to arrange necessary financing. This tactics backfired and the triggering party had to sell its share at a low price.[65]

IV. REASONS FOR USING INTEREST TRANSFER CLAUSES

Theoretical literature offers various justifications for regulating interest transfers by private contracts. The following sections build on the results of these studies to show the effects of transfer restrictions in settings maximally approximated to real-life situations.

A. First Purchase Rights

First purchase rights, in effect, are a weak form of a veto right on third party entries into the capital of a firm[66] and on disposing securities by existing owners.[67] The reasons for exercising this "veto right" can be different and context specific—for instance, the desire to keep the small number of investors, confidentiality issues, the importance of personal expertise or special relations of the partners, or the need to keep the existing balance of power in a firm.[68]

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[64]*See* Valinote v. Ballis, 295 F.3d 666, 667 (7th Cir. 2002); Urban Archaeology Ltd. v. Dencorp Investments, Inc., 12 A.D.3d 96, 105, 783 N.Y.S.2d 330, 336 (N.Y. App. Div. 2004).

[65]*See* Arkady Ostrovsky, *A Russian Phoenix Struggles to Stay Free*, FINANCIAL TIMES, Feb. 20, 2006.

[66]*See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 45–46 (Del. Ch. 2010) (according to the facts of this case summarized in the masterly written opinion of Chancellor Chandler, the two controlling stockholders of craigslist, Inc., which runs the popular advertisement website, sought to impose a right of first refusal on the minority stockholder, eBay, Inc., an e-commerce company, to protect their "interests in controlling the culture of craigslist, including the composition of its stockholders."); Easterbrook & Fischel, *supra* note 36, at 273 (referring to the importance of share transfer restrictions in maintaining family control in non-listed corporations).

[67]*See* David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1, 43–46 (1999) (emphasizing the importance of the right for inhibiting unilateral sales of shares, as opposed to controlling sales to undesirable third-party buyers).

[68]If the parties lack financial resources to preempt a third party offer, then the firm itself can be named as a right-holder. In more than one-quarter of cases of employing first

Where such reasons are present, existing investors place higher (intangible) value on securities than potential outside buyers. Hence, in the absence of transfer restrictions, a partner can use the threat of selling securities to a third party strategically for the purpose of strengthening its bargaining position in other matters or extracting a higher price from other partners. First purchase rights provide a solution to this hold-up problem, for they discourage changes in the initial ownership structure or, if not enough, allow the right-holder to prevent transfers to outsiders by buying the selling partner's interest. It follows that by preventing opportunistic renegotiation of investment terms, very much alike other contingent ownership rights, first purchase rights stipulate ex ante efficient investments.

Both variations of first purchase rights pursue the same result, but they have different implications for the contracting parties. Incentives of the parties in applying one or the other vary depending on circumstances. Several studies tried to show individual and joint-efficiency implications of a right of first refusal and a right of first offer for the contracting parties, as well as compare these implications.[69]

1. Economic Analysis of a Right of First Refusal

Under a right of first refusal, potential third-party buyers need to incur evaluation and negotiation costs to make an offer.[70] At the same time, the right-holder has better knowledge about the firm and its business prospects.[71] The size of transaction costs that third parties face and information asymmetry gap between the right-holder and third parties increase with the uniqueness of the property at sale.[72] Obviously, in non-listed firms, where first purchase rights are usually employed, lack of market prices and exemption from extensive disclosure lead to large transaction costs for third-party buyers and to strong insider information advantages. In the absence of a right of first refusal, the argument goes, the outside buyer's probability of success depends on the probability of the valuation of the buyer being higher of the price offered by the right-holder.[73] Where a transfer is subject to a right of first refusal, an outside buyer can succeed only if the right-holder is not buying. Therefore, in the presence of a right of first refusal, third-party

purchase rights by the LLCs included in the study sample, the firm itself, in addition to or instead of its members, was the holder of a first purchase right.

[69]*See, e.g.,* Albert H. Choi, *A Rent Extracting Theory of Right of First Refusal*, 57 J. IND. ECON. 252 (2009); Walker, *supra* note 67 (for a right of first refusal); Grosskopf & Roth, *supra* note 16; Hua, *supra* note 59; (for a right of first offer); Kahan et al., *supra* note 59 (for comparing the two rights as to their joint-efficiency implications).

[70]Walker, *supra* note 67, at 16.

[71]*Id.*, at 17–18.

[72]*Id.*, at 18.

[73]Walker, *supra* note 67, at 19.

buyers, due to uncertainty, are discouraged from making offers. As a result, either the seller's realization potential or the offer price of the shares is reduced.[74]

If there is a guaranteed potential third-party buyer, the economic effect of a right of first refusal is thus to transfer welfare from the seller to the right-holder. From the stand-alone perspectives of each contract party, a right of first refusal is beneficial for the right-holder. From joint-efficiency perspective, however, the parties are better off or, at least, indifferent, as the loss of the seller is offset by the gain of the right-holder.[75] First purchase rights are contingent options for which a right-holder is expected to pay.[76] Hence, to the extent the seller is compensated at the contracting stage for agreeing to encumber its transfer right with a right of first refusal, the parties in combination are not incurring additional costs.[77]

But a third-party offer is never guaranteed. Transaction costs and uncertainty imposed by a right of first refusal on potential outside buyers reduce the combined wealth effect for the contractual parties. Weak demand from potential competing outside bidders who value equity securities more than the right-holder, results in an opportunity cost for the seller that cannot be offset proportionally by the gain of the right-holder.[78] Meanwhile, an alternative measure, such as a mandatory open auctioning of securities, would ensure a superior joint-efficient result for the contracting parties for the purposes of controlling third party entries into the firm's capital.[79] Consequently, a right of first refusal can be as efficient as an auction if (1) the third-party transaction costs are low, (2) the third-party interest in the securities put up for sale is low, or (3) right-holders are not likely to exercise their rights.[80]

Let's consider first the last case. When faced with an intention of a partner to exit, a holder of a right of first refusal is not choosing between preserving the (intangible) value of holding securities by exercising its

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[74]Kahan et al., *supra* note 59, at 346–49; Walker, *supra* note 67, at 19–21. This argument also appears in the decision of the Delaware Court of Chancery in *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 45 (Del. Ch. 2010).

[75]Choi, *supra* note 69, at 259–60.

[76]*See, e.g.*, Bateman v. 317 Rehoboth Ave., LLC, 878 A.2d. 1176, 1183–84 (Del. Ch. 2005). A rough intuition why an option comes with a price is that it is a right that is expected to be exercised only where a right-holder expects a gain. In the absence of a downside risk, a party is expected to pay a price for buying an option. Accordingly, from the right-holder's perspective, the question whether to contract for an option depends solely on the difference between the potential benefits of the right and the costs of obtaining it.

[77]In the practice of business organizations, this compensation would commonly take place by the mutual encumbrance of the transfer rights of the contracting parties by a right of first refusal.

[78]Kahan et al., *supra* note 59, at 351–52; Walker, *supra* note 67, at 26–27.

[79]Walker, *supra* note 67, at 41.

[80]*See* Kahan et al., *supra* note 59, at 351–52 (arguing that a right of first refusal generates a joint-efficient result for the contracting parties when third-party transaction costs are low).

right or not-exercising the right and losing this value. A third-party buyer could be a good fit to the project, which preserves or increases this value. Thus, when a third party is considering whether to incur costs and make an offer for securities encumbered by a right of first refusal, it takes into account not only the probability of its offer price being higher of the valuation of the right-holder, but also the probability of fitting into the project as perceived by the right-holder. Even if the right-holder may have a higher valuation of securities than the third-party buyer, the latter can be the purchaser if the right-holder does not consider the transfer value-destroying for the project.[81] In other words, if the right-holder expects the third party to be at least as good as the departing member, the probability of exercising the right is low. In fact, what a right of first refusal achieves is involving the right-holder indirectly into the negotiations between the seller and an outside buyer.

This implies that if the time horizon for analyzing the right is broadened to include the initial contracting stage and ex post effects of the equity transfer, the right might still ensure the most efficient result for the contracting parties by encouraging partnership and preventing value-decreasing transfers. This is mostly the case where the contracting parties have made investments in relation-specific capital or have developed special relations. In both cases, the possibility of strategic bargaining after investments are sunk can create incentives for both parties to hold up and behave opportunistically.[82] A right of first refusal, by reducing the marketability of securities in cases of strategic transfers to third parties, drives up the costs of behaving opportunistically. In the absence of this right, given uncertainty following a transfer by a partner, the parties have weaker incentives to cooperate and invest.

Special relations is not the only scenario where a right of first refusal is superior to an auction. Auctions are not necessary in sales of readily-available assets whose prices are easy to establish, but are useful in defining prices of assets whose value, due to the asset's idiosyncrasy or uncertain consumer demand, might be unclear.[83] Equity participation in non-listed firms normally is a unique asset and, indeed, belongs to the

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[81]In this setting, not all third parties are discouraged from incurring transaction costs and bidding for securities encumbered by a right of first refusal. Only potential buyers that are expected to be opposed by a right-holder might be deterred. Although stipulating all potential buyers might ensure the best joint-efficient result for the contracting parties at the time of exit of one of them, it can prevent forming the partnership in the first place and is likely to destroy value after the sale.

[82]*See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 52–56 (1985); Benjamin Klein, Robert Crawford, & Armen Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 298–302 (1978); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233, 241–42 (1979).

[83]*See* Liran Einav, Chiara Farronato, Jonathan D. Levin, & Neel Sundaresan, *Sales Mechanisms in Online Markets: What Happened to Internet Auctions?*, 5–6 (NBER Working Paper No. 19021, 2013), available at http://www.nber.org/papers/w19021.

second group.[84] If it were easy to establish the price of the offered securities, there would have been no need in auctions, for the seller would have known how close the price offered by the right-holder was to the market price. Likewise, when the uniqueness of the property is so strong that it is not likely to attract significant outside interest, giving away a right to an auction again is not costly. Therefore, where a firm pursues a project that is strongly tied to the interests and abilities of its members, contracting for a right of first refusal, rather than organizing an auction for selling the partners' equity-holdings, can be an efficient solution.[85] In particular, two highly-specialized IT companies can combine their efforts to develop a new technology for memory cards. Given the specificity of the knowledge, it is not likely that participation in the joint venture can generate strong interest from (many) third parties. Meanwhile, the partners, because they are disclosing and providing to each other their technological developments, can be strongly interested in limiting the access of third parties to the project.

2. Economic Analysis of a Right of First Offer

The effect of a right of first offer is different. According to this right, the securities can be transferred to a third party only at a price equal to or exceeding the price negotiated between a seller and a right-holder. Depending on the type of a right of first offer, either a seller or a right-holder has to disclose its valuation. Hence, the bargaining behavior of a seller or a right-holder, as applicable, is affected. Both scenarios, however, benefit outside buyers by signaling insider information about the value of the securities. This reduces their transaction costs. In addition, under a right of first offer, potential outside buyers, as second movers, benefit from increased certainty of the fate of their offers. Consequently, a right of first offer is expected to increase the interest of third parties and, as a direct result of this, the joint-efficiency of the contracting parties. A closer look, however, reveals a more complicated story.

