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Tags and drags: the ties that bind

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Damon Fisher and Hamed Meshki of Kirkland & Ellis discuss the challenges of shareholder restrictions in portfolio companies

Minority shareholders in private companies are typically restricted from transferring their shares. These restrictions reflect shareholders' desire to maintain equity ownership as among one another. They also restrict the ability of certain key investors, such as management, from de-linking their investment from that of the controlling shareholder and thereby misaligning their respective interests. The contractual transfer rights of private company shareholders are therefore critical to the shareholders' ability to obtain liquidity for their investment. Minority shareholders often have "tag-along" rights and "drag-along" obligations with respect to controlling shareholders. These are the ties that bind shareholders so as to permit (or, depending on one's perspective, obligate) them to act in concert with respect to their exit from the investment. They can ensure that a minority shareholder will not be left behind following a lone exit by a controlling shareholder, and conversely, that a controlling shareholder can deliver to a buyer a company free of minority holdouts.

Minority shareholders are generally restricted from initiating share transfers, but they commonly are given the right to participate or "tag along" in sales of shares by other shareholders, usually the controlling shareholder, who are not similarly restricted. This provides minority shareholders an opportunity to share in controlling premiums that would otherwise be paid only to the controlling shareholder. The threshold question that typically arises is whether the tagging shareholder must sell its shares on the same terms as those on which the controlling shareholder is selling, or whether the tagging shareholder may avoid certain obligations, such as exposure to the buyer in respect of indemnity claims relating to the company and its business. Separately, where fewer than all shareholders participate in the tag-along sale, questions arise as to how to allocate the unelected portion - to the initiating seller or among all participants.

Tag-along mechanics are complicated by the existence of multiple classes of shares disparately held between the controlling shareholder and minority shareholders. Often, tag-along rights apply only with respect to the particular class(es) of shares being sold by the initiating holder. However, where the controlling shareholder and minority shareholders hold different classes of shares, or hold classes of shares in different relative proportions, a need may arise to discuss cross-class tag-along rights. In such cases, pro ration based on the number of shares held by the parties is too simplistic, and consideration must be given to relative equity ownership by value.

Finally, where shareholders hold shares that are entitled to customized distribution priorities and multiple classes of shares may be sold to a single buyer, careful thought should be given to whether the shares, once sold, should be converted in the hands of the buyer to a single class - what the buyer's preferences will be in this regard and what impact, if any, such a conversion (or not requiring such a conversion) might have on the distribution priorities among the other shareholders.

Critical to the controlling shareholder is the ability to cause a sale of the company with as few obstacles as possible. In this regard, the importance of the "drag-along" right is easy to underestimate, particularly where the controlling shareholder controls the board and can effect a sale of the company through its board and shareholder voting position. The drag-along right generally requires that minority shareholders participate in the sale and waive appraisal rights. It also minimizes disclosure requirements precedent to obtaining a shareholder vote with respect to the sale and importantly, it removes the sale decision from the board context, where directors' fiduciary duties may significantly impact their considerations in approving the sale (particularly applicable where the controlling shareholder holds a preferred class of shares and most or all of the sale proceeds are expected to go to the holders of the preferred).

As with the other transfer provisions, the dynamics of the shareholder base may significantly impact the negotiation of drag-along rights and obligations. Common are limitations on the obligations of minority shareholders with respect to indemnification for claims made by the buyer in respect of the business of the company. However, other limitations are sometimes negotiated to address particular desires or concerns of minority shareholders. Consider again the common shareholder in the context of a drag-along sale in which the aggregate sale proceeds are less than the liquidation preference of the preferred stock. A significant minority shareholder who holds common stock might negotiate for certain limitations, including the right to buy out the preferred shareholder in such case. A minority shareholder might also insist that if it be dragged into a transaction, the sale proceeds be paid in cash or marketable securities or at least that any other private securities provide for certain minimum investor rights.

As with tag-along sales, where multiple classes of stock are involved, pro ration must be determined by reference to relative equity ownership, by value. However, with respect to both tag-along sales and drag-along sales, adjustments in purchase price or ultimate proceeds should not follow that same pro ration. Rather, they are properly allocated to the junior class of shares and, in the case of downward adjustments, next to successively senior classes of shares. In other words, these adjustment items (indemnity payment obligations, transaction expenses, earn-out payments, to name a few) should be treated as an adjustment to purchase price, and pro ration should be calculated after giving effect to that adjustment.

Shareholders of private companies must carefully consider a host of issues and scenarios as it relates to the transferability of private company stock. The lack of a liquid market for those securities, the general dearth of detailed information regarding the company and securities laws restrictions make the tool-box of contractual rights and obligations of shareholders with respect to transferability critically important to the prospects of preserving value and ultimately securing liquidity. Tag-along and drag-along provisions are important tools in that tool-box. Their terms can vary widely from one agreement to the next and require not only an understanding of the shareholders' respective interests and priorities, but creativity and experience to craft the solutions best-suited to address those interests and priorities. ■