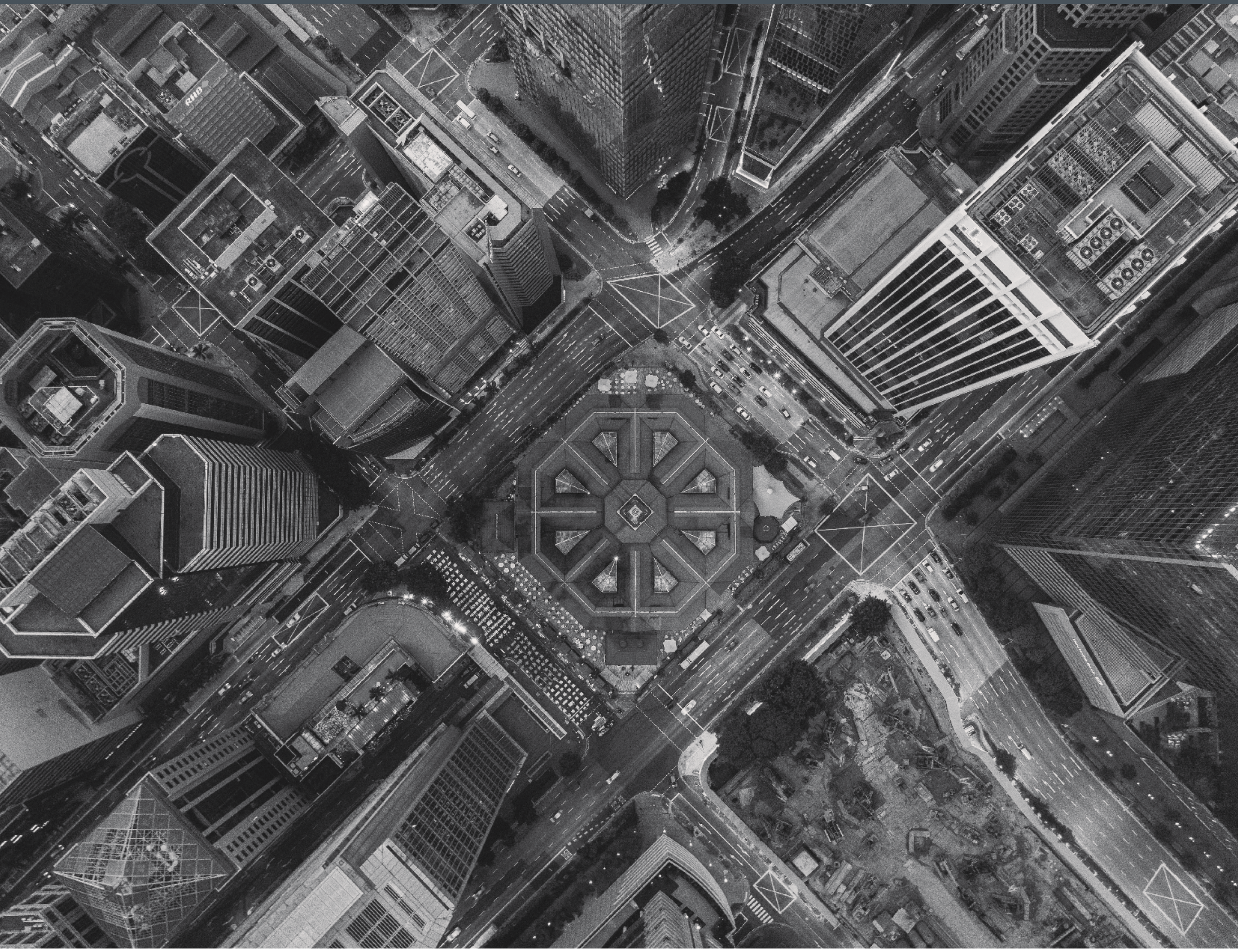

NAVIGATING A SHAREHOLDERS AGREEMENT: DRAG ALONG AND TAG ALONG RIGHTS

In the third of our HFW Insights: Navigating a shareholders agreement series, in which we distil common corporate and transactional issues into bite-sized insight, we explore drag along and tag along rights as contractual mechanisms of investment realisation.

"Drag-along rights and tag-along rights are important forms of investment realisation in a shareholders agreement."

What is a drag-along right?