The problem is that a right of first offer shifts the uncertainty from outside buyers to the contracting parties. Now it is the seller who, given information asymmetry with regard to the private valuations of third parties, needs to offer a lower sale price to the right-holder (if the right requires the seller to define the sale price) or to decide whether to sell to the right-holder or reject the latter's offer and look for other buyers on a

[84]*See* Walker, *supra* note 67, at 16.

[85]Similarly, where asset-specificity results in high transaction costs for third parties, but not for the right-holder (for instance, because of the right-holder's insider knowledge and prior relationships), a right of first refusal can generate a positive joint-efficient result. *See* Kahan et al., *supra* note 59, at 352–53.

market (if the sale price is offered by the right-holder).[86] It may thus cause a situation where, following the seller's decision not to risk and solicit higher valuations at a market, the right-holder gets the securities even if its valuation is lower than the valuations of potential outside buyers.[87]

In practice, the problem of information asymmetry of the seller can be, and often is, solved. The seller can—in order to inform itself about whether to sell, on what terms, and whether to pass on the right-holder's offer—test the market by engaging in preliminary discussions with potential outside buyers before activating a right of first offer.[88] Often these preliminary discussions can reach a quite advanced stage, rendering a right of first offer to a mere formality that the seller needs to comply with in order to finalize the sale with the outside buyer. Indeed, it is possible that the right-holder preempts the third-party buyer by accepting the seller's offer price or, if the right-holder has to define the price, the right-holder's offer price exceeds the price agreed by the seller and the third party. In these cases, the third party cannot recover valuation and negotiation costs it has incurred. Thus, the further negotiations with the third-party buyer go, the higher the risks of the third party and the lower the seller's risks are. This, as long as outside buyers are informed that the securities are encumbered by a preemptive right, is expected to deter them from investing too much resources in negotiating a transfer prior to the clarification of the position of the right-holder.[89]

Preliminary accumulation of information by a seller, who as the result is better informed about its bargaining strategy, has two important implications. First, the seller is no longer forced to lower its offer (if the right requires the seller to define the sale price) and is better informed whether to accept or reject the right-holder's offer (if the right-holder is required to offer the price). Therefore, the seller can extract the highest price on a market for its securities. This will increase the joint-efficiency

[86]Indeed, if delays are not costly, the seller can always choose not to trade with the right-holder and test the market afterwards. Following this, the seller, if it has to lower the sale price, can go through another procedure of a right of first offer. However, this strategy also informs the right-holder who can adapt its bargaining strategy.

[87]*See* Hua, *supra* note 59, at 392; Kahan et al., *supra* note 59, at 354–56.

[88]This practice is permitted by case law. *See* RCM LS II, LLC v. Lincoln Circle Associates, LLC, 2014 WL 3706618, at *7 (Del. Ch. 2014).

[89]In *RCM LS II, LLC v. Lincoln Circle Associates, LLC*, the seller and the third-party buyer exploited the wording of the contractual right of first offer to compensate the third party for the incurred costs in the case the right-holder would have elected to exercise its preemptive right. According to the right of first offer, if the right-holder did not timely accept the seller's offer, the seller could transact with any outside buyer at a sale price not lower than 97% of the price offered by the seller to the right-holder. After agreeing a sale price with the third party, the seller offered slightly higher price to the right-holder (within the 3% discount range); if the right-holder elected to buy, the third party would have received half of the price difference as a termination fee. The court ruled that the seller breached the right of first offer by failing to state accurately the price at which it was willing to sell to the outside buyer. 2014 WL 3706618, at *2, *3, *8 (Del. Ch. 2014).

of the parties of a right of first offer. Second, advanced negotiations transfer value from the right-holder to the seller. In particular, if the seller is offering the sale price, it will indicate a price equal to the highest valuation in an open market, which is not necessarily the valuation of the right-holder; if the right-holder is invited to make an offer, the seller is better informed whether to accept this offer or to reject it and auction the securities at a higher price on a market. As a result, the right-holder may end up in a situation where it paid for obtaining an ineffective right of first offer. Hence, at some point market testing by the seller shall be curbed not to frustrate the results of the agreement between the parties of a right of first offer.

As to the information asymmetry problem of the right-holder, it has information neither about interest from third parties, nor about the negotiations between the seller and any third party. If the offer is made by the seller, the right-holder will use its preemptive purchase right if its valuation of the securities is higher. If the right-holder is making the offer, the only way to overcome the effect of information asymmetries is to indicate an offer price close to the right-holder's maximal valuation of the securities.

A mandatory open auctioning of securities, by analogy to the case of a right of first refusal, would ensure a better joint-efficient result for the contracting parties than a right of first offer if the only thing what mattered was the maximization of the combined profit of contracting parties at the stage of transferring securities by one of them. Yet, a right of first offer impacts the joint-efficiency of the parties by making partnerships possible.

Compared with a right of first refusal, however, a right of first offer is a weaker means for controlling third-party entries into a firm's capital and inhibiting exit by partners. The right-holder cannot decide on acting after observing a third-party. Given the information asymmetry gap, the right-holder has to act if it places higher (intangible) value on securities than any outside buyer does. After failing to timely accept the seller's offer or the seller's rejection to deal with the right-holder, outside buyers no longer face uncertainty and are thus encouraged to bid.

It follows that the implications of a right of first offer for the joint-efficiency of contractual parties are different from the effects of a right of first refusal—the seller, rather than a right-holder, is expected to reap the larger portion of the parties' joint profits. In addition, where a right of first offer requires the right-holder to define the sale price, the seller can elect to sell at the same price to a third party. This weakens the preemptive right of the right-holder and lowers the probability that the right-holder will get the securities. The right is effective only if the right-holder's valuation of the securities is higher than the valuations of outside buyers. Therefore, contracting parties are expected to pay the lowest price for obtaining this particular form of a right of first offer[90] and the highest for having stronger veto power of a right of first refusal; a right of first offer where the seller offers the sale price is situated in the middle of the two.

B. Tag-Along Rights

Theoretical models predict that the size of a controlling block affects the incentives of a controlling group for private benefit extraction.[91] The lower is the size of an equity-holding an outside buyer needs to obtain for establishing control over the firm, the stronger its incentives for extracting private benefits of control are. Small economic interest allows sharing the costs of private benefit extraction with other investors.[92] Contrary to this, investors with large cash flow rights internalize more costs of their own opportunistic actions and thus extract less costly private benefits.[93]

A tag-along right anticipates this conflict and offers solutions. A full tag-along right compels a third party to buy more securities than it is necessary to obtain control. This reduces its incentives to extract private benefits and makes moral hazard less severe. Instead, cash flow maximization incentives are strengthened. A proportional tag-along right gives the seller incentives to conduct an ex ante check of a potential buyer or face ex post risks of becoming a disadvantaged minority vis-à-vis the new controlling investor. The seller is expected to sell only if the buyer is not likely to destroy shareholder value or if it agrees to purchase all securities. In addition, under both variations, the beneficiaries of a tag-along right get a fair exit option before the conflict materializes itself. As such, tag-along rights, in analogy with the mandatory bid rule, prevent value-decreasing control transactions where the benefits of the

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[90] Although a right of first offer increases the payoff of the seller in the joint profits of the parties, it does not make the right-holder worse off compared with the no-right case. The right-holder can nullify any effect of the right by simply abstaining from exercising it.

[91] *See* Morten Bennedsen & Daniel Wolfenzon, *The Balance of Power in Closely Held Corporations*, 58 J. FIN. ECON. 113, 115 (2000); Mike Burkart, Denis Gromb, & Fausto Panunzi, *Why Higher Takeover Premia Protect Minority Shareholders*, 106 J. POL. ECON. 172, 178–81 (1998).

[92] *See* Bennedsen & Wolfenzon, *supra* note 91, at 115; Burkart et al., *supra* note 91, at 178–81.

[93] *See* Bennedsen & Wolfenzon, *supra* note 91, at 115; Burkart et al., *supra* note 91, at 178–81. Empirical evidence from listed companies supports this claim. *See* Stijn Claessens, Simeon Djankov, Joseph P.H. Fan, & Larry H.P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FINANCE 2741, 2754–64 (2002) (using data for listed companies from East Asia region); Paul A. Gompers, Joy Ishii, & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1061ff. (2010) (using data for listed US companies).

seller and the buyer come at the expense of other investors, rather than owing to value creation.[94]

As a corollary, tag-along rights encourage investments by the contracting parties. Normally contractual agreements entitle their parties with special rights that are not provided in statutes and organizational documents of firms. These rights serve as guarantees for the protection of the partners' interests. Being contractual rights, they cannot be enforced against third-party buyers, unless the assignment of the agreement occurs.[95] A third-party buyer is free to extract more private benefits than the former controlling investor did. This implies that a controlling partner can threaten to sell to such a third party with the aim of leveraging its bargaining position. Even in the absence of strategic opportunism, uncertainty created by a possible value-decreasing control change can frustrate initial investments. Tag-along rights provide an opportunity to exit if an outside buyer is not willing to join to the agreement. This opportunity is important for ex ante planning of investments, for without special rights the investments can be worthless.[96]

Tag-along rights are substitutes for other investor protection rights.[97] In firms with a small number of members (up to 10), minority co-sale rights are actively used in cases of waiving the fiduciary duties of members and managers, as well as granting important decision-making rights to controlling members.[98] In cases where controlling members do not owe any fiduciary duties to minority members in a sale-of-control transaction and minority members are not in a position to block such a transaction, a tag-along right is the only means that can protect the minority interests.[99]

However, a tag-along right comes at a cost. A full tag-along right forces an outside buyer to buy more securities (up to 100%) at a higher price or obliges the selling holder to share control premium with all

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[94]*See* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957, 971 (1994).

[95]The situation can be different if investments are organized via the use of the LLC form. The governance structure of LLCs and special rights of members are typically found in LLC operating agreements. Any limited liability company member or an assignee of a limited liability company interest, regardless of executing the LLC agreement, is a party to and bound by it. DEL. CODE ANN. tit. 6, § 18–101(7) (2015). *See also* Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 287 (Del. Supr. 1999); Seaport Vill. Ltd. v. Seaport Vill. Operating Co., 2014 WL 4782817, at *2 (Del. Ch. 2014).

[96]The effect of a tag-along right on stipulating cooperation in relationship-specific investment projects is analyzed in Chemla et al., *supra* note 5, at 105–06 and Maria Isabel Sáez Lacave & Nuria Bermejo Gutiérrez, *Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-along and Drag-along Clauses*, 11 EUR. BUS. ORG. L. REV. 423, 437–38 (2010).

[97]*See* Suren Gomtsian, *Contractual Mechanisms of Investor Protection in Non-Listed Limited Liability Companies*, 60 VILL. L. REV. 955, 974–75 (2015).

