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Private Ordering of Exit in Limited Liability Companies: Theory and Evidence from Business Organization Contracts

Suren Gomtsian*

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*PhD researcher at Tilburg University, Department of Business Law; Tilburg Law and Economics Center (TILEC); P.O. Box 90153, 5000 LE Tilburg, The Netherlands; e-mail: s.gomtsyan@tilburguniversity.edu. Part of this research was conducted at Fordham Law School, where I was a visiting research fellow. Earlier versions of this article received a prize for the best paper of a young scholar at the Second International Law and Economics Conference at Bilkent University and the Sixth Annual Conference of the Spanish Association of Law and Economics. The article benefited from excellent comments by Michael Asimow, Benjamin Engst, Tim Friehe, Juan Jose Ganuzo, Martin Gelter, Gillian Hadfield, Lin Lin, Michal Shur-Ofry, William Simon, Kathryn Spier, Eric Talley, Christoph Van der Elst, David Walker, and the participants of the Second International Law and Economics Conference at Bilkent University in Ankara, Turkey, the Second Conference for Junior Researchers at Stanford Law School in Stanford, California, the Annual Meeting of the National Business Law Scholars Conference at the Seton Hall University School of Law in Newark, New Jersey, the Annual Conference of the Spanish Association of Law and Economics in Santander, Spain, the Annual Meeting of the German Law and Economics Association in Düsseldorf, Germany, the Annual Conference of the European Association of Law and Economics in Vienna, Austria, the 2015 International Junior Faculty Forum at Stanford Law School, the First Conference on Empirical Legal Studies in Europe at the University of Amsterdam, the Netherlands, and a TILEC work-in-progress meeting in Tilburg, the Netherlands. Special thanks to the editors of the American Business Law Journal, especially Laurie Lucas and Terence Lau, and two anonymous referees for many suggestions and thoughtful and thorough comments. I gratefully acknowledge financial support provided by the "Research Talent" grant from the Netherlands Organization for Scientific Research (NWO).

INTRODUCTION

Where statutes fall short, contract can fill the gap. In organizing and forming businesses, partners encounter many problems both while structuring their relations and later during the functioning of the venture.[1] Examples include the definition or calculation of each party's contribution and of corresponding voting rights,[2] self-dealing by one of the parties,[3] opportunistic renegotiation of cooperation terms with the aim of extracting more benefits from the project,[4] deadlocks in decision-making,[5] and the resulting paralysis of the firm.[6] Transactional lawyers have designed different contractual provisions dealing with these problems in cases where legislative solutions are deemed insufficient or inappropriate. For example, under many circumstances, they can be efficiently and effectively solved by private ordering of interest or share transfers.[7] Contingent ownership provisions (explicit and implicit options)[8] encourage investments, limit agency, moral hazard, and hold-up problems, prevent escalations of conflicts, and provide business partners with swift means for exiting investments.[9]

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.[10] In partnerships, notwithstanding restrictions on the transferability of

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[1]See, e.g., Steven R. Salbu & Richard A. Brahm, Strategic Considerations in Designing Joint Venture Contracts, 1992 COLUM. BUS. L. REV. 253, 254 (1992).

[2]See id. at 291.

[3]See, e.g., Zohar Goshen, Conflicts of Interest in Publicly-Traded and Closely-Held Corporations: A Comparative and Economic Analysis, 6 THEORETICAL INQ. L. 277, 280–81 (2005); Douglas K. Moll, Minority Oppression and the Limited Liability Company: Learning (Or Not) From Close Corporation History, 40 WAKE FOREST L. REV. 883, 956–57 (2005).

[4]See, e.g., Edward B. Rock & Michael L. Wachter, Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations, 24 J. CORP. L. 913, 928 (1999).

[5]See, e.g., Meghan Gruebner, Note, Delaware's Answer to Management Deadlock in the Limited Liability Company: Judicial Dissolution, 32 J. CORP. L. 641, 646–49 (2007); Jonathan Macey, The Nature of Conflicts of Interest Within the Firm, 31 J. CORP. L. 613, 628 (2006).

[6]See, e.g., Macey, supra note 5, at 628.

[7]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."

[8]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 et al., An Analysis of Shareholder Agreements, 5 J. EUR. ECON. ASSOC. 93, 95 (2007).

[9]See Chemla et al., supra note 8, at 100–03; Georg Nöldeke & Klaus M. Schmidt, Sequential Investments and Options to Own, 29 RAND J. ECON. 633, 639–48 (1998).

[10]See infra notes 36–38 and accompanying text.

partnership interests,[11] the right of each partner to force the dissolution of the firm ensures an equivalent result.[12] The situation is different in non-listed limited liability firms where the members, because of locked investments, depend more heavily upon each other on major decision-making.[13] This explains the importance of private ordering of interest transfers in ensuring successful cooperation in non-listed limited liability firms, particularly where the probability of private benefit extraction or hold-up is high.

In spite of this need, business partners often overlook governance planning.[14] They are more likely to direct attention towards the economic side of the business and limit the design of the governance structure to the most obvious matters—allocation of ownership and voting rights.[15] Statutory rules, which can be inadequate or insufficient, are relied upon for filling the gaps in planning.[16] The pool of available contractual instruments, however, is much larger. The initial allocation of ownership and voting rights is a one-time event. Theoretical models demonstrate that unconditional ownership structures alone are not sufficient to limit control inefficiencies and induce efficient investments in either simultaneous,[17] or sequential investments.[18] The dynamic nature of relationships between business partners requires mechanisms that can facilitate ownership re-allocation in response to shifting conflicts. Interest transfer clauses create contingent ownership structures that can be altered at the initiative of the

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[11]Unlimited liability of a general partner coupled with the 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 alleviates 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.

[12]See infra note 44.

[13]See infra notes 39–43 and accompanying text.

[14]See, e.g., George W. Dent, Jr., Gap Fillers and Fiduciary Duties in Strategic Alliances, 57 BUS. LAW. 55, 80 (2001) (explaining the use of simple contracts in strategic alliances as a way to preserve trust between the partners); Jason M. Hoberman, Practical Considerations for Drafting and Utilizing Deadlock Solutions for Non-Corporate Business Entities, 2001 COLUM. BUS. L. REV. 231, 242 (2001) (noting that enthusiasm about engaging in a new venture complicates advanced contractual planning).

[15] See Salbu & Brahm, supra note 1, at 291–93 (listing strategic matters typically resolved by joint venture contracts: allocation of ownership, control, and information rights).

[16] See Dent, supra note 14, at 69 ("When cooperation falters, partners dust off and read their contract, but they may have been careless, even deliberately so, in its drafting. Predicting how a court will fill the contract's gap and construe fiduciary duties then becomes crucial in determining how the parties resolve their dispute.").

[17]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) (showing that 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).

[18]See Nöldeke & Schmidt, supra note 9, at 640–41.

parties along with evolving conflicts of interests.[19] In addition, by offering ways out of decision-making deadlocks, contingent ownership structures allow the parties to choose optimal initial ownership structures for a wide variety of circumstances.[20]

This article examines the use of various transfer clauses by investors in closely-held firms. All rights covered in this study are purely contractual in 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, are well-understood by parties and counsel, and have been tested many times.[21] Their widespread use suggest that transfer restrictions maximize the joint gains of the parties (the contractual surplus) and are effective.

Transfer restrictions have been addressed in the literature through theoretical models.[22] Testing the predictions of these models has been problematic, because special rules on interest transfers are typically used in closely-held business entities, where the agreements of the investors are typically kept confidential. For a long time, the best scholars could do was to test the theoretical implications in simulated laboratory experiments.[23] This article summarizes a study that attempts 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) whose operating agreements were filed with the United States Securities and Exchange Commission (SEC). The sample companies were not start-ups or small operations; 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 answer some puzzling questions. In brief, contractual choices are not accidental. Depending on the underlying conflicts and ownership structure, the parties not only contract for different transfer clauses, but also choose strategically different variations of these clauses. Since the founders of the studied companies usually had access to the services of highly-qualified professional consultants, their contracting preferences 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.

This article is divided into five parts. Following the discussion of corporate governance in non-listed firms in Part I, the remainder of the article focuses on the theory and practice of contingent ownership structures. Part II introduces transfer clauses and proceeds to the

[19]See Chemla et al., supra note 8, at 100–03; Nöldeke & Schmidt, supra note 9, at 639–48.

[20]For example, a fear of decision-making deadlocks may prevent equal allocation of voting rights even though both parties are making equivalent contributions and expect equal say on governance matters.

[21]See, e.g., 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, 1172–94 (2010) (describing typical transfer clauses, important drafting considerations, and case law) [hereinafter Corporation Law Committee].

[22]See infra Part II.

[23]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).

development of arguments for using interest transfers by reviewing the theoretical literature. Where theoretical explanations are contradictory or incomplete, an attempt is made to develop the theory further by relying on models that come closer to the real practice of using transfer clauses. The sample collection process, descriptive data, and research design are presented in Part III. Part IV reports the results of the statistical analysis and offers explanations. Part V uses information from the sample agreements to illustrate common techniques used in drafting interest transfer clauses. The article concludes that standard forms of interest transfer clauses commonly applied by lawyers to all firms may not be satisfactory. The empirical results highlight that adaptation of contracts to the needs of each deal are important.

I. CORPORATE GOVERNANCE IN NON-LISTED LIMITED LIABILITY FIRMS

A typical governance framework of a firm includes three elements—voice, liability, and exit. Investor voting is one of the distinctive features of the law of business organizations.[24] Corporation statutes grant shareholders the right to nominate and elect board members,[25] vote on amendments to corporate charters and bylaws and on fundamental changes,[26] and make their own proposals for shareholder meetings.[27] Since 2011, 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 $75 million public equity float.[28] In addition to formal voting, investors can also express their concern by engaging in private negotiations with managers.[29] This practice is widespread among active institutional investors, who often use behind-the-scenes discussions with officers and directors to influence behavior.[30]

Where voice is not effective, due to the negligible size of equity holding, 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 directors and officers fiduciary duties of care and loyalty.[31] On controlling stockholders,[32] the law imposes, at

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

[25]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).

[26]Id. at 413.

[27]Id.

[28]See Dodd-Frank Act, Pub. L. No. 111–203, § 951, 124 Stat. 1899 (2010); SEC Final Rule, 17 C.F.R. § 240.14a–21(b) (2011), available at http://sec.gov/rules/final/2011/33-9178.pdf. See also Randall S. Thomas & Christoph Van der Elst, Say on Pay around the World, 92 WASH. U.L. REV. 653, 660–61 (2015).

[29]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).

[30]See Joseph A. McCahery et al., Behind the Scenes: The Corporate Governance Preferences of Institutional Investors, 71 J. FIN. (forthcoming 2016) (manuscript at 8, 9), http://papers.ssrn.com/abstract=1571046.

[31]The duty of care requires that directors and officers 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

a minimum, the duty of loyalty.[33] The threat of liability for failure to act in the interests of the corporation and its stockholders gives fiduciaries an incentive to act so.[34] 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.[35]

The third possible investor action is exit. Investors can liquidate investments by selling in the market, thereby terminating 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.[36] 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.[37] Even in the absence of such a threat, exit of a large number of minority investors can discipline insiders by pressuring equity prices downward. Thus, the threat of exit is a form of investor activism that can be used behind the scenes to affect managerial decisions.[38]

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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. Id. 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. S'holder Litig., 73 A.3d 17, 36–37 (Del. Ch. 2013); see also Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) (holding that officers owe fiduciary duties that are identical to those owed by corporate directors).

[32]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 Litig., No. 8541–VCP, 2014 WL 5449419, at *10 (Del. Ch. 2014).

[33]See, e.g., Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1113–15 (Del. 1994) ("[A] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.") (quoting Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. Supr. 1987)); see also Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719 (Del. 1971). Delaware courts operate with the term "fiduciary duties of controlling shareholders" without specifying the exact type of the duty. In re Crimson Exploration Inc. Stockholder Litig., 2014 WL 5449419, at *12–14. Nevertheless, unless a controller engaged in a conflicted transaction, entire fairness review cannot be triggered. Id.