In the event of a sale of a controlling interest by the shareholder(s) holding a specified majority of shares, a drag-along right enables the selling majority shareholder to procure an exit by forcing the remaining minority shareholders to similarly sell their shares to a *bona fide* third party purchaser on broadly the same terms.

From the perspective of the majority shareholder, a drag-along right has two key advantages.

Firstly, it increases the marketability of the investee business by delivering a target company with no minority interests (purchasers may be unwilling to participate in a joint venture structure with a motley of minority shareholders with differing interests).

Secondly, it potentially secures a higher "premium for control" share valuation by delivering the entire interest in the target company to the prospective purchaser (as opposed to only a partial shareholding).

Important considerations when negotiating drag-along rights

1. Form of consideration

In most cases, drag-along rights may only be invoked by the majority shareholder where the transfer to the third-party purchaser is for cash consideration.

Where the drag provision will apply equally to transfers for non-cash consideration, this may be met with strong resistance from the minority shareholders. This is on the basis that they may potentially be forced to swap their current shareholding for shares in an unknown company in which the exit options are even more limited, e.g. if the governance regime of the new company provides for a general prohibition on share transfers or does not cater for tag along rights.

2. Price

Minority shareholders may, if in a strong negotiating position, insist on a minimum price level in order to avoid being dragged at an undervalue – for instance, if the majority shareholder goes insolvent and has its assets sold on a "fire sale" basis.

Further, if non-cash consideration is to be included, minority shareholders may also want a mechanism in place to verify that the price offered for their shares has been fairly valued and is above the minimum price level.

3. Representations and warranties

Minority shareholders subject to a drag-along right should not, and are typically not expected to, give representations and warranties other than as to capacity and title. This is on the basis that they have no control over the warranty package agreed by the selling majority shareholder in the sale documentation.

What is a tag-along right?

Where a majority shareholder is looking to sell its shares, a tag-along right enables the minority shareholders to exit from the joint venture by obliging the selling majority shareholder to procure that the prospective third-party purchaser extends its offer to include the shares of the minority shareholders on broadly the same terms.

From the perspective of minority shareholders, a tag-along right provides a potentially viable exit route. In the absence of tag-along rights, minority shareholders run the risk of being left behind when the majority shareholder liquidates its investment and consequently being locked in the joint venture with a new and unfamiliar partner.

Further, in delivering a larger controlling stake to the prospective purchaser, such "co-sale rights" may, as above, potentially secure a higher share valuation for minority shareholders (as opposed to a standalone sale of a minority bloc of shares without any control rights).

In the context of share transfers, a tag-along right will often afford minority shareholders with a greater degree of protection as compared with a right of pre-emption, especially in situations where the minority may not have the financial resources to acquire a majority stake.

Important considerations when negotiating tag-along rights

1. Threshold trigger

A common point of negotiation is whether the tag-along right should apply:

- only to a sale of all of the majority shareholder's shares; or
- to any sale of shares by the majority shareholder (with the tag-along right expressed to apply pro rata to the minority shareholders based on their respective shareholding proportions in the joint venture.

The first option may expose minority shareholders to the risk that the majority shareholder could achieve a near complete economic exit by selling a significant majority stake (though not all of its shareholding) without triggering the tag along provisions.

2. Representations and warranties

There is often a debate as to whether the minority shareholders exercising their tag-along right should be bound to give the full suite of representations and warranties similar to the selling majority shareholder.

While it is understandable for minority shareholders to seek to minimise the level of contractual assurances given (on the basis that the sale process is effectively controlled by the majority shareholder), there is a case to be made that the exercise of the tag-along right is within the control of the minority shareholders (unlike the situation under a drag-along right) and, thus, if the minority shareholders are to receive the same price per share on exit, they should bear the same exposure on the representations and warranties.

On this note, warranty and indemnity insurance does go some way towards re-allocating the risk exposure for claims and may provide a certain level of comfort to minority shareholders required to provide the same representations and warranties as the selling majority shareholder.

Key takeaways

Drag-along rights and tag-along rights are important forms of investment realisation in a shareholders agreement.

Drag-along rights favour the majority shareholder while tag-along rights are more beneficial to the minority shareholder.

When negotiating such clauses in the shareholders agreement, the salient points raised above will serve as useful reference points and negotiation tools, which could make a significant difference to a shareholder's return on its investment.

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