[98]*See id.*

[99]*See id.*

minority investors. Whether by discouraging third-party interest or by limiting the size of the premium the seller expects to receive, this right impedes interest transfers.[100] This discourages not only value-decreasing control transfers, but also reduces the probability of value-increasing transactions and results in losses for both contracting parties in the form of forgone cash flow increases.[101]

Consider the failed privatization of Cesky Telecom, a telecommunications company dominating the market in the Czech Republic, in late 2002. The consortium of buyers agreed to pay a premium to the Czech government for its 51% shareholding. According to the requirements of the tag-along right, the same price should have been paid to key investors in Cesky Telecom with a combined 33.5% holding. The negotiations between the buyers and the beneficiaries of the tag-along right directed towards lowering the purchase price failed frustrating the deal.[102]

A pro rata tag-along right hinders interest transfers as well, but for different motives. Unlike the former case, the buyer here is not affected—if it is not willing to buy all offered securities, then the selling member and each exercising tag-along right-holder shall reduce the amount of the offered securities so as to permit each party to sell securities proportionate to their respective percentage holdings. The main impact of the right is thus on the seller. First, the seller is not guaranteed that it will be able to sell the amount of securities negotiated with the buyer; if any right-holder wishes to exercise its option, then the seller's share of the securities is reduced. Therefore, a pro rata tag-along right discourages third-party interest only to the extent that the seller is not willing to become a minority investor and insists on a full transfer. This is more likely to occur if a control transaction is value-decreasing.

[100]Consider a potential buyer (*B*) ready to pay v_1 for all outstanding shares of a target corporation. The corporation has a controlling shareholder *S* whose share in the equity capital is $1 - \alpha$. *S* and the other shareholders are parties of a shareholders' agreement entitling the latter to sell all their shares along with *S* at the price offered to *S*. In *B*'s valuation of the corporation, β is the control premium—part of additional pecuniary and non-pecuniary benefits that *B* expects to get after acquiring control (if β were equal to full private benefits of *B*, then it would not make sense for *B* to transact). Accordingly, the combined value of all single stocks is $v_1 - \beta$. Without the tag-along right, *S* would get $(1 - \alpha)*(v_1 - \beta) + \beta$ (total value of its share plus the entire control premium). The $\alpha*(v_1 - \beta)$ left would be shared between the remaining shareholders. Under the tag-along right, the payoffs are different: *S* receives $(1 - \alpha)*v_1$ and the minority shareholders get $\alpha*v_1$. Either *B* has to increase its payments to $v_2 = v_1 + \alpha*\beta$ to be able to pay the control premium also to the minority shareholders, or *S* has to agree to the reduced control premium. For *S*, the sale will be optimal if the reduced control premium exceeds its current private benefits of control. For *B*, increasing the total payments to v_2 will be rational if the expected benefits of full control are not less than the additionally paid control premium. If the initial price v_1 is not changed, *S*'s payoff is reduced, decreasing the probability of the deal.

[101]*See*, *e.g.*, Bebchuk, *supra* note 94, at 971; Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 711–12 (1982).

[102]Robert Anderson & Ian Bickerton, *Doubts Surround Cesky Sale*, FINANCIAL TIMES, Nov. 25, 2002.

The incidence of value-increasing control transfers is not reduced and the seller will continue receiving third-party solicitations. Second, the seller has to share the control premium with the remaining investors.[103]

Therefore, the costs of a full tag-along right are particularly high where a non-listed firm has a strong single controlling member co-existing with a large number of minority investors and are low where either voting rights are distributed relatively evenly among the partners or minority investors are entitled to special rights.[104] In the first case, the low costs of tag-along rights follow from the high probability that the existing investors, if not acting in cooperation, are less likely to require a control premium. In the second case, special minority rights justify the claims for sharing a control premium with the controlling seller.

This analysis shows that a tag-along right imposes different costs on its contracting parties depending on the particular circumstances of organizing and structuring investments. The joint-efficiency implications of this right can vary from case to case. Contracting for a tag-along right is a strategic choice of investors made if the benefits of such encumbrance exceed the costs of the reduced marketability of their holdings. Provided that controlling investors are more legitimate to require a control premium,[105] more tag-along rights are expected in the governance agreements of firms where there is no single controlling group or the potential for private benefit extraction is limited. With a strong controlling founder, high costs of a tag-along right are justified to the extent that a tag-along commitment against self-dealing facilitates finding partners for the proposed project.

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[103] Suppose, a controlling shareholder *S* owns securities representing $1 - \alpha$ of the corporation's capital. An outside buyer *B* is willing to become a new controlling shareholder by acquiring $1 - \alpha$ at a price ν which includes a control premium. The shares are encumbered by a tag-along right entitling each shareholder to sell its pro rata share in a control transfer at the same price offered to the controlling shareholder. By negotiating only with *S*, *B* will achieve its goal at minimum transaction costs (buying the same share from more than one shareholder requires more negotiations and thus increases costs). Without the right, *S*'s payoff would be equal to ν. With the tag-along right, if all right-holders join, *S* cannot sell its entire share. It can sell only $(1 - \alpha)*(1 - \alpha)/100$ at a price $\nu - \alpha*\nu$, as $\alpha*\nu$, including partial control premium, will be distributed among the right-holders. Because the transfer price ν is not affected by the right, *B* is not discouraged from bidding as long as it can effectively commit not to divert more private benefits than *S*. Otherwise, in order not to bear the risk of losses as a minority shareholder, *S* will agree to sell only in a full 100% transfer.

[104] Evidence from Brazilian listed companies corresponds with this conclusion: tag-along rights were less likely in companies where large shareholders leveraged their control by holding more voting rights than economic interest. *See* Morten Bennedsen, Kasper Meisner Nielsen, & Thomas Vester Nielsen, *Private Contracting and Corporate Governance: Evidence from the Provision of Tag-Along Rights in Brazil*, 18 J. CORP. FINANCE 904, 916 (2012).

[105] *See* Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review*, 169 J. INST. THEOR. ECON. 160, 169 (2013); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 812–13 (2003).

C. Drag-Along Rights

A drag-along right functions as a balancing mechanism to a tag-along right. It increases the control premium of the seller, facilitates control transactions by increasing the benefits of a potential buyer, and stipulates relationship-specific investments.

From the seller's perspective, this right, by adding the securities of other investors, allows selling more securities than the seller actually owns. Depending on the activation threshold, this might render a small equity holding into a controlling package. Therefore, a drag-along right contributes to obtaining a better price for the securities of the seller and other investors that are being squeezed out.

For potential buyers, the main benefit is in the opportunity to establish full control without costly individual negotiations with each minority investor.[106] The desire to acquire a larger holding or full control is driven by two reasons. First, the freedom of each investor to abstain from selling can be used strategically in value-increasing sales with the aim of getting a higher price later.[107] A drag-along right prevents such an opportunistic behavior.[108] Second, there are additional costs and risks that minority investors can create for a potential buyer. Nevertheless, it should be admitted that these costs are larger in listed firms because they face extra costs of conforming to listing requirements and high corporate governance standards.

Finally, by preventing opportunistic refusal by a minority investor to sell in a value-increasing acquisition, a drag-along right forces the contractual parties to stick to the agreed shares of the payoff.[109] In the absence of a drag-along right, a minority party can require an increase in its payoff. This hold-up threat reduces the benefits to a potential third-party buyer.[110] In order to proceed with the transaction, the majority

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[106] *Cf.* Joseph A. McCahery, Luc Renneboog, Peer Ritter, & Sascha Haller, *The Economics of the Proposed European Takeover Directive*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, 575, 637–38 (Guido Ferrarini et al. eds., 2004).

[107] For an argument that minority free-riding increases the costs of a takeover for an acquirer of the shares of a listed firm see George K. Yarrow, *Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process*, 34 J. INDUS. ECON. 3, 10–12 (1985).

[108] Consider a buyer *B* willing to pay ν for 100% equity capital of a corporation. It is reasonable to expect that *B* values the shares at a higher price ν', otherwise it would not benefit from the transaction. The holding of the controlling shareholder *S* equals to $1 - \alpha$ and the minority shareholder *M*, accordingly, owns α share of stocks. Under a drag-along right, *S* and *M* will divide ν in proportions $(1 - \alpha)*\nu$ and $\alpha*\nu$, respectively. Without a drag-along right, *M* can refuse to sell in order to capture in future part of *B*'s added value in the amount $\alpha*(\nu' - \nu)$. This reduces the difference $\nu' - \nu$ that *B* expects to earn by acquiring control. Hence, *B* is less attracted by the prospects of the transaction. However, to the extent that this positive difference is fully attributed to private benefits of control that *B* expects to get, *M* cannot increase its payoff by not selling; all private benefits will flow to *B*.

[109] Chemla et al., *supra* note 5, at 106–07.

[110] *See supra* note 108.

seller has to share part of its initially agreed payoff with the minority investor. Precluding such hold-ups encourages investments.[111]

D. Put Options, Call Options, and Buy/Sell-Out Arrangements

Put and call options are one of the main contractual techniques aimed at resolving hold-up problems in relation-specific investments.[112] These provisions stipulate optimal investments by the means of encouraging cooperation between the contracting parties or ensuring smooth and predictable division.[113] Options, by making use of price definition mechanisms and distribution of put and call rights between the partners, induce the partners to invest optimally and, if nevertheless a conflict arises, to engage in negotiations and solve the conflict. If negotiations are unsuccessful or partners cannot even be brought together, then put and call options allow eliminating the conflict quickly by removing one of the parties from the firm and terminating their relations. In this situation, an option functions as a dispute resolution mechanism that focuses on the division of assets. In both cases, the main economic benefit is preserving the firm as a going concern, if, indeed, it is an efficient outcome. At the same time, the removed party receives fair compensation. In sum, options contribute towards optimal investments, ex ante deterrence of deadlocks, and stipulation of negotiations if a deadlock nevertheless occurs.

The type of the option (put or call) and the identity of the holder (majority or minority partner) jointly depend on the nature of the ex post problems (private benefit extraction or ex post investments) and the distribution of the bargaining power between the parties.[114] In particular, after initial investments the investing partner is vulnerable to hold-up by the other partner who should make ex post investments or commit to continue cooperation in order to create value for both parties. Increasing the holding of the latter, for example, by transferring full control to it, will suffice to induce it to make the promised investments. In this case, obviously, the efficiency considerations require granting the first investor, even if it is the majority partner, with a put option to sell its interest to the other partner. Exercising the put option at fair value will change the initial stakes of the parties in the firm and will induce optimal ex post investments, but it will maintain the parties' initially agreed shares of the payoff.[115]

On the other hand, if the risk is that the minority investor will incur private benefit costs by reason of opportunistic self-dealing by the

[111] Chemla et al., *supra* note 5, at 106–07.
[112] *Id.* at 94–95.
[113] *See id.*
[114] Chemla et al., *supra* note 5, at 98–99.
[115] *Id.* at 111–13.

controlling investor and it is the latter that can exploit its stronger bargaining position for strategic renegotiation, then the put option is granted to the minority investor. If exercised, the majority partner will end up as the sole investor of the firm. As such, the mere threat of exercising the put option by the minority investor has a deterring effect on the majority's incentives to engage in private benefit extraction.[116] The same logic applies to deterring moral hazard behavior by one of the partners—i.e. taking more risks or putting suboptimal efforts to manage.[117]

With all these benefits, relying on options can also be problematic. They can give one of the parties opportunistic incentives to create artificial grounds for activating the option. The example illustrated above clearly demonstrates the risks of manipulation of Russian roulette clauses.[118] In particular, where one of the partners possesses information about the financial position of the other partner, it can trigger a buy-out mechanism to force a financially weaker partner out of the firm. Even if the offered price is below the market price, the financially constrained partner may not be able to make a counteroffer. Similar opportunistic behavior can be encouraged in situations where one of the parties knows that the sale or purchase of the securities is costly or not affordable for its partner owing to strategic or tax reasons or for public law limitations, such as antitrust rules or foreign investment limitations.[119]

Legal practice has devised several solutions for tackling this moral hazard issue,[120] but all come with trade-offs. In particular, agreeing on a minimum price threshold or a price formula brings the partners back to the valuation issues discussed earlier;[121] providing the parties with longer time periods to arrange financing increases the costs of a deadlock for the firm. The parties can rely on good faith duty by specifying that any offer should be a good faith valuation of the fair market value of the securities. As a trade-off, this solution heavily relies on ex post adjudication costs in state or arbitration courts. Alternatively, it is possible to provide partners with an opportunity to look for a third-party buyer or to buy the securities on flexible terms.