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

[35]See STEPHEN M. BAINBRIDGE, CORPORATE LAW 187 (2nd ed. 2009) (asserting that the most important function of derivative suits is providing a means by which breaches of fiduciary duties 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).

[36]See Bootsma, supra note 29, at 116.

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

[38]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) (showing that a credible threat of a large shareholder to exit if managers do not act in shareholders' interests is an effective disciplining tool encouraging managers to take actions that increase the value of the firm); Alex Edmans, Blockholder Trading, Market Efficiency, and Managerial Myopia, 64 J. FIN. 2481, 2493–95 (2011) (showing that outside blockholders, even if they cannot intervene in the firm's management directly, can encourage managers to take actions contributing to the long-term growth of the firm

The governance of listed firms revolves around these elements of voice, liability, and exit. 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.[39] Limited options for exit increase the reliance of the firm's members on the two other elements of voice and liability.[40] One way to strengthen voice is to trade 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.[41] This further reinforces the reliance on voice and liability. Strengthened voting power—such as the common practices of equal distribution of voting rights or granting veto rights to minority investors—makes a decision-making impasse not only possible but probable.[42] As a result, locked investments in non-listed firms enhance the dependence of the firm's members upon each other's actions. Individual personalities of the members and trust between them become important.[43]

Legislators have reacted to this reality in two ways. First, they offer rules that smooth exit in non-listed firms and thus bring investors in these firms closer to the position of stockholders of listed firms. For example, in partnership law, each partner has a right to dissolve the partnership.[44] , However, when applied universally, this solution increases the uncertainty

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through informed trading of the firm's shares); Alex Edmans & Gustavo Manso, Governance through Trading and Intervention: A Theory of Multiple Blockholders, 24 REV. FIN. STUD. 2395, 2406–08 (2011) (showing that the presence of multiple outside blockholders, while weakening their incentives to intervene in the firm's management, strengthens the disciplining effect of share trading by blockholders on managers); Alan R. Palmiter, Mutual Fund Voting of Portfolio Shares: Why Not Disclose? 23 CARDOZO L. REV. 1419, 1437–38 (2002) (discussing the ability of large mutual funds to influence corporate managers by threatening to sell their holdings). Recent empirical evidence supports this argument. See McCahery et al., supra note 30, at 14–15.

[39]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 35, at 442 (emphasizing the absence of a market out mechanism as a critical difference between the public and close corporation).

[40]See ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 34–36 (1970) ("[T]he 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) (indicating that a lack of diversification induces investors in close corporations to take care); F. Hodge O'Neal, Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and Bylaw Provisions, 18 LAW & CONTEMP. PROBS. 451, 452 (1953) (discussing the difficulty of disposing of holdings strengthens the desire for a power to veto corporate decisions).

[41]See Easterbrook & Fischel, supra note 40, at 274.

[42]See Carlos L. Israels, The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution, 19 U. CHI. L. REV. 778, 781 (1952); F. Hodge O'Neal, Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses, 10 VAND. L. REV. 1, 39 (1956).

[43]See Dent, supra note 14, at 67 (explaining the importance of trust in transactions so complex that the duties of each party cannot be fully spelled out).

[44]See, e.g., RIBSTEIN, supra note 11, at 53. Indeed, from the firm's and its members' perspectives, 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. See D. Gordon Smith, The Exit Structure of Strategic Alliances, 2005 U. ILL. L. REV. 303, 311–12 (2005).

risk and hold-up problems, for every partner can threaten to dissolve the partnership.[45] Hold-ups are less likely in closely-held corporations where minority investors cannot dissolve the firm at will, but, costly though it may be, can resort to statutory and judicial remedies based on theories of minority oppression.[46] Such remedies may include an extreme option such as 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.[47]

The second solution is the reverse of the first: further weakening of exit with the aim of preventing disruptions to the balance of power within the firm by arrival of third parties. For example, default statutory rules in partnerships and limited liability companies allow partner (member) substitution only by the consent of all other partners (members).[48] Similar to the first solution, a universal application of these principles to all non-listed firms increases the hold-up problem, because every member can strategically veto interest transfers by others. 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.[49] But it is also true that a threat to exit is a form of voice.[50] Hence, if exit is not possible, voice may be handicapped in the same way where exit is too easy.[51] In other words, exit and voice work best in a balanced combination.

Accordingly, statutory rules can be inadequate or insufficient.[52] On the other hand, the pool of available contractual instruments, which can be tailored to the specific circumstances of investing in each firm, is much larger and should therefore be capable of addressing these inadequacies or insufficiencies. Various forms of put and call options,[53] including tag-along and

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

[46]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).

[47]See PAUL P. DE VRIES, EXIT RIGHTS OF MINORITY SHAREHOLDERS IN A PRIVATE LIMITED COMPANY 8–11 (2010); Miller, supra note 46, at 388.

[48]See RIBSTEIN, supra note 11, 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.

[49]See supra note 40 and accompanying text.

[50]See supra notes 37–38 and accompanying text.

[51]See HIRSCHMAN, supra note 40, at 55, 82–83.

[52]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) (arguing that no solution is right for every corporation).

[53]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. For details see infra Part II.D.

drag-along rights,[54] can strengthen exit, whereas first purchase rights[55] can preserve the agreed balance of power by limiting exit but not removing it completely.[56]

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 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.[57] In the absence of contingent rights, parties have incentives to engage in renegotiations to prevent opportunistic behavior by the other. For instance, after initial investment, the intent of one party to transfer its interest to a third-party buyer in a value-decreasing control transaction would require alterations to the ownership structure of the firm in order to prevent the transfer. By constraining renegotiation directed at exploiting a vulnerable contract party, privately designed contingent ownership structures ensure that the parties will share the firm's profits in initially agreed proportions and, therefore, allow optimal investments in the firm.[58]

This study is the first attempt to fill a gap in the scholarly literature by exploring the use of transfer restrictions. It does so by analyzing operating agreements of large non-listed limited liability companies formed in Delaware. Most of these LLCs elected corporate-like governance structures, thereby approximating the corporate governance of closely-held corporations.[59] The Delaware Limited Liability Company Act restricts interest transfers to third parties by a default rule.[60] In the absence of a modifying agreement, the assignee of an interest in a Delaware LLC 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.[61] Full member substitution requires the consent of all members.[62] By contrast, stockholders in corporations are

[54]A tag-along right allows minority members to mitigate the effect of a possible change of control in a firm by selling along with the controlling seller on the same terms. A drag-along right allows its holder—a controlling or dominating member—to force other members to sell along with the right-holder on the same terms in a third-party control transfers. See *infra* Parts II.B and II.C, respectively.

[55]Different forms of first purchase rights give their holder a priority to buy interest sold by other investors in the firm ahead of third parties at the same price and on the same terms offered by or to third parties. See *infra* Part II.A.

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

[57]See Nöldeke & Schmidt, *supra* note 9, at 639–48.

[58]See Chemla et al., *supra* note 8, at 100–03.

[59]See *infra* Part III (describing the management structure of the sample firms).

[60]DEL. CODE ANN. tit. 6, § 18–702(a), § 18–702(b)(2) (2015).

[61]*Id.* 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.

[62]*Id.* § 18–702(a).

free to transfer their shares to third parties unless shares are subject to transfer restrictions.[63] 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 examine relaxations of interest transfers, rather than restrictions.[64] Interest transfer rules thus enhance exit for otherwise locked LLC members.

The inverted default rules of corporate and LLC statutes affect the incentives of their users to contract for special transfer clauses and place them in different negotiating positions.[65] Although the following characteristics of the sample on which this study is based ameliorate these differences, they do not cancel them. First, the majority of the sample LLCs had a centralized management structure and were not organized as partnerships.[66] There were very few exceptions to this. Corporate-like centralized management reduces the need to restrict the investors' ability to alienate their interests.[67] 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.[68] 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 contracting practices may differ.

II. REASONS FOR USING INTEREST TRANSFER CLAUSES

Transfer restrictions ordering 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 the conflicting interests of the parties involved in such transfers. Change-of-control transactions and third-party interest transfers, however, are

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

[64]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 (it is, indeed, possible to design options that are activated in cases of change-of-control transactions: when a third party establishes control over one of the firm's members).

[65]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.

[66]See infra Part III.

[67]Cf. Easterbrook & Fischel, supra note 40, at 273 (arguing that where principal investors also manage, restricted share transfers can ensure that investor-managers are compatible).

[68]See infra Parts III and V.E.

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. The second group, put and call options, deal with these cases.

Theoretical literature offers various justifications for including interest transfer clauses into business organization agreements. The following sections build on the results of these studies to show the effects of transfer restrictions.

A. First Purchase Rights

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 interests sold by other members ahead of third parties.[69] There are two main variations of these rights subject to the moment when the right is activated.[70]

A right of first refusal is triggered when an owner of an LLC interest 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 its interest to an unaffiliated third-party buyer.[71] According to a right of first refusal, the owner of the interest is entitled to sell to a third party only if the right-holder passes either by refusing to buy the interest at the price and upon the terms offered by the third-party buyer or by failing to react timely.[72]

Under a right of first offer, the owner of an LLC interest that has an intention to sell, but has not formalized any transaction with a third party shall inform its intention to sell to the right-holder.[73] 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 price offered by the right-holder after the owner notifies of its intent to sell.[74] In either case, the offer defines the minimum price of the transfer.[75] If the right-holder does not timely accept the offer or the owner refuses to sell to the right-holder according

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[69]See infra notes 78–79.

[70]See RCM LS II, LLC v. Lincoln Circle Assoc., LLC, No. 9478–VCL, 2014 WL 3706618, at *7 (Del. Ch. 2014).

[71]See id. 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). See 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.").

[72]See Lincoln Circle Assoc., 2014 WL 3706618, at *7.

[73]See id.

[74]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, e.g., Grosskopf & Roth, supra note 23, at 176; Xinyu Hua, The Right of First Offer, 30 INT. J. IND. ORGAN. 389, 389 (2012); Marcel Kahan et al., First-Purchase Rights: Rights of First Refusal and Rights of First Offer, 14 AM. L. & ECON. REV. 331, 332 (2012).

[75]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.

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.[76]

Both a right of first refusal and a right of first offer give the seller a limited time to transfer its interest to a third party.[77] After this period, a first purchase right is re-activated.

In effect, first purchase rights are a weak form of a veto right on third-party entries into the capital of a firm[78] and on disposing interests by existing owners.[79] 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 members, or the need to keep the existing balance of power in a firm.[80]

Where such reasons are present, existing members place higher, intangible value on interests than potential outside buyers.[81] Hence, in the absence of transfer restrictions, an LLC member can use the threat of selling interests to a third party strategically for the purpose of strengthening its bargaining position in other matters or extracting a higher price from other LLC members. 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 member's interest. It follows that by preventing opportunistic renegotiation of investment terms, very much like other contingent ownership rights, first purchase rights stipulate efficient investments.

Both variations of first purchase rights pursue the same result, but they have different implications for the contracting parties. The parties' incentives in applying one or the other vary depending on the circumstances. Several studies have tried to show the individual and collective gains of a right of first refusal and a right of first offer for the contracting parties, as well as compare these implications.[82]

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[76]See Corporation Law Committee, supra note 21, at 1178.

[77]See F. Hodge O'Neal, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 HARV. L. REV. 773, 794 (1952).

[78]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 40, at 273 (referring to the importance of share transfer restrictions in maintaining family control in non-listed corporations).

[79]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).

[80]If the parties lack financial resources to preempt a third party offer, then the company itself can be named as a right-holder. See O'Neal, supra note 77, at 794. In more than one-quarter of cases of employing first 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. Original Research on First Purchase Rights (unpublished) (on file with the author).