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[116]*Id.* at 103–04.

[117]*See* Joel S. Demski & David E.M. Sappington, *Resolving Double Moral Hazard Problems with Buyout Agreements*, 22 RAND J. ECON. 232, 236–38 (1991).

[118]*See supra* note 65 and the accompanying text.

[119]*See* Holger Fleischer & Stephan Schneider, *Shoot-Out Clauses in Partnerships and Close Corporations: An Approach from Comparative Law and Economic Theory*, 9 EUR. COMPANY & FIN. L. REV. 35, 41 (2012).

[120]For a brief discussion *see* Fleischer & Schneider, *supra* note 119, at 48–49; Jason M. Hoberman, *Practical Considerations for Drafting and Utilizing Deadlock Solutions for Non-Corporate Business Entities*, 2001 COLUM. BUS. L. REV. 231, 248–49 (2001).

[121]*See supra* notes 61–63 and the accompanying text.

V. DATA AND RESEARCH DESIGN

The database was created by using the operating agreements of non-listed LLCs filed with the SEC. In most cases, these were subsidiaries or joint ventures formed by listed corporations. Full text search tool of the SEC's Electronic Data Gathering, Analysis, and Retrieval database (EDGAR) provides access to the electronic texts of the documents filed with the Commission during past four years. The search, which was conducted in the annual reports (form 10-K) of all filing entities submitted to the SEC during 2012, yielded LLC agreements of 887 companies formed in different US states. This database was refined by removing all agreements of one-member companies, publicly-traded LLCs, LLCs that were widely held by qualified investors but did not have a public market, and firms formed in states other than Delaware. The last restriction on the data, which reduced the sample of non-listed firms having 2 or more independent members by less than 14%, aimed to eliminate the possible influence of state statutory differences on contractual choices that parties had made. The final database contains operating agreements of 289 companies formed according to the Delaware Limited Liability Company Act. Of the total number, 168 firms had 2 non-affiliated members, 62 had from 3 to 10 independent members, and the remaining 59 had more than 10 independent members. Most of the LLC agreements in the sample were entered after 2006. A typical agreement is more than 50 pages-long and contains detailed rules of conduct for the contractual parties.

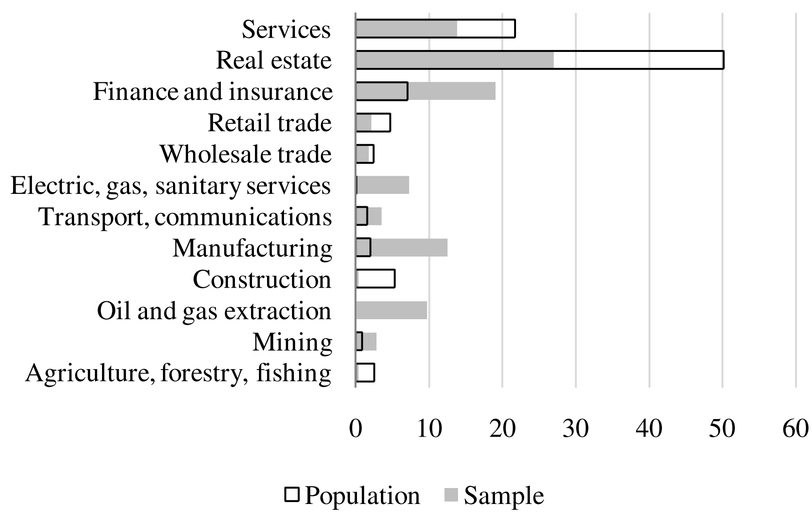
The preliminary study of the sample operating agreements revealed several cases where the LLC members, although not necessarily formally affiliated, had relations making the use of detailed contractual provisions for investor protection secondary. These were cases where one (group) of the members held top-management position(s) at the board of the other member or all members were employees of a third firm. Descriptive statistics includes information for the total sample, but at the stage of conducting inferential statistical analysis these firms, given close relations of their members, were removed from the database. Thus, for defining the circumstances of using transfer restrictions the sample contains a total of 243 LLCs.[122]

The LLC form is used in various business industries. The majority of all LLCs operate in real estate sector; LLCs are also popular in professional services, finance and insurance, construction, and trade (Figure I). The sample contains companies from different industries as well. Figure I compares the industrial division of the sample and the

[122]The reduced sample includes 158 firms with 2 members, 56 firms with the number of members from 3 to 10, and 29 firms with more than 10 members. Few of the discarded LLCs had transfer restrictions in their operating agreements: first purchase rights were used in 2 LLCs, tag-along and drag-along rights—in 5 companies, and 4 LLCs had option clauses.

total LLC population based on the first two digits of the Standard Industrial Classification Codes (SIC Codes). Most of the firms in the sample came from finance and real estate sectors (more than 46%). Services, manufacturing, oil and gas, and transportation services are strongly represented as well. The comparison with the industrial representation of all LLCs taxed as a partnership reveals many similarities.[123] However, the sample is heavily overrepresented in manufacturing, oil and gas, and electric sectors and is underrepresented in services and construction. The main explanation for these differences can be the fact that the sample is skewed towards larger businesses. The different share of real estate firms can be explained by the fact that many LLCs holding interests in real estate are formed locally.

Figure I. Industrial representation of the sample, %



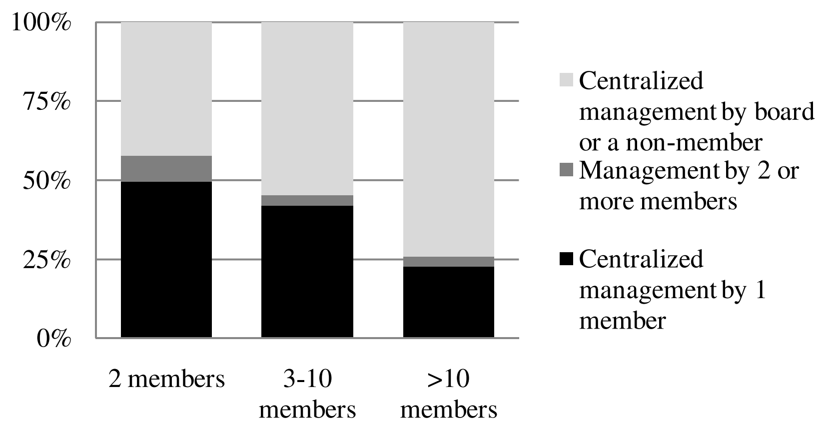
Note: The total population data include all LLCs that filed partnership tax returns for the tax year of 2011.

Almost all companies in the sample had a centralized management structure. More than half of the sample companies with 2 members were member-managed, but only in 14 companies both members had management rights. In most cases, the management was centralized and only one of the members was responsible for it. The remaining 42.2% had centralized management by a non-member or by a board of directors.

[123]This comparison excludes one-member LLCs taxed as a sole proprietorship and is more appropriate given the fact that the sample includes only firms with 2 or more members. The data on LLCs taxed as a partnership are taken from Ron DeCarlo, Lauren Lee, & Nina Shumofsky, *Partnership Returns, 2011*, STATISTICS OF INCOME BULLETIN, Fall 2013, at 184–86.

With the increase in the number of members, centralized management by a board of directors becomes more common. Almost 55% in the 3–10 member firms had boards of directors. The corresponding figure is 74% in firms with more than 10 members. Figure II illustrates these data.

Figure II: Management structure of the sample LLCs



More than 70% of the sample LLCs had a member or a group of affiliated members controlling majority of voting rights. This share was the highest in the LLCs with more than 10 members (around 83%) and the lowest in the companies with 3–10 members (about 64%). In 2-member LLCs 72% had a controlling member.

In the sample LLCs with 2 members, more than 86% left intact the statutory transfer restriction.[124] In about 43.5% of the 2-member firms, the members agreed to restrict the alienation of their interests by first purchase rights. These rights were very often substituting the default transfer restriction. With the growth of the number of company members, most of the transfer restrictions, with the apparent exception of a tag-along right, become less common. The statutory transfer restriction was not waived in 71% of the 3–10 member LLCs and 64.5% of the sample companies with more than 10 members. Contrary to the LLCs with few members, the approval often had to be given by the board or the managing member, rather than by each member. However, similar to 2-member companies, often the statutory restriction was subordinated to first purchase rights, which were used in 38.7% and 41.9% of the sample firms with 3–10 and more than 10 members, respectively.

All agreements were coded based on a scorecard containing 84 questions affecting investor rights. The general coding criteria were defined based on (1) the background information, (2) information about

[124] *See supra* notes 48–49 and the accompanying text.

the voting and equity rights of the LLC members, and (3) the main differences of the legal regime of LLCs as opposed to the corporate statute. In addition, a separate questionnaire was used to code detailed information about the contractual design of transfer restrictions. These questions included information about the type of the right, its variations, and typical characteristics (for instance, grounds for activating the right). The author read all 289 sample agreements and coded the variables as either zero (a negative answer) or one (a positive answer).

Likely circumstances of using different forms of transfer restrictions were defined by using regression analysis. Because both dependent and independent variables are categorical, the analysis relies on logit regressions. Dependent variables in all regressions are different forms of interest transfer restrictions. Independent variables are grouped into four categories—the number of LLC members, voting rights, contractual rights, and industrial division. Since the number of members is strongly correlated with the ownership structure of the sample firms (e.g., two-member firms tended to have members with equal voting or veto rights and firms with a larger number of members were likely to have a large controlling member), these two groups of independent variables were used as alternatives in two separate regressions.

The freedom to contract out of fiduciary duties is one of the principal differences of a Delaware LLC as opposed to corporations. Whereas mandatory fiduciary duties of shareholders and managers play an important role in investor protection in the traditional corporate setting, the members of Delaware LLCs are free to expand, restrict partially, or waive in full fiduciary duties of members or managers[125] or limit or eliminate liability for breach of these duties.[126] In addition to voting rights, the contractually agreed scope of fiduciary duties is used to define the strength of investor rights.

The last group of independent variables includes information about the industry of the sample firms. The size of the firms is another important factor that can define the choice of transfer restrictions—the larger the firm, the stronger the reasons of rational investors to spend resources on contractual design are.[127] Unfortunately, financial results are available for few sample firms, which as non-listed firms are not obliged to disclose such information. Nevertheless, it is reasonable to assume that most of the LLCs, given the disclosure of their LLC agreements by listed firms, were large.

[125]DEL. CODE ANN. tit. 6, § 18–1101(c) (2015).

[126]*Id.*, § 18–1101(e).

[127]*See*, *e.g.*, Means, *supra* note 44, at 1222 (few initial assets of a firm is a rational impediment to incurring bargaining costs).

There is only one other point that needs to be addressed here. Learning externalities of lawyers,[128] rather than ensuring joint-efficient outcomes for business partners, can define the choice of interest transfer rules. Associates at large law firms are normally expected to use the extensive libraries of their law firms to design transfer clauses instead of starting from the scratch in each new case. Hence, prior experiences at law firms can affect subsequent choices. The evidence that lawyers involved in the drafting of the sample agreements relied on boilerplate transfer clauses, however, is not compelling.[129] Consequently, other factors, along with the experiences of law firms, must have driven the choice and the design of these clauses.

VI. THE PRACTICE OF CONTRACTING FOR INTEREST TRANSFERS

This Part presents the results of the study and offers explanations for the findings. Regression models are reported in the appendix.

A. First Purchase Rights

In the sample of 289 companies, in 111 (more than 38% of all) the members contracted for first purchase rights with regard to their interests. In four agreements, the abstract description of the rights did not allow distinguishing a particular type of a first purchase right. After removing these cases, the final sample contains 107 LLCs. The two-thirds of these firms had only two members. The most popular was a right of first refusal—almost 58% of the firms with first purchase rights used this right. The share of firms that used a right of first offer where the seller offers the purchase price was about 29% and the remaining

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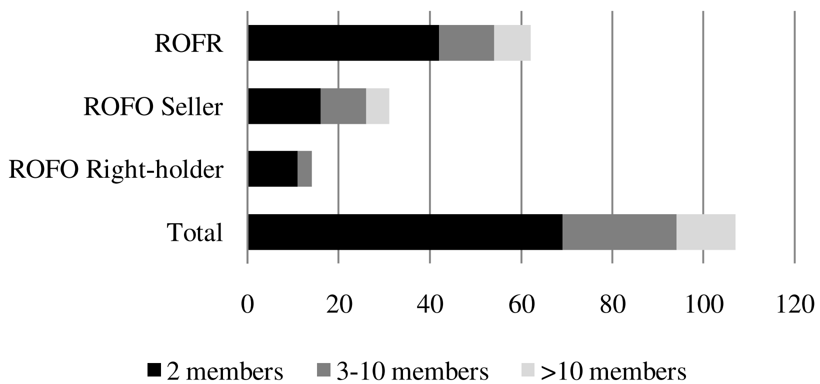
[128]*See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 720–21 (discussing learning externalities related to drafting efficiency).

[129]The texts of the documents allow identifying lawyers involved in the drafting of the LLC agreements—assuming that lawyers indicated in the notices clause are the ones who assisted the parties in drafting and negotiating the agreement—in 127 firms, which consist about 44% of the entire sample. Only four law firms were involved in drafting at least five LLC agreements in the capacity of a lawyer of different clients: Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates (7 agreements), Simpson Thacher & Bartlett LLP (6 agreements), Kirkland & Ellis LLP, and Latham & Watkins LLP (both 5 agreements). The comparison of all agreements drafted by each of these firms reveals that not only agreements include different variations of interest transfer clauses, but also the design of the clauses varies. This certainly does not suggest that lawyers draft different contracts every time. The most likely explanation, rather, is that although lawyers use boilerplate forms to start the drafting of an agreement, there are clauses which they adjust to the needs of a given transaction. Alternatively, law firms may develop several forms of a boilerplate contract tailored to different circumstances, specifically subject to the voting power of a client, the number of investors, an industry of the firm, or even its geographical location. Surely, interactions between the opposing parties or between their lawyers matter as well: contractual negotiations can lead to results that differ from the standard texts normally employed by each side's lawyer.

13% had a right of first offer where the right-holders offer the sale price (Figure III).

Figure III. The prevalence of different forms of first purchase rights



Notes: ROFR stands for a right of first refusal; ROFO Seller and ROFO Right-holder are rights of first offer where the seller or right-holder offers the sale price, respectively.

Two reasons make it difficult to test the implications of the theories of a right of first refusal and a right of first offer. First, the encumbrance of interests with preemptive rights is often reciprocal.[130] This complicates measuring the value paid for a first purchase right, whether by monetary or non-monetary means, such as other contractual rights. Second, an LLC member may end up as a seller of its interest or a buyer of interests offered by others. Based on the probability analysis of a likely future scenario, the contracting party can choose the particular first purchase right that fits its interests the best. The result of this analysis, however, is private knowledge. Nevertheless, the analysis of the sample rights reveals some interesting results.

Table A-1 shows the prevalence of using different types of first purchase rights depending on the ownership and voting patterns of the sample LLCs. The evidence comes to support the argument that first purchase rights are used where the partners have special contractual relations allowing each to affect decision-making. Under these circumstances, the traditional fiduciary duties are secondary. Special relations make the company vulnerable to the threatened or actual entries of third parties which can change the established balance of power,

[130]The evidence supports the reciprocal nature of first purchase rights in the business organizations setting. Only in one-quarter of the cases the rights were not reciprocal. A right of first offer, regardless of its variation, was likelier to be non-reciprocal than a right of first refusal.

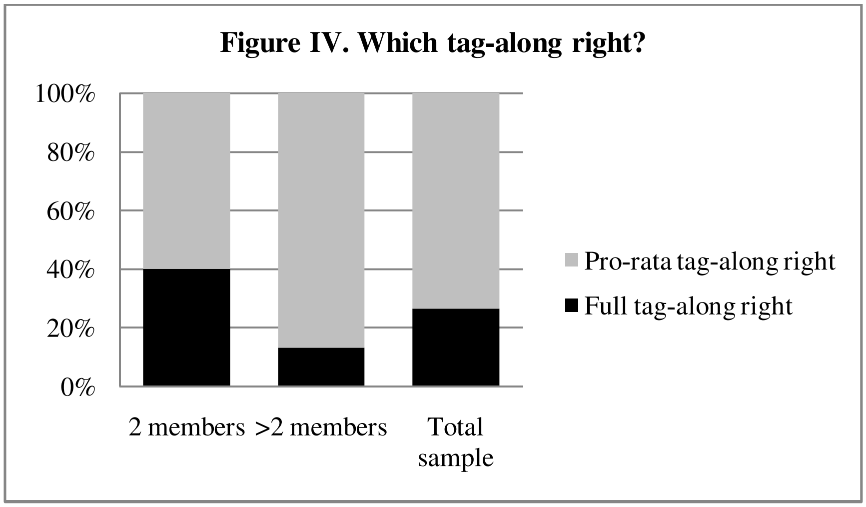
patterns of the members' behavior, or their priorities. First purchase rights encourage investments by making third-party transfers of interests less likely. The strongest form of these rights, a right of first refusal, gives a right-holder say on any third-party transfer. It is used reciprocally in cases of special relations between the members with equal bargaining power. On the contrary, if there was a controlling right-holder, it was unlikely that it would have a preemptive right under a right of first offer where the right-holder defines the sale price.

These results can be explained by the predicted effects of the variations of first purchase rights. In two-member LLCs with both members holding equal ownership and voting rights, members are the most willing to impede equity transfers to outsiders and influence the replacement of a member by a third party. Therefore, they prefer a reciprocal right of first refusal to a right of first offer. The greater becomes the number of members, the higher the potential costs of a seller resulting from the reduced realization potential of a right of first refusal are (unless the right-holders are passive minority investors that are unlikely to exercise their rights). In firms with a large number of investors, outside buyers face an extremely high uncertainty risk with regard to their offers because any right-holder can thwart a third-party bid. If a member is allowed to sell its equity only after receiving a bona fide third-party offer and complying with the procedural requirements of a right of first refusal, then agreeing to such a right, in effect, means locking in the investors in the firm. The potential losses of a seller from encumbering its equity securities by a preemptive right are limited under a right of first offer. Not only the increased certainty attracts more third party interest, but the right can create a competitive auction between the numerous right-holders.[131] However, a right of first offer where the right-holder defines the sale price, due to the limited value for its holders, is not attractive for controlling members with strong negotiating power. This type of a right of first offer, consequently, appears mostly in LLCs without a controlling investor.

B. Tag-Along and Drag-Along Rights

The share of the LLCs in the sample with tag-along rights is slightly above 31% (90 firms out of the total of 289). More widespread were tag-along rights entitling the right-holders to sell in proportional shares with the main selling member (73.33%). In the remaining 26.67% of cases, the seller could not sell any units unless the third-party buyer committed to buy all outstanding units (Figure IV). Table A-2 presents comparative data on the two variations of a tag-along right.

[131]The signs of the correlations of the variations of first purchase rights and the number of LLC members correspond with these analysis, but the relationships are not significant.



A tag-along right, obviously, has a value where the partners cannot block third-party transfers of interests to third parties. Therefore, the right was used as an alternative to unanimous voting or veto rights. Given the comparative advantages of a proportional tag-along right as opposed to a full tag-along right, it is not surprising that most of the members of the sample companies contracted for the first type. This right is more likely to discourage value-decreasing control transactions, but has limited negative effect on value-increasing transfers. A full tag-along right, by contrast, affects equally both types of control transfers.

A full tag-along right was likely to appear in LLCs with a small number of members and if the investors had strong rights. The reason, perhaps, is that in these situations investors contract for rights that balance each other and a controlling member, if any, has limited maneuvering room for extracting private benefits. Contrary, under weak minority rights, a pro rata tag-along right is the appropriate measure. With the increasing number of members, the costs of providing strong decision-making rights to each investor increase as well. Majority voting becomes the most viable decision-making rule. Accordingly, one or several members become a controlling party and enjoy the benefits of such control. In these cases, large members resist a full tag-along right and are likely to agree to a proportional tag-along right, which has a limited effect on discouraging potential interest from outside buyers.

The evidence is supportive of the argument that a drag-along right is balancing tag-along rights. The sample contains 74 companies where the members contracted for a drag-along right. In almost three-quarters of the LLCs, a drag-along right was contracted along with a tag-along right and only 9.46% of the agreements included stand-alone drag-along rights. A drag-along right was commonly contracted in LLCs with a controlling member.

C. Put Options, Call Options, and Buy/Sell-Out Arrangements

Though the theoretical implications of put and call options and of buy/sell-out options have been extensively studied, practical evidence on their use, similar to other interest transfer clauses, is rare. The data from the agreements of the sample companies shed more light on the use of options in non-listed LLCs.