[81]See Walker, supra note 79, at 17 ("In almost every case in which a [first purchase right] exists, the potential outside buyer should recognize that an insider may place idiosyncratic value on the property. In the close corporation context, for example, the insiders may value maintaining family ownership and control. . . .").

[82]See, e.g., Albert H. Choi, A Rent Extracting Theory of Right of First Refusal, 57 J. IND. ECON. 252 (2009); Walker, supra note 79, at 43–47 (for a right of first refusal); Grosskopf & Roth, supra note 23, at 176; Hua, supra note 74, at

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.[83] At the same time, the right-holder has better knowledge about the firm and its business prospects.[84] The size of transaction costs that third parties face and the information asymmetry gap between the right-holder and third parties both increase with the uniqueness of the property at sale.[85] 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. Without a right of first refusal, the outside buyer's probability of success arguably depends on the probability of the buyer's valuation being higher than the price offered by the right-holder.[86] Where a transfer is subject to a right of first refusal, an outside buyer can succeed only if the right-holder is not buying.[87] Therefore, in the presence of a right of first refusal, third-party buyers are discouraged from making offers due to uncertainty. As a result, either the seller's realization potential or the interest's offer price is reduced.[88]

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 a joint contractual surplus 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.[89] First purchase rights are contingent options for which a right-holder is expected to pay.[90] 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.[91]

389; (for a right of first offer); Kahan et al., supra note 74, at 332 (for comparing the two rights as to their implications for the joint surplus of the contracting parties).

[83]Walker, supra note 79, at 16.

[84]Id. at 17–18.

[85]Id. at 18.

[86]Id. at 19.

[87]See supra note 72 and accompanying text.

[88]Kahan et al., supra note 74, at 346–49; Walker, supra note 79, at 19–21. See also eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 45 (Del. Ch. 2010).

[89]Choi, supra note 82, at 259–60.

[90]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.

[91]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. See infra note 225.

A third-party offer, however, 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.[92] Weak demand from potential competing outside bidders who value LLC interests more than the right-holder results in an opportunity cost for the seller that cannot be proportionally offset by the gain of the right-holder.[93] An alternative measure, such as a mandatory open auctioning of interests, would ensure a superior result for the contracting parties for the purposes of controlling third party entries into the firm's capital.[94] 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 LLC units for sale is low, or (3) right-holders are not likely to exercise their rights.[95]

In considering the latter of these cases, when faced with an intention of a member to exit, a holder of a right of first refusal is not choosing between preserving the value of holding interests by exercising its right or not-exercising the right and losing value. A third-party buyer could be a good fit to the project, which would preserve or increase value. Thus, when a third party is considering whether to incur costs and make an offer for an LLC interest encumbered by a right of first refusal, it takes into account not only the probability of its offer price being higher than 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 interest than the third-party buyer, the latter can purchase if the right-holder does not consider the transfer destroying value for the project.[96] 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 both the initial contracting stage and effects of the interest transfer, the right might still ensure the most efficient result for the contracting parties by encouraging cooperation 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.[97] A right of first refusal, by reducing the

[92]Walker, supra note 79, at 25–27.

[93]Kahan et al., supra note 74, at 351–52; Walker, supra note 79, at 26–27.

[94]Walker, supra note 79, at 41.

[95]See Kahan et al., supra note 74, at 351–52 (arguing that a right of first refusal generates an efficient result for the contracting parties when third-party transaction costs are low).

[96]In this setting, not all third parties are discouraged from incurring transaction costs and bidding for interests 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 collective result for the contracting parties at the time of exit of one of them, it can prevent cooperation in the first place and is likely to destroy value after the sale.

[97]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.

marketability of interests in cases of strategic transfers to third parties, drives up the costs of behaving opportunistically. In the absence of this right, given the uncertainty following a transfer by a member, the parties have weaker incentives to cooperate and invest.

The special relations scenario is not the only one in which a right of first refusal is superior to an auction. Auctions are not necessary in sales of readily-available assets with easily-established prices, but are useful in defining prices of assets whose value, due to the asset's idiosyncrasy or uncertain consumer demand, might be unclear.[98] Equity participation in non-listed firms normally is a unique asset and, indeed, belongs to the second group.[99] If it were easy to establish the price of the offered interest, there would have been no need for auctions since 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 is, again, 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 members' interests, can be an efficient solution.[100] For example, 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 firm can generate strong interest from many third parties. Meanwhile, the parties, because they are disclosing and providing to each other their technological developments, can be strongly interested in limiting the access to the project by third parties.

2. Economic Analysis of a Right of First Offer

The effect of a right of first offer is different. According to this right, encumbered interests 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.[101] Depending on the type of right of first offer, either a seller or a right-holder has to disclose its valuation.[102] 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 interest. This reduces their transaction costs. In addition, under a right of first offer, potential outside buyers, as second movers, benefit from

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Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 J. L. & ECON. 233, 241–42 (1979).

[98]See Liran Einav, Chiara Farronato, Jonathan D. Levin, & Neel Sundaresan, Sales Mechanisms in Online Markets: What Happened to Internet Auctions?, 5–6 (Nat'l Bureau of Econ. Research, Working Paper No. 19021, 2013), http://www.nber.org/papers/w19021.

[99]See Walker, supra note 79, at 16.

[100]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 surplus for the contracting parties. See Kahan et al., supra note 74, at 352–53.

[101]See supra notes 73–76 and accompanying text.

[102] See supra note 74 and accompanying text (if the agreement requires the seller to offer the price, then the seller has to disclose its valuation; in contrast, if the price is proposed by the right-holder, the right holder discloses its valuation).

increased certainty of the fate of their offers.[103] Consequently, a right of first offer is expected to increase the interest of third parties and the joint gains 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 market (if the sale price is offered by the right-holder).[104] 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 encumbered interest even if its valuation is lower than the valuations of potential outside buyers.[105]

In practice, the problem of information asymmetry of the seller can be, and often is, solved. Particularly, 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.[106] Such preliminary discussions can reach an advanced stage, turning a right of first offer into a mere formality that the seller needs to comply with in order to finalize the sale with the outside buyer.[107] 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 advance, the higher the risks of the third party and the lower the seller's risks are. As long as outside buyers are informed that the interest is encumbered by a preemptive right, this is expected to deter them from investing too many resources in negotiating a transfer prior to the clarification of the position of the right-holder.[108]

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[103]See O'Neal, supra note 77, at 802 (under a right of first refusal, prospective buyers may be reluctant to make offers if their offers will fix the price at which the right-holders are privileged to buy; third-party interest can be strengthened by permitting a seller to offer a price).

[104]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.

[105]See Hua, supra note 74, at 392; Kahan et al., supra note 74, at 354–56.

[106]This practice is permitted by case law. See RCM LS II, LLC v. Lincoln Circle Assocs., LLC, No. 9478–VCL, 2014 WL 3706618, at *7 (Del. Ch. 2014).

[107] See id. at *3–4.

[108]In Lincoln Circle Assocs., 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. Id. at *2–3. 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. Id. at *4–5. After secretly 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. Id. at *5. 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. Id. at *8.

Aside from helping the seller form a bargaining strategy, preliminary accumulation of information by a seller has two important implications. First, if the right requires the seller to define the sale price, the seller is no longer forced to lower its offer and is better informed as to whether or not to accept the right-holder's offer, assuming the right-holder is required to offer the price. Therefore, the seller can extract the highest price on a market for its interest. This will increase the joint profits of the parties of a right of first offer. Second, advanced negotiations transfer value from the right-holder to the seller. For example, 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 as to whether to accept this offer or to reject it and auction the interest at a higher price on the 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 is curbed so as 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 third-party interest, 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 interest 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 interest.

A mandatory, open auctioning of interests, 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 that mattered was the maximization of the combined profit of contracting parties at the stage of transferring interests by one of them. Yet, a right of first offer impacts the joint gains of the parties by making cooperation 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 parties. 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 value on LLC interest 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 gains 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.[109] This weakens the preemptive right of the right-holder and lowers the probability that the right-holder will get the interest. The right is effective only if the right-holder's valuation of the interest 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

[109] See supra note 76 and accompanying text.

right of first offer 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.[110]

B. Tag-Along Rights

A tag-along right is contracted for primarily to address conflicts between investor groups in sales of interests of significant size to third parties.[111] In a typical situation of applying a tag-along right, the selling owner of interest is in possession of a controlling block and the co-selling investors hold minority positions. It is the obligation of the selling owner to inform the right-holders about their right to exercise their co-sale rights. A tag-along right: (1) provides its holders with an opportunity to exit the firm in cases of large member changes and (2) effectively forces the main seller to share a control premium with the remaining investors.[112]

There are two main variations of this right with different effects on the seller and outside buyers. Under the first variation, an outside buyer, after acquiring large interest in a target company, has to extend its offer to the remaining members on the same terms—a full tag-along right.[113] The second variation does not oblige an outside buyer to make an offer for all outstanding LLC units. 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 the transfer and provide right-holders an opportunity to co-sell their interests on a pro rata basis—a proportional tag-along right.[114] As a result, the seller, instead of fully cashing out its investment, may become a minority investor along with others.

Theoretical models predict that the size of a controlling block affects the incentives of a controlling group for private benefit extraction.[115] The lower the size of a holding an outside buyer needs to obtain for establishing control over the firm, the stronger its incentives for extracting private benefits of control. Small economic interests allow sharing the costs of private benefit extraction with other investors.[116] On the other hand, investors with large cash flow

[110]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. See supra note 90.

[111]See Corporation Law Committee, supra note 21, at 1185.

[112]See Corporation Law Committee, supra note 21, at 1185. 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. Original Research on Tag-Along Rights (unpublished) (on file with the author).

[113]See infra Figure IV.

[114]See infra Figure IV.

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

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

rights internalize more costs of their own opportunistic actions and, thus, extract less costly private benefits.[117]

A tag-along right anticipates this conflict and offers solutions. A full tag-along right compels a third party to buy more interest than is necessary to obtain control.[118] 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 checks of a potential buyer or face risks of becoming a disadvantaged minority vis-à-vis the new controlling investor.[119] The seller is expected to sell only if the buyer is not likely to destroy firm value or if it agrees to purchase all LLC units. 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, like the mandatory bid rule, prevent value-decreasing control transactions where the benefits of the seller and the buyer come at the expense of other investors, rather than owing to value creation.[120]

Tag-along rights also encourage investments by the contracting parties. Normally contractual agreements grant parties special rights that are not provided in statutes and organizational documents of firms.[121] These rights serve as guarantees for the protection of the parties' interests. Being contractual rights, they cannot be enforced against third-party buyers, unless the assignment of the agreement occurs.[122] Thus, a third-party buyer is free to extract more private benefits than the former controlling investor. This implies that a controlling member 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 the agreement. This opportunity is

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[117]See Bennedsen & Wolfenzon, supra note 115, at 115; Burkart et al., supra note 115, at 178–81. Empirical evidence from listed companies supports this claim. See Stijn Claessens et al., 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 et al., 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).

[118]See supra note 113 and accompanying text.

[119]See supra note 114 and accompanying text.

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

[121]See John J. Ghinger, III, Shareholders' Agreements for Closely Held Corporations: Special Tools for Special Circumstances, 4 U. BALT. L. REV. 211, 211–12 (1975).