Out of the total sample of 289 firms, in 170 LLCs the members contracted for one or another form of options. Figure V shows the popularity of different forms of options. The options took the form of minority put and call rights in 21.18% and 27.65% of cases, respectively. Majority call rights appeared in 41.18% of the LLC agreements using options. Majority put rights were rarely used. Buy/sell-out clauses, where either party could be a buyer or a seller, were employed in every fourth sample company with an option clause in its operating agreement (26.47%).

Figure V. Option types, %

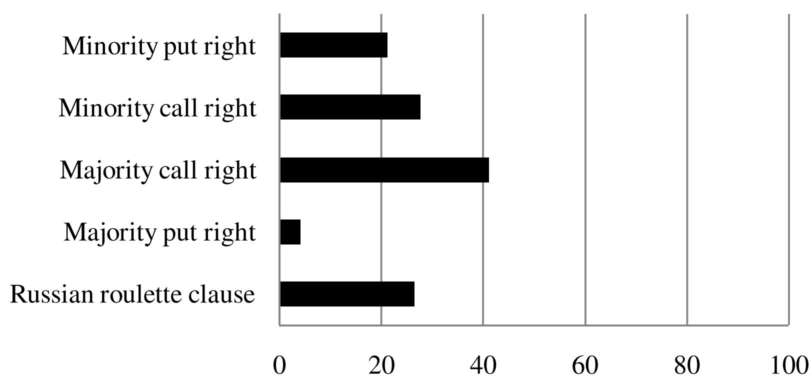


Table A-3 presents the results of the statistical analysis. As predicted, unconditional minority put rights were used to prevent opportunistic self-dealing by controlling members where the minority members could not rely on their voting rights to affect day-to-day decision-making and major decisions. These options, except cases of stipulating optimal investments in relation-specific projects with sequential investing, have limited value in 2-member firms with equal voting rights. Indeed, an investor can use voting rights to prevent expropriation by its partner.

Where a minority investor has sufficient financial resources and experience relevant to the business project, majority self-dealing and hold-up strategies can be discouraged also by granting a minority investor a call right. Unlike a minority put right, which typically could be activated anytime by its holder, minority call right required a specific cause for activation—decision-making deadlock, failure to make investments by the controlling member, breach of the agreement by the controlling member, or change of control in the controlling member.[132] Similar causes were required for the activation of majority call options. In the circumstances of equal voting or minority veto rights, the call right of one of the two partners was an effective instrument to overcome deadlocks. The option took the form of a call right rather than a put right because a put right could be used strategically to create artificial deadlocks and obtain bargaining advantage over a financially-constrained partner not able to perform its obligation to buy the offered interest.

Special types of put and call options, buy/sell-out arrangements, in the majority of cases could be activated anytime. Less often were conditional buy/sell options that could be triggered following a deadlock or breach of the agreement by one of the parties. We would expect buy/sell-out arrangements in 50-50% projects. The data show that these provisions were almost in all cases used in 2-member firms. Though equal economic interest in the LLC was not a necessary condition for contracting for a buy/sell-out provision, equal voting rights and equal board representation in general were.

Theoretical models show that where both contractual parties have private valuations not known to each other, buy/sell-out arrangements can lead to inefficient results.[133] In particular, the triggering party defines the price based on the probability analysis of being a seller or a buyer. If it believes that the other party has higher valuation and is likely to buy, the triggering party offers a price above its own valuation. Contrary, if the triggering party is likely to buy, it offers a price below its own valuation. Where these estimates are right, the results of buy/sell-out clauses are efficient. However, if the receiving party has a valuation between the triggering party's own valuation and the offered price, the triggering party may end up as a buyer where it would be more efficient to sell or as a seller where it would be more efficient to buy.[134]

The inefficiencies can be mitigated by choosing the right triggering party. De Frutos and Kittsteiner offer a model based on negotiations before activating a buy/sell-out option that aims to define the right

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[132]Change of control can be dealt with also by first purchase rights entitling the right-holder to acquire the equity holding of its partner if the latter is subject to change of control. However, first purchase rights often did not cover indirect transfers of the encumbered units. This necessitates drafting special call options.

[133]*See* R. Preston McAfee, *Amicable Divorce: Dissolving a Partnership with Simple Mechanisms*, 56 J. ECON. THEORY 266, 276–78 (1992). A result is efficient if full control over the firm is transferred to the partner that values it most.

[134]*See id.*

triggering party.[135] Choosing the right triggering party can also ensure a fair result[136] if the parties of a buy/sell-out option have one-sided asymmetric information about the price (one party is better informed than the other).[137] These studies suggest that, when contracting for a buy/sell-out option, the parties would either allow negotiations before activating the option or would define in the agreement the triggering party whose offer would lead to an equitable and/or efficient result. If the latter is the party with better information about the firm which can accurately value the securities, then the parties are looking for an equitable division; if the offering party is the one with the higher valuation, then the outcome is efficient.[138] Contrary, where the agreement is silent and any party can trigger the option, the effect of the buy/sell-out mechanism on resolving deadlocks is very limited—since each party prefers the other party to activate the mechanism, both are expected to refrain and stay deadlocked.[139]

The practice of the sample LLCs does not support these predictions. Only in few cases the agreements specified the party that was entitled to trigger a buy/sell-out procedure. In the vast majority of situations, any of the contractual parties could activate the clause. Interestingly, the evidence points in the direction that buy/sell-out options were often used in real estate firms. These are the firms where information asymmetries of the parties with regard to valuations are, perhaps, the lowest. Valuing real estate projects is relatively easier even for external parties given predictable cash flows. On the other hand, the inclusion of the buy/sell-out mechanisms in the governance agreements of real estate joint ventures can also be motivated by the long-established practices of professional consultants, rather than by the efficiency or fairness considerations. In particular, in 2008, the American Bar Association's Business Law Section published the Model Real Estate Development Operating Agreement for limited liability companies which included a

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[135] *See* María-Angeles de Frutos & Thomas Kittsteiner, *Efficient Partnership Dissolution under Buy-Sell Clauses*, 39 RAND J. ECON. 184, 188–91 (2008). In a recent study, Professors Landeo and Spier argue that courts, since they design a valuation mechanism ex post and are thus able to pick the right party to make a triggering offer, can use buy/sell-out options to ensure fair division of assets in judicially ordered business dissolutions. *See* Landeo & Spier, *supra* note 16, at 176; Claudia M. Landeo & Kathryn E. Spier, *Irreconcilable Differences: Judicial Resolution of Business Deadlock*, 81 U. CHI. L. REV. 203, 206 (2014).

[136] A result is fair if the allocation of payoffs between the parties accurately reflects the agreed ownership allocation.

[137] Landeo & Spier, *supra* note 16, at 160–62; Landeo & Spier, *supra* note 135, at 210–13. Ensuring equitable results in contractual buy/sell options is important because otherwise the parties have incentives to engage in opportunistic behavior with the purpose of changing the proportions of the initially agreed allocations. For instance, an advantaged party can create an artificial deadlock to activate a buy/sell option and buy out (sell out) its partner at a low (high) price.

[138] *See* Landeo & Spier, *supra* note 16, at 162.

[139] *See id.*

buy/sell provision pursuant to which any of the members could activate the procedure.[140]

Sometimes, but not often, the parties used a modified version of a Russian roulette mechanism where a triggering party is not offering the price of the option. The price is, rather, defined by an independent third party after the activation of the option.[141] Engaging an independent appraiser, if the valuation is performed accurately, mitigates inefficient and inequitable outcomes related to buy/sell-out mechanisms. However, given the additional costs, this modification is useful only where the reasons for sub-optimal outcomes of utilizing buy/sell options are well-pronounced.[142]

VII. THE CONTRACTUAL DESIGN OF INTEREST TRANSFERS

The study also revealed the main parameters of interest transfer clauses. The contracts commonly addressed the following aspects: triggering events, notification rules, price and payment terms, the size of an interest affected by the transfer, and measures of enforcement in case the parties fail to comply with their contractual obligations. The following description is based on information from the sample LLC agreements, which are on file with the author.

A. Events Triggering Interest Transfer Clauses

Trigger events define the moment when a right is activated. Rights of first refusal come into effect when an LLC member receives a third party offer or has agreed to sell its interest to a third party. Both grounds are facts that can be easily established. The activation moment of rights of first offer typically was defined broadly—an *intention* of a member to sell its interest. Most of the agreements were silent about the permissibility of any contacts between a seller and potential non-member buyers prior to notifying the right-holder. Evidently, some scope for freedom of action is acceptable.[143]

Likewise, the trigger events for the two variations of tag-along rights were different. In almost two-thirds of cases, proportional tag-along rights applied to any sale of interest, regardless of the number of

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[140]*See* Joint Task Force of Committee on LLCs, Partnerships and Unincorporated Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW. 385, 472–78 (2008).

[141]*See* Wetmore v. MacDonald, Page, Schatz, 476 F.3d 1, 2 (1st Cir. 2007).

[142]*E.g.*, in *Wetmore v. MacDonald, Page, Schatz*, though both partners had equal voting rights, only one was engaged in the daily management of the business and, as a result, could use its experience to organize a competing business if it was bought out. 476 F.3d 1, 2, 5 (1st Cir. 2007). By agreeing to set a minimum bidding floor defined by an independent appraiser, the parties limited the room for strategic behavior by the better experienced partner.

[143]*See supra* notes 88–89 and the accompanying text.

LLC units being transferred. By contrast, a full tag-along right, as a rule, was activated if a seller agreed to transfer an interest exceeding a certain minimum threshold. The LLC agreement of STi Prepaid, LLC, provider of international prepaid phone cards, illustrates this practice.[144] The company's operating agreement included both types of a tag-along right. If any member desired to sell all or part of its units, the co-selling right-holders could participate in the sale on a pro rata basis. However, if the majority member agreed to transfer more than 25% of the outstanding units, the minority members could elect to sell all their units.[145]

By including a drag-along right in private agreements, the contracting parties voluntarily consent to be squeezed-out. Therefore, as long as the initial expression of the will of the parties is voluntary and informed, the drafters of a drag-along right can, theoretically, set the activation threshold at any level. More than 80% defined a minimum threshold for activating a drag-along right. The lowest threshold was set at 25%. The most frequently adopted triggering point, however, was the transfer of more than 50% of the outstanding LLC units. The parties often did not define a specific threshold and tied the activation of the right to the transfer of all interest by a controlling member, regardless of a specific size.

Trigger events for the types of options differed as well. If minority put options and buy/sell-out arrangements typically could be initiated anytime at the will of a right-holder, majority call options often required a specific cause for activation—such as deadlock in decision-making or breach of an agreement. Often an option was effective after a certain stabilization period following the launch of the project. This choice reflects the wish of the parties to commit their resources and efforts to ensure the success of the undertaking. Such a commitment is facilitated by the enthusiasm that usually accompanies joint ventures during the initial period of their development; deadlocks are unlikely at this stage.

B. Notice Rules after Interest Transfer Clauses are Triggered

The second aspect of contracting for transfer clauses is the content of the notice and the length of the period during which the right-holders can exercise their right. Lengthy notice periods, with the resulting uncertainty and the need to reserve financial resources for a longer period, and cumbersome information disclosure requirements may discourage potential buyers.[146] On the other hand, short notice periods

[144]*See* Sti Prepaid, LLC, Amended and Restated Limited Liability Company Agreement (Leucadia National Corp., Form 10-Q Ex. 10.3) (May 9, 2007).

[145]*Id.*

[146]*See* Corporation Law Committee of the Association of the Bar of the City of New York, *The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*, 65 BUS. LAW. 1153, 1187 (2010).

and limited disclosure may force right-holders to make ill-advised decisions without possessing adequate information.[147] The maximum time period for the completion of the sale is also important, for during this period members cannot sell their interests to other buyers.[148]

An effective right of first refusal requires a detailed disclosure of the material terms of the third-party offer, including the identity of the offeror, to the right-holder.[149] Yet, even if the agreement does not require disclosure of all these terms, the selling member is encouraged to disclose, for the right-holder is obliged to match only those terms disclosed in the notice.[150] If non-disclosure of the terms, however, disadvantages the right-holder, notice defects prevent the right from being triggered.

For both types of first purchase rights, the seller's offer shall remain open during an agreed period. A first purchase offer is an irrevocable option that can be exercised by the right-holder anytime during this period.[151] It was very seldom when the parties agreed that an offer could be revoked by the seller.

The majority of the agreements on tag-along rights provided for notice periods ranging from 15 to 30 days prior to the proposed transfer. In addition to the price and payment details, more than half of the agreements required the disclosure of the identity of the buyer and almost a quarter included information about non-cash consideration. More than half of the agreements established a maximum period for completing the transfer.

C. Price and Payment Terms

Similar to notice rules, payment terms are of particular importance where a third-party buyer is involved. Contracting for a right of first refusal does not imply itself that the seller cannot accept any terms from an outside buyer that practically cannot be matched by the right-holder (for instance, agreeing on receiving a specific property as a consideration in kind). The four main means of addressing non-cash consideration problem in a right of first refusal were (1) allowing only cash or easily-marketable security offers, (2) requiring the seller to include a good faith estimate of the third party's non-cash offer in the triggering notice, (3)

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[147] *See id.*

[148] *See id.*

[149] Under a right of first offer, the seller is required to describe the price and other terms and conditions of the sale or, if the right-holder has to define the price, only the number of the offered units.

[150] *See* Union Oil Co. of Cal. v. Mobil Pipeline Co., 2006 WL 3770834, at *14 (Del. Ch. 2006) (if the seller expects the right-holder to match a given term, the term must be stated in the right of first refusal notice).

[151] *See* Robert K. Wise, Andrew J. Szygenda, & Thomas F. Lillard, *First-Refusal Rights Under Texas Law*, 62 BAYLOR L. REV. 433, 493 (2010).

designing a procedure of valuation by independent appraisers, or (4) requiring the full disclosure of the third party's offer and letting the right-holder to use this information for making its own valuation. Theoretically the problem of non-cash consideration can reveal itself also in the context of a right of first offer. But the evidence shows that more than half of the right-of-first-offer agreements ignored this issue. The reason, perhaps, is that outside buyers, who are the most interested in clarifying the possibility of making non-cash offers, are not a contracting party of a right of first offer and thus cannot affect the negotiating process. This, however, does not necessarily mean that non-cash consideration is not allowed. It is very likely that courts will allow non-cash offers and the matter will boil down to the assessment of the offer as to its compatibility with the terms and conditions of the right-holder's offer.

Determining the proper price of LLC interests in the context of tag-along and drag-along rights is crucial.[152] Differentiated payments to large and minority members can be justified from the perspective of control premiums because minority investors are less legitimate to require such premiums. Nevertheless, transaction costs (e.g., the need to engage independent experts for valuation) and information asymmetries might prevent parties from detailed contracting. Consequently, almost universal in the sample firms was the requirement to pay the same price in the same form to all transferring members.

D. The Size of an Interest Subject to a Transfer

The size of an interest that sellers can or have to transfer is another aspect that the parties of interest transfer clauses commonly determine. The main concern is that if right-holders can exercise their rights partially, then the selling party could be left with a small holding with insignificant voting power and the balance of power in the firm will be affected. Particularly, minority investors in drag-along rights are worried whether they can be forced to transfer their interests in a sale of less than 100% of all issued and outstanding units. The sample agreements solved this issue either by requiring the transfer of the entire interest in the affected company (56.76% of the firms) or allowing each transferring member to sell its pro rata share (32.43%). Similar to a proportional tag-along right, pro rata transfers under a drag-along right have a disciplining effect on the controlling seller.

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[152]Valuation is, perhaps, the most important in the context of buy and sell options. Their effectiveness entirely depends on the ability of the parties to define the proper price for exercising an option. This matter is described in detail above. *See supra* Part III.C.

For the same reason, in call options it was common to require from the calling member to acquire all interest of the partner. On the contrary, the holder of a put right could sell all or any portion of its interest.

When it comes to exercising first purchase rights, an additional factor comes into play. Smaller holdings may generate less interest from potential buyers and can be valued lower. If the right-holders can buy less than offered, a potential deal with a third-party buyer may thus be frustrated. Accordingly, first purchase rights were usually conditioned upon buying all offered interests and only in 17.76% of cases the right-holders were free to buy less than offered.

In case there were two or more right-holders of first purchase rights, the parties usually agreed on distributing offered LLC units among purchasing right-holders proportionally and on second round offers that provided a right-holder that elected to purchase all its share with an opportunity to buy the remaining units (if one or more right-holders exercised their preemptive right partially or did not exercise it).

E. Measures Strengthening the Enforcement of Transfer Clauses

The contracting parties supplemented interest transfer clauses with different provisions that reduce the costs of their enforcement. One instance, which is also mentioned above, is the combination of first purchase rights with the statutory default rule restricting interest transfers in LLCs.[153] The evidence on contracting for first purchase rights suggests that the statutory approval clause is not a universal solution for all non-listed firms. But it can be useful for strengthening the enforcement of other transfer clauses. Almost 60% of the sample firms backed up first purchase rights with the statutory approval clauses. If a third-party buyer is in compliance with the procedure of first purchase rights, it automatically becomes a substituted member; otherwise, an approval clause applies.

The explanation of this practice is straightforward: transfer consents are extremely strong means for incumbent members to affect third party transfers. In a non-listed firm with a small number of members, each member, as a rule, can block transfers. First purchase rights, while giving incumbent members a priority in purchasing the units of selling members, do not prevent third-party transfers completely. A third party can become a substituted member subject to the willingness/ability of incumbents to exercise their preemptive rights. At the same time, first purchase rights are backed up by a default approval clause in order to prevent any transfers in violation of the contractually agreed first purchase rights.

[153] *See supra* note 55 and the accompanying text.

Such a combination was commonplace also for other transfer clauses. The main contractually agreed remedy for the failure of a selling member to comply with the procedure of a tag-along right was the declaration of the transfer null and void and the refusal to recognize the third-party transferee as a substituted member of the LLC (more than 91% of the cases). Other remedies for enforcing tag-along rights were entitling right-holders to buy-out the seller or put their units to the seller, an option to dissolve the firm, or a termination of special voting rights of a defaulting member. These remedies are easily enforceable and limit the costs of applying a tag-along right.

The parties can strengthen the enforceability of buy/sell-out clauses by using bonding mechanisms. Particularly, the failure of a buyer to close the transaction can be remedied by allowing the seller to retain a certain percentage of the purchase price deposited after activating the buy/sell-out procedure as liquidated damages or to buy out the buyer at a discounted price (usually at 5% or 10% discount). More than half of the contracted buy/sell-out clauses included one of these remedies or both.

A case from the US court practice shows, however, how a bonding provision, if not drafted carefully, can sabotage contractual option mechanisms. In *Decker v. Decker*, a buy/sell-out option to which two brothers, who were in business together, were party, was activated following a deadlock. The brother interested in the dissolution of the firm made an oppressive offer at a very high price without any intention to close the purchase. As expected, the receiving brother elected to sell and, because the transfer was not closed, the parties appeared in the court at dissolution proceedings.[154] The court considered a bonding provision in the agreement as an anticipation by the parties that the buyer might not close an accepted buy/sell-out offer. The appropriate remedy, according to the court, was the one clearly stated in the agreement—an activation of the bonding mechanism rather than awarding damages or granting an injunction.[155] If a contractually drafted specific remedy is the only remedy and cannot be invoked by the seller alternatively to other remedies generally available to the parties for breach of contract, such as damages or specific performance, a buy/sell-out mechanism may be turned into a mere formality that can be easily neutralized.[156]

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[154]Decker v. Decker, 726 N.W.2d 664, 666–67 (Wis. App. 2006).

[155]*Id.*, at 668–69. The Delaware Court of Chancery offered similar interpretation in a parallel case. *See* Eureka VIII v. Niagara Falls Holdings, 899 A.2d 95, 116 (Del. Ch. 2006).

[156]In another US case, the court constructed the buy/sell-out agreement in a way to prevent such abusive behavior. According to the agreement, each party had to submit simultaneously a price for which it would be willing to sell its interest or buy the other party's interest and the higher bidder would be the buyer at the price equal to the average of the two prices. When the higher bidder failed to close, the court ruled that the lower bidder could buy the interest of the higher bidder at its own offer price, rather than at the average price. Otherwise, the party who sought to evade the buy/sell-out mechanism could completely thwart the process by "submitting outrageously high bids on which it had no intention to perform." Larken Minnesota, Inc. v. Wray, 881 F.Supp. 1413, 1415–17, 1418 (D. Minn. 1995).

VIII. CONCLUSION

This study analyzed different interest transfer restrictions from the perspective of joint-efficiency of the contracting parties and looked to the practice for real-life evidence. Because of the locked investments and in the absence of default dissolution rights of each member, transfer restrictions are a crucial part of governance agreements of non-listed limited liability firms. The study shows how transfer clauses balance the interests of the LLC members. Accordingly, investors can rely on these contractual instruments to stipulate efficient investments.

Specifically, first purchase rights achieve two main results—they give the right-holder a say on third-party entries into the capital of the firm and discourage changes in the initially allocated ownership structure of the firm. These effects can lead to efficient results by encouraging investments where the contracting parties have made relation-specific investments or have special relations. Therefore, first purchase rights cannot be an optimal solution for all non-listed firms and are chosen by the contracting parties taking into account the aspects of each business project. A tag-along right mitigates conflicts in sale-of-control transactions by discouraging value-decreasing transfers. A drag-along right has a high value where minority rights are strong and a potential outside buyer cannot extract large private benefits. Weak minority protection, on the other hand, reduces the value of a drag-along right. In practice, however, other factors than these affect the adoption of a drag-along right—it is typically used in combination with a tag-along right as a counterbalance. Since change-of-control transactions in particular and interest transfers to third parties in general are extraordinary events in the life of LLCs, investors need instruments for dealing with conflicting interests in the course of ordinary business. Put and call options deal with these cases and, not surprisingly, are the most commonly used transfer restrictions.

Given the role of contractually created exit rules, investors need explanations when and how to rely on various transfer clauses and their variations. The choices of large sophisticated actors documented in this study can assist in understanding particular circumstances where one or the other transfer restriction ensures the pursued outcomes. Not only different transfer restrictions are used to address specific problems of cooperation of business partners, but modifications of each of them do have varying outcomes for the involved parties.