[122]The situation can be different if investments are organized via LLC form. The governance structure of LLCs and special rights of members are typically found in LLC operating agreements. R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803–CC, 2008 WL 3846318, at *1 (Del. Ch. 2008) ("For Shakespeare, it may have been the play, but for a Delaware limited liability company, *the contract's the thing*. . . . [I]t is the contract that defines the scope, structure, and personality of limited liability companies.") (internal quotation marks and citation omitted). 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, 293 (Del. Supr. 1999) (holding that the LLC, which did not itself execute the LLC agreement defining its governance and operation, is nevertheless bound by the agreement); Seaport Vill. Ltd. v. Seaport Vill. Operating Co., No. 8841–VCL, 2014 WL 4782817, at *2 (Del. Ch. 2014) ("[T]he LLC and its members are parties to and bound by the LLC agreement, regardless of whether they sign it.").

important for investment planning, because without special rights the investments can be worthless.[123]

Tag-along rights are substitutes for other investor protection rights.[124] 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.[125] In cases where controlling members have no 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 of protection for the minority interests.[126]

However, a tag-along right comes at a cost. A full tag-along right forces an outside buyer to buy more interest (up to 100%) at a higher price or obliges the selling holder to share control premium with all 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.[127] This discourages value-decreasing control transfers and reduces the probability of value-increasing transactions and results in losses for both contracting parties in the form of forgone cash flow increases.[128]

Consider the failed privatization of Cesky Telecom, a telecommunications company which dominated the market in the Czech Republic in late 2002.[129] The consortium of buyers

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[123]See Chemla et al., supra note 8, at 105–06; see also 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) (analyzing the effect of a tag-along right on stipulating cooperation in relationship-specific investment projects).

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

[125]See id.

[126]See id.

[127]Consider a potential buyer (B) ready to pay ν_1 for all outstanding units of a target LLC. The LLC has a controlling member S whose share in the ownership structure is $1 - \alpha$. S and the other members are parties of an agreement entitling the latter to sell all their LLC units along with S at the price offered to S. In B's valuation of the LLC, 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 units is $\nu_1 - \beta$. Without the tag-along right, S would get $(1 - \alpha)*(\nu_1 - \beta) + \beta$ (total value of its interest plus the entire control premium). The $\alpha*(\nu_1 - \beta)$ left would be shared between the remaining members. Under the tag-along right, the payoffs are different: S receives $(1 - \alpha)*\nu_1$ and the minority members get $\alpha*\nu_1$. Either B has to increase its payments to $\nu_2 = \nu_1 + \alpha*\beta$ to be able to pay the control premium also to the minority members, 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 ν_2 will be rational if the expected benefits of full control are not less than the additionally paid control premium. If the initial price ν_1 is not changed, S's payoff is reduced, decreasing the probability of the deal.

[128]See, e.g., Bebchuk, supra note 120, at 971; Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 YALE L.J. 698, 711–12 (1982).

[129]Janine Brewis, JP Morgan Dealt Blow by Cancelled Cesky Telecom Deal, FINANCIAL NEWS (Dec. 3, 2002), http://www.efinancialnews.com/story/2002-12-03/jp-morgan-dealt-blow-by-cancelled-cesky-telecom-deal; see also Enrique Costa-Montenegro et al., IEEE 802.11 in Europe, GLOBAL COMMC'NS NEWSLETTER, (Dep't of Info. Tech.

agreed to pay a premium to the Czech government for its 51% shareholding.[130] 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.[131] The negotiations between the buyers and the beneficiaries of the tag-along right, which were intended to lower the purchase price, failed frustrating the deal.[132]

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 interests, then the selling member and each exercising tag-along right-holder shall reduce the amount of the offered units so as to permit each party to sell interests proportionate to their respective percentage holdings. Thus, the main impact of the right is on the seller. First, the seller is not guaranteed that it will be able to sell the number of LLC units negotiated with the buyer; if any right-holder wishes to exercise its option, then the seller's share of the interest 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. 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.[133]

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. Conversely, the costs are low where either voting rights are distributed relatively evenly among the members or minority investors are entitled to special rights.[134] In the case of even distribution, 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 special

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and Commc'ns, Polytechnic Univ. of Cartagena, Cartagena, Spain), Sept. 2003, at 3–4, http://www.comsoc.org/files/Publications/Magazines/gcn/pdf/gcn0903.pdf.

[130]Brewis, supra note, 129; see also Peter Ross, Management Strategies in the Czech Telecommunications Sector: A Comparative Study of Český Telecom and T-Mobile, 19 THE INT'L J. OF HUM. RES. MGMT 2216, 2224 (2003).

[131]Brewis, supra note, 129.

[132]See Robert Anderson & Ian Bickerton, Doubts Surround Cesky Sale, FINANCIAL TIMES (Nov. 25, 2002).

[133]Suppose, a controlling member S owns interest representing $1 - \alpha$ of the LLC's ownership structure. An outside buyer B is willing to become a new controlling member by acquiring $1 - \alpha$ at a price ν which includes a control premium. The interests are encumbered by a tag-along right entitling each member to sell its pro rata share in a control transfer at the same price offered to the controlling member. By negotiating only with S, B will achieve its goal at minimum transaction costs (buying the same interest from more than one member 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 interest. 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 member, S will agree to sell only in a full 100% transfer.

[134]See Morten Bennedsen et al., Private Contracting and Corporate Governance: Evidence from the Provision of Tag-Along Rights in Brazil, 18 J. CORP. FIN. 904, 916 (2012) (analyzing evidence from Brazilian listed companies that corresponds with the conclusion that tag-along rights were less likely in companies where large shareholders leveraged their control by holding more voting rights than economic interest).

rights case, strong 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-welfare implications of this right can vary from case to case. Contracting for a tag-along right is a strategic choice for investors, made if the benefits of such encumbrance exceed the costs of the reduced marketability of their holdings. Assuming that controlling investors have more legitimacy to require a control premium, 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.[135] 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 investors for the proposed project.

C. Drag-Along Rights

A drag-along right allows its holder—the main selling owner of the LLC interest—to force other investors to sell along with the right-holder on the same terms in a control transfer to a third party.[136] A drag-along right functions as a balancing mechanism to a tag-along right. It increases the seller's control premium, facilitates control transactions by increasing the benefits of a potential buyer, and stipulates relationship-specific investments.

From the seller's perspective, this right allows selling more interest than the seller actually owns by adding the interests of other investors. Depending on the activation threshold, this might turn a small holding into a controlling package. Therefore, a drag-along right contributes to obtaining a better price for the interest of the seller and the other investors 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.[137] The desire to acquire a larger holding or full control is driven by two prerogatives. First, investor freedom to abstain from selling can be used strategically in value-increasing sales with the aim of getting a higher price later.[138] A drag-along right prevents such an opportunistic behavior.[139] Second, there are

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[135]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) (explaining that a rational controlling member will seek compensation for its governance contribution through private benefit extraction).

[136]See Corporation Law Committee, supra note 21, at 1182.

[137]Cf. Joseph A. McCahery et al., 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).

[138]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).

[139]Consider a buyer B willing to pay v for 100% interest of an LLC. It is reasonable to expect that B values the interest at a higher price v', otherwise it would not benefit from the transaction. The holding of the controlling member S equals to $1 - \alpha$ and the minority member M, accordingly, owns α share of units. Under a drag-along right,

additional costs and risks that minority investors can create for a potential buyer.[140] Nevertheless, it should be admitted that these costs are larger in listed firms, because they face extra costs in conforming to regulatory and listing requirements and high corporate governance standards.[141]

Finally, by preventing a minority investor's opportunistic refusal to sell in a value-increasing acquisition, a drag-along right forces the contractual parties to stick to the agreed shares of the payoff.[142] 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.[143] In order to proceed with the transaction, the majority seller has to share part of its initially agreed payoff with the minority investor. Precluding such hold-ups encourages investments.[144]

D. 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.[145] A call option, on the contrary, is the right of the holder to buy the interests of other members.[146]

Put and call contractual arrangements, due to information asymmetries and bounded rationality of the contracting parties, are difficult to devise at the outset.[147] First, contractual parties have to define the type of the option (put or call); the identity of the holder (majority or minority); and the state when the option can be activated.[148] Information asymmetries with

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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.

[140] See, e.g., Edward F. Greene, Corporate Freeze-Out Mergers: A Proposed Analysis, 28 STAN. L. REV. 487, 494 (1976) (noting particularly, the presence of minority investors may raise questions of conflict of interest and usurpation of corporate opportunity or create risks of litigation by minority investors over governance decisions).

[141] See, e.g., M. Todd Henderson & Richard A. Epstein, The Going-Private Phenomenon: Causes and Implications, 76 U. CHI. L. REV. 1, 3 (2009) (ongoing disclosure requirements, mandatory internal procedures, limitations on the qualifications of people who can serve on the board of directors, and other requirements raise the costs of operating as a public corporation); Eric L. Talley, Public Ownership, Firm Governance, and Litigation Risk, 76 U. CHI. L. REV. 335, 336 (2009) (finding many private-equity deals are at least partially inspired by an organizational desire to escape the burdens of public ownership, including litigation risk).

[142] Chemla et al., supra note 8, at 106–07.

[143] See supra note 139.

[144] Chemla et al., supra note 8, at 106–07.

[145] See, e.g., Kerry M. Lavelle, Drafting Shareholder Agreements for the Closely-Held Business, 4 DEPAUL BUS. L.J. 109, 113 (1991).

[146] See id. at 126.

[147] See Chemla et al., supra note 8, at 115.

[148] See BAINBRIDGE, supra note 35, at 456; Chemla et al., supra note 8, at 115.

regard to the nature of future problems and bargaining power distribution will prevent parties from optimal contracting.[149] Even in the light of assuming full rationality of the parties, private arrangements will generally remain incomplete, because contracting parties can program future problems, but, given transaction and enforcement costs, cannot fully describe them.[150]

The second drafting problem is the definition of a fair price for exercising the option.[151] Information asymmetries between the parties at the stage of exercising option rights may affect their respective valuations.[152] Theoretical models of optimal options rely either on fixed prices[153] or third-party valuation of the option price at the exercising date.[154] 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.[155]

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 interest. 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.[156] However, such a buy/sell-out mechanism is

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[149]See Chemla et al., supra note 8, at 115.

[150]See generally Eric Brousseau & Jean-Michel Glachant, The Economics of Contracts and the Renewal of Economics, in THE ECONOMICS OF CONTRACTS: THEORIES AND APPLICATIONS, 3, 10–12 (Eric Brousseau & Jean-Michel Glachant eds., 2002).

[151]See BAINBRIDGE, supra note 35, at 456; David Keith Page, Setting the Price in a Close Corporation Buy-Sell Agreement, 57 MICH. L. REV. 655 (1959).

[152]See Landeo & Spier, supra note 23, at 160–61.

[153]See, e.g., Nöldeke & Schmidt, supra note 9, at 637.

[154]See, e.g., Chemla et al., supra note 8, at 98.

[155]See BAINBRIDGE, supra note 35, at 459 (showing that the value defined by a third-party appraiser depends in large part on the employed methodology, thereby making this valuation method uncertain and unpredictable); O'Neal, supra note 77, at 801, 804 (explaining that agreeing on an exact price is usually satisfactory for a short period but the price may lose its relevance after some time; third-party appraisal can become quite expensive); Page, supra note 151, at 674 (noting the major drawback of third-party appraisal is its expense). 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. Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author). 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. When parties to a contract agree to be bound by a contractually established 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., No. 9978–CB, 2015 WL 9488249, at *9–11 (Del. Ch. 2015). Alternatively, the parties can opt for a certain level of judicial review for an appraisal process. Id.

[156]See MCCAHERY & VERMEULEN, supra note 39, at 149.

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.[157]

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 interests are valued based on the price offered by the first mover.[158] The first moving party is unable at the trigger date to anticipate the decision of the counterparty either to put its interest or to call the interest of the triggering party at the offer price.[159] Thus, the clause is a double-edged sword for its users, because the offering party can be forced to either buy or sell the interest. As a result, the parties have strong incentives to offer a price closer to the fair value of the interest.[160]

The following example illustrates the flaws of the mechanism. The shareholders of VSMPO-Avisma, one of the world's largest producer of titanium products, contracted for a Russian roulette mechanism.[161] 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.[162] 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.[163] These tactics backfired and the triggering party had to sell its share at a low price.[164]

Put and call options are one of the main contractual techniques aimed at resolving hold-up problems in relation-specific investments.[165] These provisions stipulate optimal investments by encouraging cooperation between the contracting parties or ensuring predictable division.[166] Options, by making use of price definition mechanisms and the distribution of put and call rights between the parties, induce the members to invest optimally and, if a conflict arises, to engage in

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[157]See F. Hodge O'Neal, Preventive Law: Tailoring the Corporate Form of Business to Ensure Fair Treatment of All, 49 MISS. L.J. 529, 555–56 (1978).