Although the study relies on data from the operating agreements of LLCs, the results can be extended to other forms of limited liability organizations. The study has both theoretical and practical implications. Along with advancing the existing theories, its results can be used in the process of drafting business organization agreements and in interpreting and enforcing the provisions of these agreements.

Table A-1. Logit model of using first purchase rights

Independent variables	**1**				**2**			
	First purchase rights	**ROFR**	**ROFO Seller**	**ROFO Holder**	**First purchase rights**	**ROFR**	**ROFO Seller**	**ROFO Holder**
Number of LLC members								
Two members	0.0521	0.0551	-0.0602	0.0431				
	(0.0674)	(0.0616)	(0.0452)	(0.0365)				
Voting rights								
Unanimous voting or veto rights					0.1708***	0.1112*	0.0226	0.0174
					(0.0609)	(0.0583)	(0.0450)	(0.0321)
Member controlling more than 50%					-0.0728	-0.0864	0.0464	-0.0611*
					(0.0644)	(0.0579)	(0.0484)	(0.0332)
Minority managing member					-0.0069	0.0470	-0.0050	0.0591
					(0.0923)	(0.0857)	(0.0704)	(0.0361)
Contractual rights								
No fiduciary duties for managers	0.1594**	0.1410*	0.0386	0.0288	0.1605**	0.1498**	0.0240	0.0322
	(0.0733)	(0.0731)	(0.0537)	(0.0417)	(0.0721)	(0.0722)	(0.0535)	(0.0404)
Industry effect								
Mining, oil and gas	0.0607	0.0888	-0.0611	0.0357	0.0493	0.0815	-0.0673	0.0371
	(0.0938)	(0.0844)	(0.0760)	(0.0355)	(0.0929)	(0.0838)	(0.0761)	(0.0351)
Manufacturing	0.0798	0.1044	-0.0065	-0.0474	0.0888	0.1146	-0.0016	-0.0342
	(0.0947)	(0.0848)	(0.0650)	(0.0590)	(0.0929)	(0.0836)	(0.0651)	(0.0562)
Real estate	-0.1837**	-0.1369	-0.0364	-0.0918	-0.1654*	-0.1257	-0.0647	-0.0867
	(0.0835)	(0.0843)	(0.0613)	(0.0609)	(0.0903)	(0.0921)	(0.0667)	(0.0614)
Services	0.1739*	0.1665**	0.0301	-0.0085	0.1972**	0.1811**	0.0445	-0.0101
	(0.0939)	(0.0817)	(0.0599)	(0.0455)	(0.0918)	(0.0805)	(0.0603)	(0.0441)
Log likelihood	-156.10	-136.87	-90.25	-48.81	-151.59	-133.48	-90.56	-45.10
Pseudo R^2	0.0607	0.0619	0.0271	0.0883	0.0879	0.0852	0.0238	0.1578
Log likelihood ratio	20.18***	18.07***	5.03	9.46	29.20***	24.85***	4.42	16.90**
Observations	243	243	243	243	243	243	243	243

Dependent variable is the choice of any first purchase right (columns 2 and 6) or one of the three variations of first purchase rights (columns 3–5 and 7–9). The logit model reports marginal effects and standard errors (in parentheses). One asterisk indicates significance at the 10% level; two asterisks denote significance at the 5% level; and three asterisks at the 1% level. The first regression uses the number of LLC members, their contractual investor rights, and industrial division of the sample firms as independent variables. The second regression replaces voting rights for the number of members. All independent variables are dummy variables taking values 0 (if the answer to the underlying question is negative) or 1 (if the answer is positive). Industrial division is defined based on the first two digits of the Standard Industrial Classification Codes (SIC codes). ROFR stands for a right of first refusal; ROFO Seller and ROFO Holder are rights of first offer where the seller or right-holder offers the sale price, respectively.

Table A-2. Logit model of using tag-along and drag-along rights

Independent variables	*1*				*2*			
	Tag-along right	**Full tag-along right**	**Pro rata tag-along right**	**Drag-along right**	**Tag-along right**	**Full tag-along right**	**Pro rata tag-along right**	**Drag-along right**
Number of LLC members								
Two members	-0.1841***	0.0451	-0.2029***	-0.1711***				
	(0.0554)	(0.0432)	(0.0443)	(0.0505)				
Voting rights								
Unanimous voting or veto rights					-0.1276**	0.0296	-0.1544***	-0.0894*
					(0.0567)	(0.0384)	(0.0494)	(0.0535)
Member controlling more than 50%					0.0455	0.0543	0.0082	0.1136**
					(0.0622)	(0.0452)	(0.0548)	(0.0570)
Minority managing member					-0.1113	-0.0812	-0.0324	-0.0206
					(0.0997)	(0.0660)	(0.0984)	(0.0986)
Contractual rights								
No fiduciary duties for managers	0.0905	-0.0673*	0.1753***	0.1454**	0.0714	-0.0682*	0.1584**	0.1218*
	(0.0692)	(0.0393)	(0.0647)	(0.0667)	(0.0689)	(0.0399)	(0.0665)	(0.0667)
Industry effect								
Mining, oil and gas	0.0157	-0.0675	0.0429	-0.0757	0.0158	-0.0584	0.0356	-0.0807
	(0.0898)	(0.0940)	(0.0743)	(0.0870)	(0.0899)	(0.0930)	(0.0755)	(0.0873)
Manufacturing	0.1776**	0.0837	0.0885	0.1262	0.1806**	0.0822	0.0934	0.1330*
	(0.0867)	(0.0621)	(0.0720)	(0.0779)	(0.0862)	(0.0615)	(0.0728)	(0.0777)
Finance and insurance	-0.2362*	-0.0277	-0.2055*	-0.0126	-0.2325*	-0.0250	-0.2271*	-0.0026
	(0.1326)	(0.0946)	(0.1220)	(0.0998)	(0.1331)	(0.0943)	(0.1264)	(0.1004)
Real estate	-0.1501*	0.0519	-0.2809***	-0.2522***	-0.1662*	0.0754	-0.3321***	-0.3115***
	(0.0861)	(0.0570)	(0.0992)	(0.0931)	(0.0904)	(0.0583)	(0.1047)	(0.0969)
Services	0.1040	0.0644	0.0456	0.0827	0.1123	0.0684	0.0439	0.0948
	(0.0871)	(0.0646)	(0.0726)	(0.0784)	(0.0877)	(0.0643)	(0.0747)	(0.0794)
Log likelihood	-137.64	-69.33	-110.30	-123.29	-138.05	-67.98	-113.54	-124.18
Pseudo R^2	0.1250	0.0608	0.2068	0.1550	0.1224	0.0791	0.1836	0.1489
Log likelihood ratio	39.32***	8.98	57.53***	45.22***	38.51***	11.67	51.05***	43.45***
Observations	243	243	243	243	243	243	243	243

Dependent variable is the choice of any tag-along right (columns 2 and 6), one of the two variations of tag-along rights (columns 3–4 and 7–8), or a drag-along right (columns 5 and 9). The logit model reports marginal effects and standard errors (in parentheses). One asterisk indicates significance at the 10% level; two asterisks denote significance at the 5% level; and three asterisks at the 1% level. The first regression uses the number of LLC members, their contractual investor rights, and industrial division of the sample firms as independent variables. The second regression replaces voting rights for the number of members. All independent variables are dummy variables taking values 0 (if the answer to the underlying question is negative) or 1 (if the answer is positive). Industrial division is defined based on the first two digits of the Standard Industrial Classification Codes (SIC codes).

Table A-3. Logit model of using put options, call options, and buy/sell-out clauses

Independent variables	1				2			
	Buy/sell-out clause	Put right, holding ≤ 50%	Call right, holding ≤ 50%	Call right, holding ≥ 50%	Buy/sell-out clause	Put right, holding ≤ 50%	Call right, holding ≤ 50%	Call right, holding ≥ 50%
Number of LLC members								
Two members	0.2728***	0.0115	0.2315***	0.1947***				
	(0.0784)	(0.0505)	(0.0712)	(0.0661)				
Voting rights								
Unanimous voting or veto rights					0.3164***	-0.0212	0.1544***	0.1876***
					(0.0678)	(0.0462)	(0.0560)	(0.0586)
Member controlling more than 50%					0.0449	0.1087*	-0.0293	0.0729
					(0.0503)	(0.0570)	(0.0536)	(0.0628)
Minority managing member					0.0190	-0.0664	-0.0035	-0.1500*
					(0.0581)	(0.0730)	(0.0668)	(0.0864)
Contractual rights								
No fiduciary duties for managers	0.0116	-0.0470	-0.0309	0.0429	0.0123	-0.0523	-0.0087	0.0555
	(0.0574)	(0.0498)	(0.0577)	(0.0698)	(0.0554)	(0.0494)	(0.0582)	(0.0692)
Industry effect								
Mining, oil and gas	-0.2910**	0.0475	-0.0026	0.0097	-0.2715**	0.0539	-0.0027	0.0154
	(0.1359)	(0.0745)	(0.0809)	(0.0931)	(0.1240)	(0.0736)	(0.0813)	(0.0920)
Manufacturing	-0.0573	0.0241	0.0387	0.0786	-0.0641	0.0205	0.0271	0.0612
	(0.0818)	(0.0791)	(0.0819)	(0.0919)	(0.0759)	(0.0779)	(0.0815)	(0.0906)
Real estate	0.0725	0.0848	0.0756	0.0924	0.0762	0.0919	0.1139*	0.1525*
	(0.0531)	(0.0620)	(0.0620)	(0.0744)	(0.0576)	(0.0636)	(0.0685)	(0.0796)
Services	-0.0452	0.0774	-0.0216	0.0554	-0.0276	0.0760	-0.0311	0.0611
	(0.0825)	(0.0719)	(0.0916)	(0.0942)	(0.0774)	(0.0714)	(0.0916)	(0.0931)
Log likelihood	-96.66	-96.68	-108.12	-137.27	-88.54	-93.35	-110.20	-135.49
Pseudo R^2	0.1669	0.0172	0.0830	0.0471	0.2396	0.0511	0.0653	0.0594
Log likelihood ratio	39.56***	3.38	19.58***	13.56**	55.80***	10.05	15.41*	17.12**
Observations	243	243	243	243	243	243	243	243

Dependent variable is the choice of a minority put option (columns 3 and 7), a call option held by a minority or a majority member (columns 4 and 8 and columns 5 and 9, respectively), or a buy/sell-out clause (columns 2 and 6). The logit model reports marginal effects and standard errors (in parentheses). One asterisk indicates significance at the 10% level; two asterisks denote significance at the 5% level; and three asterisks at the 1% level. The first regression uses the number of LLC members, their contractual investor rights, and industrial division of the sample firms as independent variables. The second regression replaces voting rights for the number of members. All independent variables are dummy variables taking values 0 (if the answer to the underlying question is negative) or 1 (if the answer is positive). Industrial division is defined based on the first two digits of the Standard Industrial Classification Codes (SIC codes).