[158]See, e.g., 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, 38–39 (2012).

[159]See id.

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

[161]Natalia Shurmina, *Russia's VSMPO to Boost Titanium Capacity by a Third in 5 Years*, REUTERS (Jul. 29, 2015, 6:31 AM), http://www.reuters.com/article/russia-crisis-vsmpo-avisma-cor-idUSL5N1092VY20150729 (acknowledging VSMPO's significance in the titanium production industry); Yakov Pappe & Ekaterina Drankina, Russia Getting Nationalized, KOMMERSANT (Oct. 19, 2007), http://www.kommersant.com/p813945/r_1/Rosoboronexports_expansion_exceeds_any_imagination/.

[162]Pappe & Drankina, supra note 161.

[163]Arkady Ostrovsky, A Russian Phoenix Struggles to Stay Free, FINANCIAL TIMES (Feb. 20, 2006), http://www.ft.com/intl/cms/s/0/21aaed7c-a1b5-11da-9ca4-0000779e2340.html#axzz49AJYwpr7.

[164]Ostrovsky, supra note 163.

[165]Chemla et al., supra note 8, at 94–95.

[166]See id.

negotiations and solve the conflict.[167] If negotiations are unsuccessful or the parties cannot 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.[168] At the same time, the removed party receives fair compensation.[169] In sum, options contribute towards optimal investments, 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 member) jointly depend on the nature of the expected underlying problems and the distribution of bargaining power between the parties.[170] In particular, after initial investments, the investing member is vulnerable to hold-up by the other member who should make investments or commit to continue cooperation in order to create value for both parties.[171] Increasing the holding of the latter (for example, by transferring full control to it), will suffice to induce it to make the promised investments.[172] In this case, efficiency considerations require granting the first investor, even if it is the majority member, with a put option to sell its interest to the other member.[173] Exercising the put option at fair value will change the initial stakes of the parties in the firm and will induce optimal investments, but it will maintain the parties' initially agreed shares of the payoff.[174]

On the other hand, if there is a risk the minority investor will incur private benefit costs by reason of opportunistic self-dealing by the 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.[175] If exercised, the majority member will become the sole investor of the firm. As such, the mere threat of the minority investor's exercise of the put option has a deterring effect on the majority's incentives to engage in private benefit extraction.[176] The same

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167 See generally MCCAHERY & VERMEULEN, supra note 39, at 149 (emphasizing the role of options in stipulating negotiations between joint venture partners).

168 See generally Richard Arlen Saliterman, Dissolution and Buy-Out Provisions as Potential Solutions for Close Corporation Dissension, 1974 UTAH L. REV. 38, 46 (1974) (pointing to the advantage of buy-out provisions in dealing with disagreements without the expense of losing continuous corporate existence).

169 See id.

170 Chemla et al., supra note 8, at 98–99.

171 Id. at 111–13.

172 Id.

173 Id.

174 Id.

175 Id. at 103–04.

176 Id.

logic applies to deterring moral hazard behavior by one of the members—i.e. taking more risks or exerting suboptimal efforts to manage.[177]

With all of these benefits, relying on options can also be problematic because they can give one of the parties opportunistic incentives to create artificial grounds for activating the option.[178] The example illustrated above clearly demonstrates the risks of manipulation of Russian roulette clauses.[179] In particular, where one of the parties possesses information about the financial position of the other party, it can trigger a buy-out mechanism to force a financially weaker party out of the firm.[180] Even if the offered price is below the market price, the financially constrained party 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 interest is costly for its counterparty, because of strategic reasons, tax reasons, or for public law limitations, such as antitrust rules or foreign investment limitations.[181]

Legal practice has devised several solutions for tackling this problem, but all of them come with trade-offs.[182] For example, agreeing on a minimum price threshold or a price formula brings the parties back to the valuation problems discussed earlier;[183] 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 by specifying that any offer should be a good faith valuation of the fair market value of the interest. The trade-off of this solution is its heavy reliance on adjudication costs in state courts or arbitration. Alternatively, it is possible to provide members with an opportunity to look for a third-party buyer or to buy the interest on flexible terms.

III. DATA AND RESEARCH DESIGN

For purposes of this article's original analysis, a database was created by using the operating agreements of non-listed LLCs filed with the SEC (the "Database").[184] In most cases, these were subsidiaries or joint ventures formed by listed corporations. The "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.[185] The search was conducted in the annual reports (form 10-K) of all filing entities submitted to the SEC

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

[178]See, e.g., O'Neal, supra note 157, at 556.

[179]See supra notes 164–164 and accompanying text.

[180]See O'Neal, supra note 157, at 556.

[181]See Fleischer & Schneider, supra note 158, at 41.

[182]For a brief discussion of those solutions, see Fleischer & Schneider, supra note 181, at 48–49; Hoberman, supra note 14, at 248–49.

[183]See supra notes 153–155 and accompanying text.

[184]Original Research on LLC Agreements (unpublished) (on file with the author).

[185]See https://searchwww.sec.gov/EDGARFSClient/jsp/EDGAR_MainAccess.jsp

during 2012 and 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 reduced the sample of non-listed firms having two or more independent members by less than 14% in an effort 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.[186] Of the total number, 168 firms had two non-affiliated members, 62 had from three to ten independent members, and the remaining 59 had more than ten independent members. Most of the LLC agreements in the sample were entered after 2006.[187] A typical agreement in the Database 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 that made the use of detailed contractual provisions for investor protection secondary. These were cases where one 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 while conducting inferential statistical analysis, these firms were removed from the database because of the close relations of their members. Thus, for defining the circumstances of using transfer restrictions, the sample contains a total of 243 LLCs.[188]

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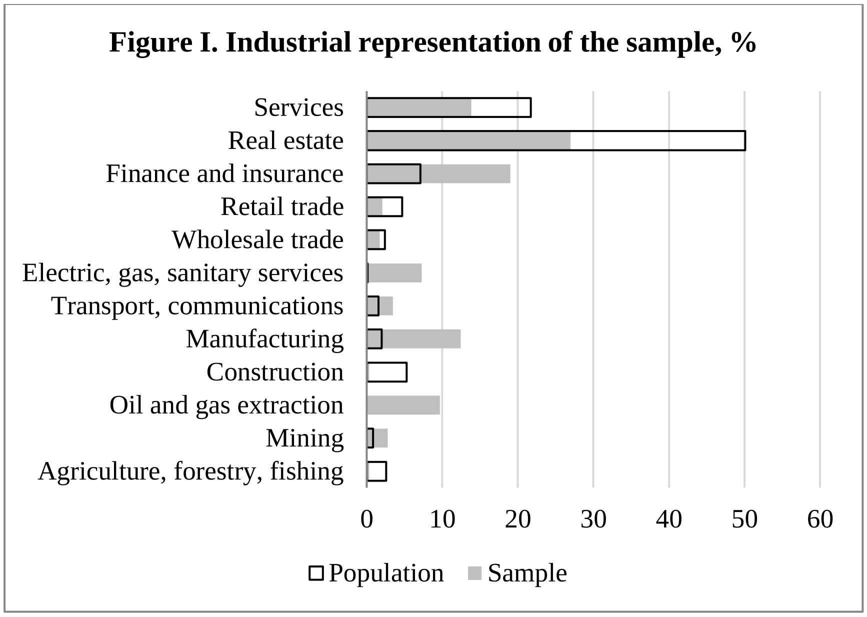
[186]Original Research on LLC Agreements (unpublished) (on file with the author).

[187]Original Research on LLC Agreements (unpublished) (on file with the author).

[188]The reduced sample includes 158 firms with two members, 56 firms with the number of members from three to ten, and 29 firms with more than ten members. Few of the discarded LLCs had transfer restrictions in their operating agreements: first purchase rights were used in two LLCs, tag-along and drag-along rights—in five companies, and four LLCs had option clauses.



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

The LLC form is used in various business industries. The majority of all LLCs operate in the real estate sector.[189] LLCs are also popular in professional services, finance and insurance, construction, and trade.[190] The sample contains companies from different industries as well. Figure I compares the industrial division of the sample and the total LLC population based on the first two digits of the Standard Industrial Classification Codes (SIC Codes). More than 46% of the firms in the sample came from finance and real estate sectors.[191] Services, manufacturing, oil and gas, and transportation services are strongly represented as well.[192] The comparison with the industrial representation of all LLCs taxed as a partnership reveals many similarities.[193] However, the sample is heavily overrepresented in the manufacturing, oil and gas, and electric sectors and is underrepresented in services and construction.[194] The main explanation for these differences is 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.

[189]See supra Figure I.

[190]See supra Figure I.

[191]See supra Figure I.

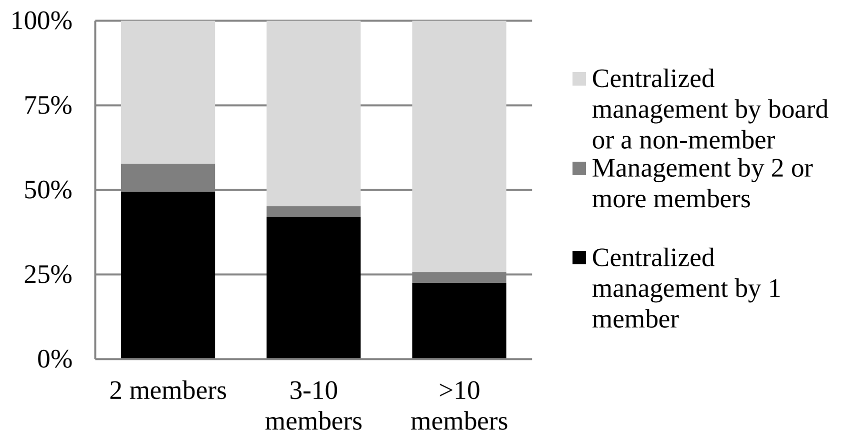
[192]See supra Figure I.

[193]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 two or more members. Ron DeCarlo et al., Partnership Returns, 2011, STATISTICS OF INCOME BULLETIN, Fall 2013, at 184–86 (detailing the data on LLCs taxed as a partnerships).

[194]See supra Figure I.

Almost all companies in the sample had a centralized management structure. More than half of the sample companies with two members were member-managed, but only in 14 companies did both members have management rights.[195] 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.[196] With the increase in the number of members, centralized management by a board of directors becomes more common. Almost 55% of the firms with three to ten members had boards of directors.[197] The corresponding figure is 74% in firms with more than ten members.[198]

Figure II: Management structure of the sample LLCs



More than 70% of the sample LLCs had one member or one group of affiliated members controlling majority of voting rights.[199] This share was the highest in the LLCs with more than ten members (around 83%) and the lowest in the companies with three to ten members (about 64%).[200] In two-member LLCs, 72% had a controlling member.[201]

In the sample LLCs with two members, more than 86% left the statutory transfer restriction intact.[202] In about 43.5% of the two-member firms, the members agreed to restrict the alienation of their interests by first purchase rights.[203] These rights were very often substituting

[195]See infra Figure II.

[196]See infra Figure II.

[197]See infra Figure II.

[198]See infra Figure II.

[199]Original Research on LLC Agreements (unpublished) (on file with the author).

[200]Original Research on LLC Agreements (unpublished) (on file with the author).

[201]Original Research on LLC Agreements (unpublished) (on file with the author).

[202]See supra notes 60–62 and accompanying text.

[203]Original Research on LLC Agreements (unpublished) (on file with the author).

the default transfer restriction. As the number of company members grows, most of the transfer restrictions, except for a tag-along right, become less common. The statutory transfer restriction was not waived in 71% of the LLCs with three to ten members and 64.5% of the sample companies with more than ten members.[204] Unlike the LLCs with few members, approval often had to be given by the board or the managing member, rather than by each member. However, like two-member companies, the statutory restriction was often subordinated to first purchase rights, which were used in 38.7% and 41.9% of the sample firms with three to ten and more than ten members, respectively.[205]

All agreements were coded based on a scorecard containing 84 questions affecting investor rights. The general coding criteria were defined based on (1) background information, (2) information about 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 (e.g. grounds for activating the right). I read the 289 sample agreements and coded the variables as either negative ("0") or positive ("1").

The likely circumstances of using different forms of transfer restrictions were defined using regression analysis. Because both dependent and independent variables are categorical, the analysis relies on logit regressions. The dependent variables in all regressions are different forms of interest transfer restrictions. The 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,[206] these two groups of independent variables were used as alternatives in two separately-run regressions.

The freedom to contract out of fiduciary duties is one of the principal differences of a Delaware LLC as opposed to corporations.[207] Where the 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, partially restrict, or waive the fiduciary duties of members or managers[208] or to limit or eliminate liability for breach of these duties.[209] In addition to voting rights, the contract's scope of fiduciary duties is used to define the strength of investor rights.

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[204]Original Research on LLC Agreements (unpublished) (on file with the author).

[205]Original Research on LLC Agreements (unpublished) (on file with the author).

[206]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.

[207]See Leo E. Strine, Jr. & J. Travis Laster, The Siren Song of Unlimited Contractual Freedom, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11 (Robert W. Hillman & Mark J. Loewenstein eds., 2015).

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

[209]Id. § 18–1101(e). See also Winnifred A. Lewis, Note, Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 82 FORDHAM L. REV. 1017, 1029–34 (2013) (describing the current state of Delaware law on fiduciary duties in LLCs and its development); Mary Siegel, Publicly-Traded LLCs: The

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.[210] Unfortunately, financial results are only available for a few sample firms, because as non-listed firms they are not obliged to disclose such information. Nevertheless, it is reasonable to assume that most of the LLCs were large, since their LLC agreements were disclosed by listed firms as material definitive agreements entered into by a filing entity outside of its ordinary course of business.

Learning externalities of lawyers, rather than ensuring efficient outcomes for business partners, can define the choice of interest transfer rules.[211] Associates at law firms are normally expected to use the extensive libraries of their law firms to design transfer clauses instead of starting from scratch in each new case.[212] Hence, the pool of prior knowledge and expertise of law firms can affect subsequent choices.[213] The evidence that lawyers drafting sample agreements adopted boilerplate transfer clauses, however, is not compelling.

Specifically, the texts of the sample documents allow identifying lawyers involved in the drafting of the LLC agreements in 127 firms, which constitute approximately 44% of the entire sample. About half of the involved lawyers were from the nation's top law firms.[214] Out of 97 law firms, 49 are in The 2015 Am Law 100 list and 43 are the first 100 law firms in The 2015 NLJ 350 ranking.[215] Only four law firms were involved in drafting at least five LLC agreements

New Kid on the Exchange, 68 SMU L. REV. 885, 886–90 (2015) (describing different views on the permissive treatment of fiduciary duties in Delaware LLCs and contrasting this to the mandatory fiduciary duties in corporations).

[210]See, e.g., Elisabeth de Fontenay, Law Firm Selection and the Value of Transactional Lawyering, 41 J. CORP. L. 393, 424–25 (2015) (explaining that with large transactions, the cost of engaging a high-volume law firm is more likely to be offset by the additional benefit from obtaining better economic terms); Means, supra note 52, at 1222 (suggesting that few initial assets of a firm is a rational impediment to incurring bargaining costs).

[211]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).

[212]See, e.g., Wilson Sonsini Goodrich & Rosati, Professional Corporation, Professional Development and Knowledge Management Programs (2013), https://www.wsgr.com/PDFs/professional-development-brochure.pdf (describing the extensive database of sample documents that attorneys can use as "high-quality starting points for further drafting" or negotiating precedents).

[213]See O'Neal, supra note 42, at 52 ("What he [the lawyer drafting a corporate charter] has done in the past in drafting charters and what his colleagues at the bar are now doing shape his thinking and limit his conduct.").

[214]There is no standard definition of "Big Law" or top-tier law firms. For the purposes of this article, the definition includes all firms from the American Lawyer's ranking of 100 largest law firms by gross revenue for 2015 and the first 100 law firms from the National Law Journal's ranking of top 350 firms by the total number of attorneys for 2015. See The 2015 Am Law 100: Rich and Richer, THE AM. LAW., Apr. 27, 2015; The 2015 NLJ 350, NAT'L L.J., Jun. 8, 2015.

[215]Original Research on LLC Agreements (unpublished) (on file with the author).

as lawyers of different clients.[216] The comparison of all agreements drafted by each of these four firms reveals not only that the agreements include different variations of interest transfer clauses, but also the design of the clauses varies.[217]

This certainly does not suggest that lawyers draft different contracts every time. The most likely explanation is that despite large law firms' use of boilerplate forms to draft an agreement, they adjust certain clauses to the needs of the transaction at hand.[218] Alternatively, law firms may develop several forms of a boilerplate contract tailored to different circumstances, including the voting power of a client, size of the target firm/transaction, the number of investors, an industry of the target firm, or even its geographical location. The interactions between the opposing contract parties or between their lawyers are important, because bilateral contractual negotiations may lead to results that differ from the standard texts normally employed by each side's lawyer.[219] Consequently, other factors must have driven the choice and the design of transfer clauses covered by this study.[220]

IV. THE PRACTICE OF CONTRACTING FOR INTEREST TRANSFERS

This section presents the results and explanations for the findings. Regression models are reported in the appendix.

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[216]The four firms were 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). Original Research on LLC Agreements (unpublished) (on file with the author).

[217]Original Research on LLC Agreements (unpublished) (on file with the author).

[218]See de Fontenay, supra note 210, at 397 (suggesting that associates at elite law firms now devote much, if not most, of their time to aggregating and comparing their firm's "market precedent" in preparation for a client's potential transaction and use this knowledge to define appropriate deal terms under prevailing market conditions). See also Wilson Sonsini, supra note 212 (explaining that the firm's deal database, which contains detailed profiles of acquisitions, public offerings, and venture financings from the past several years where the firm was engaged, allows transactional lawyers to find prior comparable deals and use them to assess the "state of the market," get precedent deal documents, or ask questions to the attorneys who worked on the earlier deals).

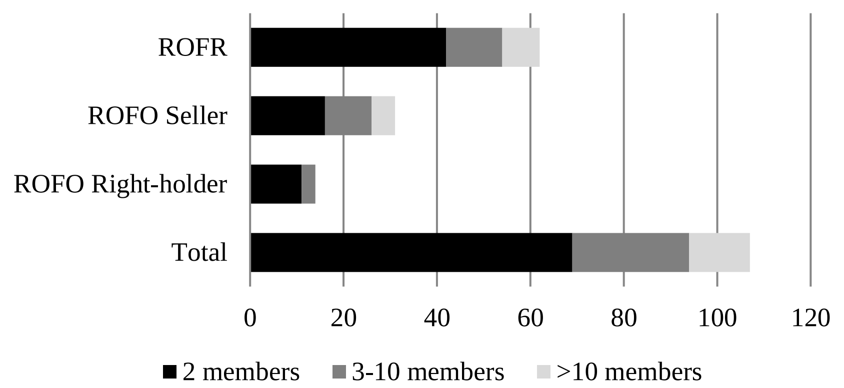
[219]See generally de Fontenay, supra note 210, at 406 (noting that some corporate transactions are heavily negotiated, thereby each agreement, notwithstanding significant overlaps, presents a unique combination of terms tailored to the needs of the parties and to current market conditions).

[220]Professor O'Neal strongly argued for careful adjustment of transfer clauses in particular and governance structures in general to the particular business and to the particular contracting parties. O'Neal, supra note 77, at 775–76 (1952) ("The draftsman should use forms and instruments prepared for other businesses only as 'idea guides' or as check lists, and not permit them to channel his thinking."); O'Neal, supra note 42, at 43 ("[Most governance provisions] should mold the business form to the needs of a particular business enterprise, and of course no two business situations are exactly alike."); O'Neal, supra note 157, at 530 (a standard form should never be used as a substitute for analysis of a client's problem and a clause should never be used if its meaning and purpose are not fully understood). Professor O'Neal's work sought to assist lawyers in drafting custom-made governance provisions for closely-held firms. See generally F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE (Rev. 3d ed. 2014).

A. First Purchase Rights

In the sample of 289 companies, 111 (more than 38% of all) LLC agreements included first purchase rights.[221] In four agreements, the abstract description of the rights did not allow for distinguishing a particular type of first purchase right.[222] These cases were removed leaving a final sample of 107 LLCs. Two-thirds of these firms had only two members.[223] The most popular first purchase right was a right of first refusal as almost 58% of the firms with first purchase rights used this right.[224] The share of firms using a right of first offer where the seller offers the purchase price was about 29% and the remaining 13% used 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 the 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.[225] 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

[221]Original Research on LLC Agreements (unpublished) (on file with the author).

[222]Original Research on LLC Agreements (unpublished) (on file with the author).

[223]See infra Figure III.

[224]See infra Figure III.

[225]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 more likely to be non-reciprocal than a right of first refusal. Original Research on First Purchase Rights (unpublished) (on file with the author).

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 supports the argument that first purchase rights are used where LLC members have special contractual relations allowing each to affect decision-making.[226] 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, patterns of the members' behavior, or their priorities. First purchase rights encourage investments by making third-party transfers of interests less likely.[227] The strongest form of these rights, a right of first refusal, gives a right-holder say on any third-party transfer.[228] It is used reciprocally in cases of special relations between members with equal bargaining power.[229] Conversely, 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.[230]

These results can be explained by the predicted effects of the variations of first purchase rights.[231] In two-member LLCs with both members holding equal ownership and voting rights, members are the most willing to impede interest transfers to outsiders and influence the replacement of a member by a third party.[232] Therefore, they prefer a reciprocal right of first refusal to a right of first offer. The greater the number of members, the higher the potential costs will be for a seller resulting due to the reduced realization potential of a right of first refusal (unless the right-holders are passive minority investors that are unlikely to exercise their rights).[233] In firms with a large number of investors, outside buyers face an extremely high risk of uncertainty with regard to their offers, because any right-holder can thwart a third-party bid. If a member is allowed to sell its interest 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 effectively means locking in the investors in the firm. The potential losses of a seller from encumbering its interest by a preemptive right are limited under a right of first offer.[234] The increased certainty not only attracts more third party interest, but the right can also create a

[226]See infra Table A-1.

[227]See supra Part II.A.

[228]See supra Part II.A.

[229]See infra Table A-1.

[230]See infra Table A-1.

[231]See supra Part II.A.

[232]See supra note 97 and accompanying text (explaining that special relations or investments in relation-specific capital increase incentives to behave opportunistically by threatening to exit).

[233]See supra notes 86–88 and accompanying text (discussing the effect of a right of first refusal on the incentives of third parties to make offers).

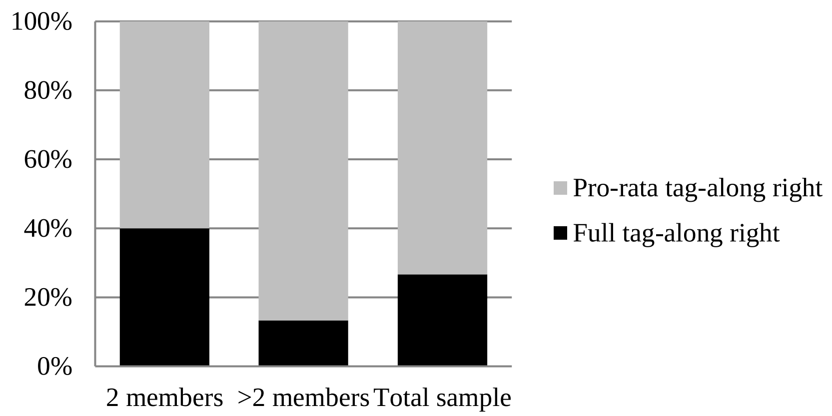
[234]See supra notes 101–103 and accompanying text (discussing the incentive effects of a right of first offer on third parties).

competitive auction between the numerous right-holders.[235] However, due to the limited value for its holders, a right of first offer where the right-holder defines the sale price is not attractive for controlling members with strong negotiating power. Consequently, this type of a right of first offer appears mostly in LLCs without a controlling investor.[236]

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).[237] Tag-along rights entitling the right-holders to sell in proportional shares with the main selling member (73.33%) were more widespread.[238] 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 reports comparative data on the two variations of a tag-along right.

Figure IV. Which tag-along right?



A tag-along right, obviously, has value where LLC members cannot block third-party transfers of interests to third parties.[239] Therefore, the right was used as an alternative to unanimous voting or veto rights.[240] Given the comparative advantages of a proportional tag-along right to a full tag-along right, it is not surprising that most of the members of the sample companies contracted for the first type.[241] This right is more likely to discourage value-

[235]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. See infra Table A-1.

[236]See infra Table A-1.

[237]Original Research on LLC Agreements (unpublished) (on file with the author).

[238]See infra Figure IV.

[239]See supra notes 124–126 and accompanying text.

[240]See infra Table A-2.

[241]See supra Figure IV.

decreasing control transactions, but has a limited negative effect on value-increasing transfers.[242] A full tag-along right, by contrast, affects both types of control transfers equally.[243]

A full tag-along right was likely to appear in LLCs with a small number of members and if the investors had strong rights.[244] 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. Conversely, under weak minority rights, a pro rata tag-along right is the appropriate measure.[245] As the number of members increases, 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 supports the argument that a drag-along right balances 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 for along with a tag-along right. Only 9.46% of the agreements included stand-alone drag-along rights.[246] A drag-along right was commonly contracted in LLCs with a controlling member.[247]

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

Though the theoretical implications of put and call options and 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 sheds 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.[248] Majority call rights appeared in 41.18% of the LLC agreements using options.[249] Majority put rights were rarely used.[250] Buy/sell-out clauses, where either party could be a buyer or a seller, were employed in 26.47% of the sample companies with an option clause in its operating agreement.[251]

[242]See supra Part II.B.

[243]See supra Part II.B.

[244]See infra Table A-2.

[245]See infra Table A-2.

[246]Original Research on LLC Agreements (unpublished) (on file with the author).

[247]See infra Table A-2.

[248]See infra Figure V.

[249]See infra Figure V.

[250]See infra Figure V.

[251]See infra Figure V.

Figure V. Option types, %

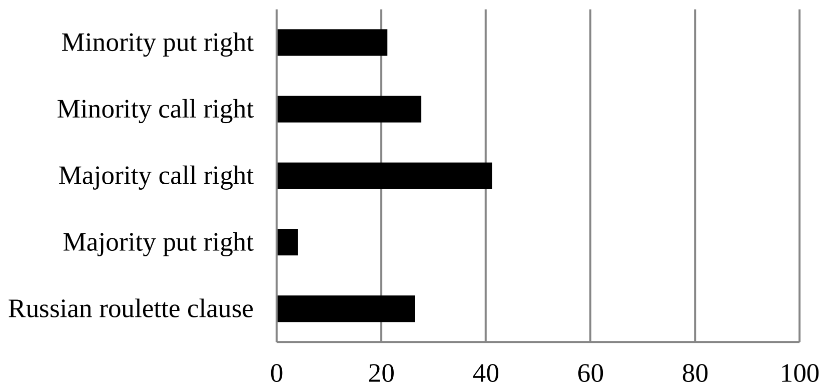


Table A-3 presents the results of the statistical analysis. As predicted, unconditional minority put rights were used to prevent opportunistic self-dealing by controlling members where the minority members could not rely on their voting rights to affect day-to-day decision-making and major decisions.[252] These options have limited value in two-member firms with equal voting rights, except in cases of stipulating optimal investments in relation-specific projects with sequential investing.[253] An LLC member can use voting rights to prevent expropriation by the other member.

Where a minority investor has sufficient financial resources and experience, majority self-dealing and hold-up strategies can be discouraged by granting a minority investor a call right.[254] Unlike a minority put right, which typically could be activated anytime by its holder, a minority call right requires 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.[255] Similar causes were required for the activation of majority call options.[256] In the circumstances of equal voting or minority veto rights, the call right of one of the two members was an effective instrument to overcome deadlocks.[257] The option took the form of a call right rather than a put right, because a put right

[252] See infra Table A-3.

[253] See infra Table A-3.

[254] See infra Table A-3.

[255] Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author). Change of control can be dealt with also by first purchase rights entitling the right-holder to acquire the equity holding of a member which 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.

[256] Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

[257] See infra Table A-3.

could be used strategically to create artificial deadlocks and obtain bargaining advantage over a financially-constrained member 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.[258] Less often were conditional buy/sell options that could be triggered following a deadlock or breach of the agreement.[259] We would expect buy/sell-out arrangements in LLCs where members have equivalent rights.[260] The data shows that these provisions were almost in all cases used in two-member firms.[261] 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.[262]

Theoretical models show buy/sell-out arrangements can lead to inefficient results where both contractual parties have private valuations not known to each other.[263] In particular, the triggering party defines the price based on the probability analysis of being a seller or a buyer.[264] 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.[265] Conversely, if the triggering party is likely to buy, it offers a price below its own valuation. Where these estimates are correct, the results of buy/sell-out clauses are efficient.[266] However, 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, if the receiving party has a valuation between the triggering party's own valuation and the offered price.[267]

The inefficiencies can be mitigated by choosing the correct triggering party. De Frutos and Kittsteiner offer a model based on negotiations before activating a buy/sell-out option that aims to define the triggering party.[268] Choosing the correct triggering party can also ensure a fair

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[258]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

[259]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

[260]See, e.g., O'Neal, supra note 157 at 555.

[261]See infra Table A-3.

[262]See infra Table A-3.

[263]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 member that values it most. Id.

[264]See id.

[265]See id.

[266]See id.

[267]See id.

[268]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 23, at 176; Claudia M. Landeo & Kathryn E. Spier, Irreconcilable Differences: Judicial Resolution of Business Deadlock, 81 U. CHI. L. REV. 203, 206 (2014).

result[269] if the parties of a buy/sell-out option have one-sided asymmetric information about the price.[270] 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 has better information about the firm and can accurately value the interests, then the parties are looking for an equitable division; if the offering party has the higher valuation, then the outcome is efficient.[271] On the other hand, 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.[272]

The practice of the sample LLCs does not support these predictions. In only a few cases the agreements specified the party that was entitled to trigger a buy/sell-out procedure.[273] In the vast majority of situations, any of the contractual parties could activate the clause.[274] Interestingly, the evidence points the fact that buy/sell-out options were often used in real estate firms.[275] The inclusion of the buy/sell-out mechanisms in the governance agreements of firms operating real estate projects can be motivated by the long-established practices of professional consultants, rather than by the efficiency or fairness considerations. For example, 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 buy/sell provision pursuant to which any of the members could activate the procedure.[276]

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.[277] Instead, the price is

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[269]A result is fair if the allocation of payoffs between the parties accurately reflects the agreed ownership allocation. See Landeo & Spier, supra note 23, at 147.

[270]Landeo & Spier, supra note 23, at 160–62; Landeo & Spier, supra note 268 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 co-investor at a low (high) price.

[271]See Landeo & Spier, supra note 23, at 162.

[272]See id.

[273]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

[274]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

[275]See infra Table A-3.

[276]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).

[277]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

defined by an independent third party after the activation of the option.[278] Engaging an independent appraiser mitigates inefficient and inequitable outcomes related to buy/sell-out mechanisms. However, given the additional costs, this modification is only useful where the reasons for sub-optimal outcomes of utilizing buy/sell options are well-pronounced.[279]

V. THE CONTRACTUAL DESIGN OF INTEREST TRANSFER CLAUSES

The study also revealed the main parameters of drafting 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.

A. Events Triggering Interest Transfer Clauses

A trigger event activates an interest transfer clause. 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.[280] Both grounds are facts that can be easily established. The trigger event for rights of first offer typically was defined broadly: an intention of a member to sell its interest.[281] Most of the first offer clauses were silent about the permissibility of any contacts between a seller and potential non-member buyers prior to notifying the right-holder.[282] Evidently, some scope for freedom of action is acceptable.[283]

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 LLC units being transferred.[284] By contrast, a full tag-along right was activated if a seller agreed to transfer an interest exceeding a certain minimum threshold.[285] The LLC agreement of STi Prepaid, LLC, provider of international prepaid phone cards,

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[278]See Wetmore v. MacDonald, Page, Schatz, Fletcher & Co., 476 F.3d 1, 2 (1st Cir. 2007).

[279]See, e.g., id. at 1–5. In Wetmore, though both parties 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. Id. 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 party. Id.

[280]Bateman v. 317 Rehoboth Ave., LLC, 878 A.2d. 1176, 1183–84 (Del. Ch. 2005) (“a right of refusal can be exercised only when the [seller] . . . entertains an offer from a third party to purchase the property”). See also, e.g., Colt Defense LLC, Amended and Restated Limited Liability Company Agreement of Colt Defense LLC (Form S-4/A Ex. 3.1) (Mar. 21, 2011).

[281]See, e.g., CityCenter Holdings, LLC, Amended and Restated Limited Liability Company Agreement of CityCenter Holdings, LLC (Form S-4 Ex. 3.2) (Sep. 29, 2011).

[282]Original Research on First Purchase Rights (unpublished) (on file with the author).

[283]See supra notes 106–108 and accompanying text.

[284]Original Research on Tag-Along Rights (unpublished) (on file with the author).

[285]Original Research on Tag-Along Rights (unpublished) (on file with the author).

illustrates this practice.[286] 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.[287]

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 set the activation threshold at any level.[288] More than 80% defined a minimum threshold for activating a drag-along right.[289] The lowest threshold was set at 25%.[290] The most frequently adopted triggering event, however, was the transfer of more than 50% of the outstanding LLC units.[291] The parties often did not define a specific threshold. Instead, they tied the activation of the right to the transfer of all interest by a controlling member, regardless of a specific size.[292]

Trigger events for the types of options differed as well. If minority put options and buy/sell-out arrangements could be initiated anytime at the will of a right-holder, call options often required a specific cause for activation, such as deadlock in decision-making or breach of an agreement.[293] Often an option was effective after a certain stabilization period following the launch of the project.[294] This choice reflects the parties' wish to commit their resources and efforts to ensure the success of the undertaking. Such a commitment is facilitated by the

[286]See Leucadia Nat'l Corp., Amended and Restated Limited Liability Company Agreement of Sti Prepaid, LLC (Form 10-Q Ex. 10.3) (May 9, 2007).

[287]Id.

[288]See Christoph Van der Elst & Lientje Van den Steen, Opportunities in the Merger and Acquisition Aftermarket: Squeezing Out and Selling Out, in CORPORATE GOVERNANCE AND REGULATORY IMPACT ON MERGERS AND ACQUISITIONS: RESEARCH AND ANALYSIS ON ACTIVITY WORLDWIDE SINCE 1990, 191, 206–07 (Greg N. Gregoriou & Luc Renneboog eds., 2007) (explaining that from an economic perspective there are strong justifications for setting low squeeze-out thresholds).

[289]Original Research on Drag-Along Rights (unpublished) (on file with the author).

[290]See, e.g., Radio One, Inc., Amended and Restated Limited Liability Company Agreement of Interactive One, LLC (Form S-4 Ex. 3.22) (Feb. 9, 2011).

[291]Original Research on Drag-Along Rights (unpublished) (on file with the author).

[292]See, e.g., Laredo Petroleum, Inc., Second Amended and Restated Limited Liability Company Agreement of Laredo Petroleum, LLC (Form S-4/A Ex. 3.4) (Dec. 12, 2011).

[293]Compare Am. Railcar Indus., Inc., Amended and Restated Limited Liability Company Agreement of AXIS, LLC (Form 10-K Ex. 10.51) (Feb. 22, 2008) (buy/sell-out option) with Emmis Commc'ns Corp., Second Amended and Restated Limited Liability Company Agreement of Merlin Media, LLC (Form 8-K Ex. 10.1) (Sep. 1, 2011) (majority call right).

[294]See, e.g., Entravision Commc'ns Corp., Limited Liability Company Agreement of Lotus/Entravision Reps LLC (Form S-3 Ex. 10.2) (Jan. 30, 2002).

enthusiasm that usually accompanies joint ventures during the initial period of their development; deadlocks are unlikely at this stage.[295]

B. Notice Rules after Interest Transfer Clauses are Triggered

The next 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 and cumbersome information disclosure requirements may discourage potential buyers.[296] Long notice periods carry uncertainty and reflect the need to reserve financial resources for a longer period of time. On the other hand, short notice periods and limited disclosure may force right-holders to make ill-advised decisions without possessing adequate information.[297] The maximum time period for the completion of the sale is also important, because members cannot sell their interests to other buyers during this period.[298]

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.[299] Yet, even if the agreement does not require disclosure of all these terms, the selling member is encouraged to disclose, because the right-holder is obliged to match only those terms disclosed in the notice.[300] However, if non-disclosure of the terms disadvantages the right-holder, notice defects may prevent the right from being triggered.[301]

For both types of first purchase rights, the seller's offer shall remain open during an agreed period.[302] A first purchase offer is an irrevocable option that can be exercised by the right-holder anytime during this period.[303] Very seldom did the parties agree that an offer could be revoked by the seller.[304]

The majority of the agreements on tag-along rights provided for notice periods ranging from 15 to 30 days prior to the proposed transfer.[305] In addition to the price and payment details,

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[295]See generally William A. Klein, The Modern Business Organization: Bargaining Under Constraints, 91 YALE L.J. 1521, 1555 (1982) (suggesting that fear to spoil the deal prevents the parties and their lawyers from focusing on the downside risks).

[296]See Corporation Law Committee, supra note 21, at 1187.

[297]See id.

[298]See id.

[299]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.

[300]See Union Oil Co. of Cal. v. Mobil Pipeline Co., No. 19395–N, 2006 WL 3770834, at *14 (Del. Ch. 2006) (noting that if the seller expects the right-holder to match a given term, the term must be stated in the right of first refusal notice).

[301]See Robert K. Wise et al., First-Refusal Rights Under Texas Law, 62 BAYLOR L. REV. 433, 472 (2010).

[302]See O'Neal, supra note 77, at 792.

[303]See Wise et al., supra note 301, at 493.

[304]Original Research on First Purchase Rights (unpublished) (on file with the author).

[305]Original Research on Tag-Along Rights (unpublished) (on file with the author).

over half of the agreements required the disclosure of the identity of the buyer and almost a quarter included information about non-cash consideration.[306] More than half of the agreements established a maximum period for completing the transfer.[307]

C. Price and Payment Terms

Similar to notice rules, payment terms are of particular importance where a third-party buyer is involved.[308] Contracting for a right of first refusal does not imply that the seller cannot accept any terms from an outside buyer that cannot be practically matched by the right-holder (for instance, receiving a specific property as a consideration in kind).[309] The four primary 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) 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 use this information for making its own valuation.[310] Theoretically the problem of non-cash consideration can also reveal itself 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.[311] This can be explained by the fact that outside buyers, who are the most interested in clarifying the possibility of making non-cash offers, are not a contracting party to a right of first offer and, thus, cannot affect the negotiating process. Leaving the matter out of contracts, however, does not necessarily mean that non-cash consideration is not allowed. Disputes are more likely to boil down to the assessment of a third-party offer's 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.[312] Differentiated payments to large and minority members can be justified from the perspective of control premiums because minority investors have less legitimacy to require such premiums.[313] Nevertheless, transaction costs (e.g. the need to engage independent experts for valuation) and information asymmetries might prevent parties from detailed contracting. Consequently, the requirement to pay the same price in the same form to all transferring members was almost universal in the sample firms.[314]

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[306] Original Research on Tag-Along Rights (unpublished) (on file with the author).

[307] Original Research on Tag-Along Rights (unpublished) (on file with the author).

[308] See O'Neal, supra note 77, at 797–98.

[309] See Wise et al., supra note 301, at 486–87.

[310] Original Research on First Purchase Rights (unpublished) (on file with the author).

[311] Original Research on First Purchase Rights (unpublished) (on file with the author).

[312] 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 II.D.

[313] See supra note 135.

[314] Original Research on Tag-Along and Drag-Along Rights (unpublished) (on file with the author).

D. The Size of an Interest Subject to a Transfer

The size of an interest that sellers can or must transfer is another aspect that the parties of interest transfer clauses commonly determine. The main concern is the ability of right-holders to partially exercise their rights, because doing so may leave the selling party with a small holding with insignificant voting power and may affect the balance of power in the firm. Particularly, minority investors in drag-along rights are worried about 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%).[315] Similar to a proportional tag-along right, pro rata transfers under a drag-along right have a disciplining effect on the controlling seller.

For the same reason, in call options it was common to require the calling member to acquire all of the seller's interest.[316] On the contrary, the holder of a put right could typically sell all or any portion of its interest.[317]

An additional factor comes into play when exercising first purchase rights. Smaller holdings may generate less interest from potential buyers and can have lower value.[318] If the right-holders can buy less than offered, a potential deal with a third-party buyer may 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.[319]

If there are two or more right-holders entitled to exercise their first purchase rights in a given transfer, the agreement of the parties must define how the offered interest is to be distributed among them and what will happen to the units not taken by one or more right-holders.[320] In those cases, 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).[321]

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[315]Compare Emmis Commc'ns Corp., supra note 293 (full transfer) with Chrysler Group LLC, Third Amended and Restated Limited Liability Company Operating Agreement of Chrysler Group LLC (Form 10-K Ex. 3.6) (Mar. 6, 2012) (proportional distribution).

[316]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

[317]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

[318]See O'Neal, supra note 77, at 792–93 (suggesting that the restrictive provision should make clear whether the right-holder is entitled to buy less than offered; if the right-holder can buy just enough of the shares to give it control, the seller's remaining holding is far less attractive to prospective buyers).

[319]Original Research on First Purchase Rights (unpublished) (on file with the author).

[320]See O'Neal, supra note 77, at 792.

[321]Original Research on First Purchase Rights (unpublished) (on file with the author).

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 example is the combination of first purchase rights with the statutory default rule restricting interest transfers in LLCs.[322] The evidence on contracting for first purchase rights suggests 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 reinforced first purchase rights with the statutory approval clauses.[323] 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.[324]

The explanation of this practice is straightforward: a transfer consent is an extremely strong means for incumbent members to affect third-party transfers and is thus prone to hold-outs.[325] Indeed, this restraint is the default rule in the partnership statutes; but it is combined with the power of a partner to dissolve the partnership.[326] The absence of dissolution rights in many limited liability firms turns a consent clause into a device that may lock investors together forever.[327] In a non-listed firm with a small number of members, each member 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.[328] A third party can become a substituted member subject to the willingness/ability of incumbents to exercise their preemptive rights.[329] At the same time, first purchase rights are backed by a default approval clause in order to prevent any transfers in violation of the contractually agreed first purchase rights.

Such a combination was also commonplace 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 as 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).[330] Other remedies for enforcing tag-along rights entitled right-holders to buy-out the seller or put

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[322]See *supra* note 68 and accompanying text.

[323]Original Research on First Purchase Rights (unpublished) (on file with the author).

[324]See, e.g., Williams Partners L.P., Third Amended and Restated Limited Liability Company Agreement for Discovery Producer Services LLC (Form S-1/A Ex. 10.7) (Jun. 24, 2005).

[325]See O'Neal, *supra* note 77, at 785.

[326]See Edwin J. Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.F. 139, 141–42 (1969).

[327]See *id.*

[328]See O'Neal, *supra* note 77, at 785 (explaining that first purchase rights weaken the incentives of the right-holder to block transfers opportunistically by reducing the right-holder's influence on the seller; this advantage, however, comes at the expense of the need to tie up funds necessary for exercising first purchase rights).

[329] See *supra* notes 72 (for a right of first refusal) and 76 (for a right of first offer) and accompanying text.

[330]Original Research on Tag-Along Rights (unpublished) (on file with the author).

their units to the seller, an option to dissolve the firm, or a termination of special voting rights of a defaulting member.[331] 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. For instance, 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).[332] More than half of the contracted buy/sell-out clauses included one or both of these remedies.[333]

A case from the Wisconsin Court of Appeals shows how a poorly drafted bonding provision can sabotage contractual option mechanisms. In Decker v. Decker, a buy/sell-out option to which two brothers who were in business together was activated following a deadlock.[334] The LLC operating agreement specified that if one of the parties made an offer and failed to close the purchase, the other party had an opportunity to buy the interest of the failing party on the same terms and conditions.[335] The brother interested in the dissolution of the firm made an oppressive offer at a very high price without any intention to close on the offer. The receiving brother reacted to the high offer price and elected to sell. Since the transfer was not closed, the parties appeared in court at dissolution proceedings.[336] The court interpreted the contractual provision empowering the seller to buy out the defaulting buyer as an anticipation by the parties that the buyer might not close an accepted buy/sell-out offer.[337] 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.[338] If a contractually drafted specific remedy is the only remedy and cannot be invoked by the seller instead of other remedies 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.[339]

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[331]Original Research on Tag-Along Rights (unpublished) (on file with the author).

[332]See, e.g., Behringer Harvard Opportunity REIT II, Inc., Limited Liability Company Agreement of Behringer Harvard Arbors, LLC (Form 10-K Ex. 10.15) (Mar. 28, 2012) (if following the activation of a buy-sell procedure the buyer fails to close the transaction, the seller may either retain a 5% deposit as liquidated damages or elect to buy out the buyer's interest for a price equal to 95% of the original offer price).

[333]Original Research on Put Options, Call Options, and Buy/Sell-Out Arrangements (unpublished) (on file with the author).

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

[335]Id. at 668.

[336]Id. at 666–67.

[337]Id. at 669.

[338]Id. 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).

[339]In another case, the court constructed the buy/sell-out agreement in a way to prevent such abusive behavior. See Larken Minn. v. Wray, 881 F.Supp. 1413, 1415–18 (D. Minn. 1995). 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

CONCLUSION

This article analyzed various interest transfer restrictions from the perspective of the joint wealth of the contracting parties and looked to the practice for real-life evidence. When members do not have default dissolution rights, transfer restrictions are a crucial factor in governance agreements of non-listed limited liability firms, because of the locked investments that result. 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 they 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 a universal optimal solution for all non-listed firms. They are chosen by the contracting parties taking into account the individual aspects of each deal. A tag-along right mitigates conflicts in sale-of-control transactions by discouraging value-decreasing transfers. A drag-along right has high value where minority rights are strong and a potential outside buyer cannot extract large private benefits. On the other hand, weak minority protection reduces the value of a drag-along right. In practice 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 and interest transfers to third parties 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 as to when and how to rely on various transfer clauses and their variations. Different transfer restrictions are not only used to address specific problems of cooperation of business partners, but their modifications can also have varying outcomes for the involved parties. Accordingly, standard forms applied to all firms on a one-size-fits-all approach cannot be satisfactory. The choices of large sophisticated actors documented in this study can assist in understanding particular circumstances where different types of transfer restrictions ensure the intended outcomes. Although the study relies on data from the operating agreements of LLCs, the results can be extended to other forms of limited liability organizations, such as closely-held corporations.

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the higher bidder would be the buyer at the price equal to the average of the two prices. Id.at 1415. 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. Id. at 1418. 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.” Id.

APPENDIX

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).